Quarterly Market Update

"A Bull in a China Shop"

What does a second Trump presidency mean for markets?

December 2024

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Contents

Executive Summary

The December quarter closed off another remarkable year for investment markets. During a year in which elections were a dominant feature across the world, culminating in the US presidential election in November, political considerations were a particular cross wind for market participants. Indeed, President Trump's election for his second term as President, saw markets gain into the vote, as it became increasingly clear that he would be victorious. Of course, the gains were most substantial for US assets, with AI inspired momentum combining with expectations of tax cuts and deregulation as promised by the incoming administration.

December as a month was unusual, as the regular Santa "rally" did not appear, with many markets down after Federal Reserve Chair Jerome Powell gave guidance that interest rate cuts would come at a slower pace than many had hoped. Indeed, the theme of 'higher for longer' interest rates and inflation, something we have been talking about for nearly two years now, finally appears to have been accepted by the market at large.

As we begin 2025, we see an environment of both opportunities and fragilities abound. With President Trump's brash, freewheeling and bullish style, juxtaposed against an array of fragilities, including structural downturn in China, European economic weakness, elevated geopolitical tensions, the threat of tariffs, historically high valuations and market concentration in US markets, and frustratingly persistent inflation; there will be plenty to occupy the minds of investors as the year progresses.

Despite this, the potential for significant returns is meaningful. Trump's push for deregulation has the potential to spur US growth, AI's rise continues unabated, the Chinese government could (and should) forcefully stimulate their economy, in regions where inflation has subsided there is opportunity for meaningful interest rate cuts, and resilient consumer balance sheets provide scope for the current economic cycle to begin a new leg.

Ultimately, we see the investment landscape as a nuanced one, with too much opportunity to be defensive and too many risks to be bold. Much as we have done for the past 12 months, we see the environment as one of carefully targeted engagement with areas of markets where we can find high degrees of conviction, whilst maintaining a tight risk budget in areas that we can't.

In this report, we include a final 'special article' on the threats faced by the Chinese economy, before digging into key areas of focus for the coming months. Our usual Asset Class Snapshot gives you a brief overview of the main investment markets we monitor, before we dive deeper into the economic landscape in our Global Economic review. Finally, we focus on each of our asset classes, in more detail.

Asset class snapshot

Australian equities

Australian shares had a **tough final quarter** in 2024, with a 3.1%[1] drop in December leading to a -0.8% return for the period. Despite Donald Trump's re-election boosting market sentiment, concerns over tariffs on key trading partners like **China and slowing global growth weighed on the market**. The Australian economy remained strong, but inflationary pressures weighed on the RBA's ability to ease monetary conditions, challenging interest rate-sensitive valuations.

Over the year, Australian equities performed well, with the ASX 300 index up 11.4%, surpassing the 30-year average of 9.4%. Mid and large-cap companies had similar returns (11.4%[2]-11.7%[3]), while smaller companies lagged with an 8.4%[4] return. Value stocks underperformed, declining 4.6%[5] in Q4 and gaining only 3.5% for the year, while Growth stocks rose 2.9%[6] in Q4 and 19.5% for the year.

Sector-wise, **Financials ex-REITS led Q4** with a 5.9% gain, while Materials fell 11.8%. For the year, Materials and Energy were the worst performers, down 13.8% and 13.6% respectively. Information Technology excelled, gaining 48.5% over the year, mostly in the first nine months.

International equities

International equities had an **exceptional year** in 2024, gaining 20.2%[7], with a 1.3% increase in the final quarter. The Federal Reserve's guidance on interest rates in December tempered the year's end performance. US markets, **buoyed by President Trump's re-election,** saw AI-linked technology companies drive gains. The Nasdaq rose 6.4% in Q4 and 29.6% for the year, the S&P 500 gained 2.3% in Q4 and 24.5% for the year, while the Dow Jones lagged with 0.5% in Q4 and 12.9% for the year. **Growth stocks outperformed Value globally**, with Growth up 5.9%[8] in Q4 and 28.4% for the year, compared to Value's -2.1%[9] in Q4 and 13.7% for the year.

Sector-wise, Consumer Discretionary led Q4 with a 7.7% gain, driven by Tesla's 54.5% surge. Financials gained 5.8%, while Information Technology and Communication Services rose 5.4% and 6.0%, respectively. Materials performed worst, down 11.2% in Q4 and 3.8% for the year. Healthcare fell 9.4% in Q4 due to pandemic-related cost pressures. Real Estate and Utilities also struggled, down 7.3% and 6.3%, respectively, impacted by rising capital costs.

In developed markets, Europe (-2.9%[10]) and the UK (-0.2%[11]) faced challenges in Q4. Europe struggled with structural issues and the Ukraine/Russia war, while the UK grappled with post-Brexit economic balance. Japan saw strong returns, with a 5.3%[12] gain in Q4 and 20.9% for the year. The Hang Seng in Hong Kong had a remarkable year, up 22.7% in HKD terms, despite a 4.9% decline in Q4. In AUD terms, it returned 35.9%. **Currency impacts were significant**, with US dollar strength adding 10.8% to AUD returns in Q4 and 9.3% for the year.

[1] As measured by S&P ASX 300 index
[2] As measured by S&P ASX 200 index
[3] As measured by S&P ASX 100 index
[4] As measured by S&P ASX Small Ordinaries index
[5] As measured by MSCI Australian Value index
[6] As measured by MSCI Australian Growth index
[7] As measured by MSCI All Country World index (AUD hedged)
[8] As measured by MSCI Index Growth (AUD hedged)
[9] As measured by MSCI Index Value (AUD hedged)
[10] As measured by MSCI Europe (AUD hedged)
[11] As measured by FTSE 100 (AUD hedged)
[12] As measured by MSCI Japan (AUD hedged)

Real estate

Real estate assets faced a **challenging final quarter** in 2024, despite a **relatively constructive year overall**. The mixed economic conditions globally led to negative valuation impacts. **Australian and US assets performed best**, gaining 17.6%[13] and 6.6%[14] respectively for the year, though both saw around 6.5% declines in Q4 due to rising cash rate expectations. Europe's tepid growth resulted in a 10.9% drawdown for the quarter, the worst among monitored regions.

In Southeast Asia, the **struggling Chinese property** market negatively affected Singapore and Hong Kong. Hong Kong real estate fell 10.5% in Q4 and 10.8% for the year, marking over a decade of negative annualised returns. Singapore saw an 8.2% decline for the year.

Australian investors benefited from strong performance in the **domestic A-REIT market, driven by data centres**. Currency effects, particularly AUD weakness, significantly boosted US dollar-based returns by about 10% for both Q4 and the entire year.

Alternatives

Growth

The **December quarter showed mixed results** for Growth Alternatives, with traditional assets rallying while unlisted assets underperformed. **Infrastructure demand softened** due to higher debt costs, but it remains a valuable source of stable cash flows and inflation hedging. Issues in the UK water sector, particularly Thames Water, were notable, with regulatory guidance expected to be appealed.

M&A activity increased from 2023 but remained below 2021/22 levels, with higher interest rates affecting acquisition multiples. Private equity saw a record 110 sponsor-backed bankruptcies, mainly in consumer discretionary, healthcare, and IT sectors. Despite this, the focus remains on valuation multiples, debt costs, and operational capability.

Real estate markets were turbulent, with weak but slightly improved transaction volumes. Institutional investor sentiment was tepid, but cap rate expansion may have peaked, leading to increased deal activity. **Attractive discounts on real estate funds are emerging as some investors seek liquidity.**

Equity and credit markets showed dispersion, with **tightening credit spreads reducing new opportunities.** The evolving market dynamics require continuous reassessment of outlook and portfolio positioning.

Income

Market sentiment remained positive over the final quarter of 2024, with strong credit formation supported by investor demand. M&A activity picked up towards the end of the year but **refinancing of existing deals remains the bulk of activity** in 2024. Looking ahead, we are more positive on credit formation despite having recently witnessed a marginal uptick in credit defaults. Spreads compressed further over the quarter as tighter margins incentivised further refinancing of debt positions and maturity extensions.

Default rates, while marginally higher, are **still below the long-term average**. Outside of an exogenous shock, we believe the private credit markets will continue to remain healthy. The interest rate cuts by the ECB and US Fed have been broadly supportive of this trend. For now, falling interest rate costs are a net positive for corporate earnings and thus accretive to credit quality.

We have observed an increase in lender-on-lender violence (lawsuits between corporate lenders) and liability management exercises. This trend is more prevalent in the US than in Europe, prompting us to remain cautious, particularly given how much yields have fallen. On a more positive note, the restructuring of defaulted companies has generally been efficient, which highlights **the resilience and functionality of the private credit market**.

Asset-backed finance continues to be an **attractive opportunity** within private credit, providing higher relative spreads with high quality collateral. Within this space, we continue to favour more traditional segments of the market such as mortgages, equipment or invoice financing but have remained cautious of the newer structures backed by more esoteric asset types (e.g. art and timberland). While we appreciate the creativity of the financing solutions, we do not believe the collateral has been appropriately tested in a market downturn and thus we remain cautious.

Over the recent quarter, our **research efforts** have focused on **alternative income solutions** such as **royalties and insurance**. It should be noted that these opportunities are assessed on a case-by-case basis. Given a large component of the Income Alternatives portfolio is sensitive to credit markets we have focused on investment opportunities which are less correlated to credit. Within credit we are exploring specific opportunities in asset backed loans and middle market lending.

[13] As measured by S&P ASX 300 A-REIT index

[14] As measured by FTSE EPRA Nareit USA (AUD hedged)

Fixed income

Fixed income markets faced **headwinds** in Q4 2024, with **rising interest rate expectations** in the US and Australia. The US 10-year benchmark rate increased from 3.78% to 4.57%, and Australia's from 3.79% to 4.37%. **Higher rates led to lower returns** for government bonds, as capital values fell. Credit outperformed duration, with higher yields and lower interest rate sensitivity driving better returns.

In Australia, bank bills gained 1.1%[15] in Q4, while Credit performed best over the year, up 5.4%[16]. Globally, US credit markets benefited from strong economic conditions, with global High Yield bonds returning 4.0%[17] in Q4 and 13.1% for the year. **Broader credit markets also performed well**, with returns of 3.9%[18] for the quarter and 7.8% for the year.

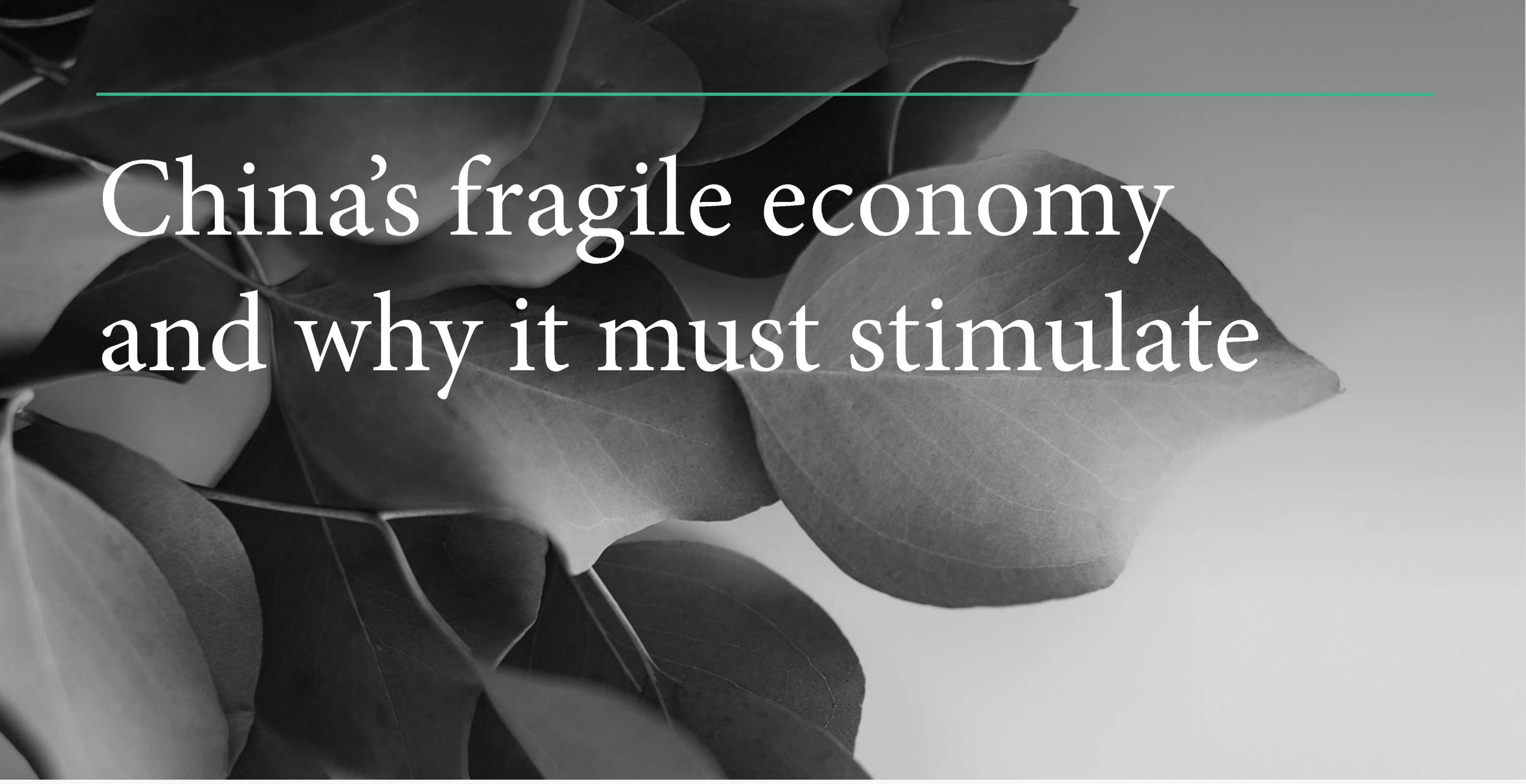
Australian cash rate

In December, the Reserve Bank of Australia (RBA) **kept the official cash rate at 4.35%** for the thirteenth consecutive month, focusing on inflation control amid a fragile economic recovery. Headline inflation eased to 2.8% year-on-year in September, but trimmed mean inflation stayed high at 3.5%. **GDP growth slowed to 0.8% year-on-year, the weakest since the early 1990s outside the pandemic**, due to weak household consumption and tight financial conditions. The **labour market remained resilient** with 4.0% unemployment in December. Wage growth moderated to 3.5% year-on-year, but low productivity growth remains a concern for future monetary easing.

Australian dollar

The Australian dollar (AUD) **fell sharply** in the December quarter, losing 10.8% against the US dollar (USD). After peaking at US$0.69 on 1 October, the AUD dropped below US$0.62 by year-end due to a combination of both global and domestic factors. The strong US economy and the **Federal Reserve's hawkish stance**, including a slower pace of rate cuts and a higher terminal rate, boosted USD demand. The US dollar index hit year-to-date highs, adding pressure on the AUD. **Weak Chinese economic data further weighed** on the AUD, as Australia's export reliance on China remained a significant factor. Increased Chinese stimulus in 2025 could support the AUD. Additionally, potential US tariffs on Chinese goods may impact global trade and Australian exports, further challenging the AUD.

[15] As measured by Bloomberg AusBond Bank Bill (AUD hedged)
[16] As measured by Bloomberg AusBond Credit (0+Y) (AUD hedged)
[17] As measured by Bloomberg Global High Yield (AUD hedged)
[18] As measured by ICE BofA Global Corporate (AUD hedged)



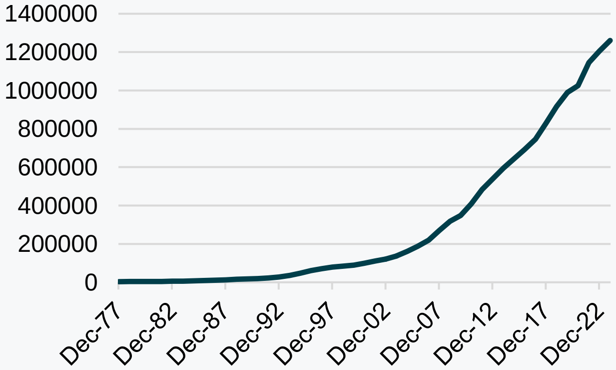
China's fragile economy and why it must stimulate

The customer is always right

China is the epitome of a 21st century success story. Having watched the country suffer under Chairman Mao's 'Great Leap Forward' and subsequent 'Cultural Revolution', in 1978 Deng Xiaoping had consolidated enough power to effectively lead the Chinese Communist Party, immediately setting about implementing economic reform. Under his "Reform and Opening Up" policy, as the package of reforms came to be known, a concerted departure from a centrally planned economy was instigated, and an embrace of a market oriented one, adopted. A system that became known as 'capitalism with Chinese characteristics'.

These reforms were a master stroke, waking a sleeping economic giant. China quickly turned from a country that had made such significant errors in resource allocation, that 10s of millions of people are estimated to have died of starvation or related causes, to a dynamic entrepreneurial economy that was on a steady march towards being the largest in the world.

Figure 1: Nominal GDP, 100 mil CNY – China



Source: FactSet, NBS. Data as of 31 December 2024.

Today, China is Australia's largest trade partner, accounting for 36%[19] of our exports. Not only that, it is the largest by a multiple. Japan, our second largest market, generates only about 40% of the amount of trade we enjoy with China. Indeed, one could easily argue that China's success has been our success. That the value of goods we sell to the country, has more than doubled in just the last 10 years and ultimately gone from $1.1bn AUD[20] in 1988 to $203.2bn AUD in 2023, clearly reflects the degree to which the two countries are aligned. When we think about Australia as the 'lucky country', one that has been relatively sheltered from recession, it is hard to imagine it being possible were it not for a rapidly growing regional 'neighbour' with a veracious hunger for our natural resources.

Concerningly, following years of being the engine for growth within the global economy, it risks becoming a drag. If things continue to progress the way they are, the country is on track to experience it's second year of deflation in a row. This would be the longest occurrence of economy wide price declines since the 1960s. Combine this with a housing slump which has wiped out approximately $19tr of wealth and the threat of another trade war with the incoming Trump administration, and it is clear that China's economic strength and the benefits Australia has accumulated from its growth, can no longer be blindly relied upon.

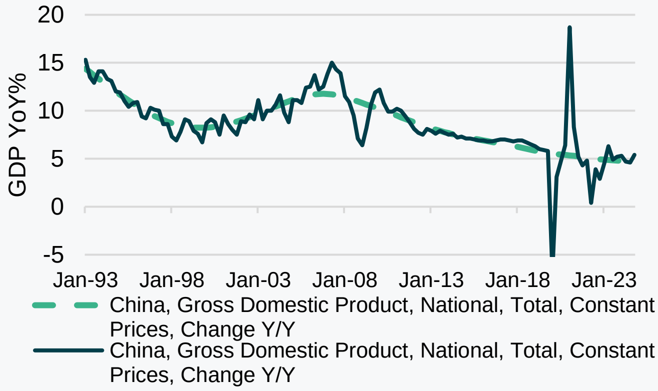
[19] As of December 2023, Australian Bureau of Statistics
[20] Australian dollars

Growing pains

The World Bank defines the 'middle-income trap' as a situation where a middle-income country is unable to transition to high-income status due to a slowdown in growth. This occurs when the factors that initially drove the country's economic growth, such as low-cost labour and capital investment, become less effective, and the country fails to develop new sources of growth, such as innovation, higher productivity, and advanced industries.

When we divert our attention from the level of China's economic output as shown in Figure 1. (China GDP) and instead focus on the country's rate of growth (Figure 2.), it becomes immediately clear that the velocity of China's rise, is on the wane. A country that was comfortably growing at a rate of high single digits, is now seeing 5% as a stretch target.

Figure 2: Chinese GDP



Source: FactSet, NBS. Data as of 31 December 2024.

Considering the key characteristics of the middle-income trap, being; a high degree of income inequality, a lack of innovation, institutional weaknesses and loss of competitive edge, we can quickly see that China has challenges in at least 3 of the four categories.

Income inequality

A large problem for China and one which has been stubbornly persistent. The measure generally used to measure this is called the Gini Coefficient. The Gini coefficient can range from zero to 1, with zero representing perfect equality and 1 indicating maximum inequality. Australia for instance, has the 17th highest level of income inequality among the countries for which data is available, with a Gini coefficient of approximately 0.32. Contrast this with China, which has levels closer to 0.5. Indeed, our research finds that one of the factors contributing to the demographic conundrum currently faced by the country, is a low degree of household formation. Which itself is being driven by the simple fact that many people in their late 20s and early 30s, are holding off starting families due to their inability to afford an apartment, with examples of property valuation multiples of greater than 30 times net income.

Institutional weaknesses

It feels strange to discuss an authoritarian state such as China, as having institutional weaknesses, as it is clear in many ways that China has strong institutions. However, when we contemplate this consideration from an economic or more precisely an 'ease of doing business' point of view, it becomes clear that there are issues. For instance, if we consider 'rule of law' and its importance to economic growth, we need to think about investment risk and the entrepreneurial spirit. If you're going to risk your wealth and or time, you ultimately need to understand the risk you are taking. If that risk is too hard to estimate because you can't rely on being protected by the law, it's not sensible to engage in that activity. When we think about 'rule of law' in our own legal framework, it can be easily described as the structure that attempts to protect 'fairness' in our society and economy. That is entirely different to its purpose in China, which is ultimately, to protect/serve the Chinese Communist Party.

Lack of innovation

With a lack of legal protection alone, it is clear that innovation may be negatively impacted. Without confidence that your risk-taking and hard work will be rewarded (if you're successful), why would you undertake that activity. Whilst we are not claiming that China is no longer innovating, it stands to reason that falling levels of innovation can be explained by the increasingly forceful change in ideology that is being implemented by President Xi, who has explicitly eschewed 'capitalism with Chinese characteristics'. When we consider the sudden crackdowns on industries such as Education and Technology, not only has foreign investment been scared off (something that appears to be lost on Chinese officials), but economic aspiration has substantially dissipated As such, our observation is that a degree of dynamism has left the Chinese economy. Of course, strategic priorities such as Defence, energy production and electric cars, are demonstrating high levels of innovation, albeit not of the organic type of creativeness that tends to drive longer term economic expansion.

Loss of competitive edge

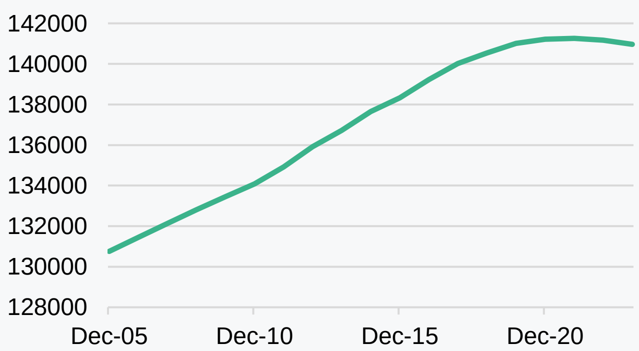
Within China, we see two avenues where a loss of competitive edge is occurring. Whilst inflation is currently at relatively low levels and property prices are significantly lower than they were just 12 months ago, cost of living pressures are mounting. As such, there is pressure on wages. Of course, when you're competing on cost as China has primarily done, wage increases can significantly threaten competitiveness. Additionally, the aforementioned loss of innovation is also a competitive detriment, as more innovative, specialised goods are less likely to compete as strongly on price. Add to this the new Trump administration and their desire to ratchet up tariffs and it is clear that the country is facing into an increasingly challenging environment.

There is a reason why the World Bank has been researching the middle-income trap for the past few decades, and that is because it tends to be the rule, not the exception. That is, the majority of countries that go through extended periods of growth, tend to get stuck part way through their economic development. This status in itself can actually lead to a reversion in economic output and is surely something that Chinese leadership should be concerning themselves with.

Population

We have discussed the demographic challenge that China faces here previously. Population growth is a crucial component of a stable economy, because simply, labour is a crucial input into economic production. Indeed, the combination of labour and capital are the two 'legs' on which an economy stands. Combined they are a powerful force. Any lack of either, and the counterpart becomes less effective.

Figure 3: Chinese Population



Source: FactSet. UNDESA. Data as of 31 December 2024.

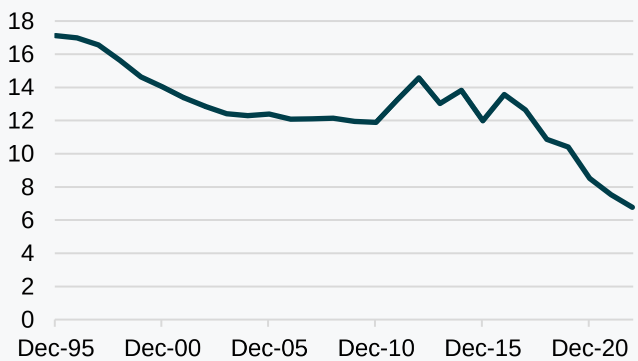
Whilst its implementation was in many ways draconian, it is unclear whether the CCP's 'One Child' policy was beneficial or harmful to Chinese economic development in the first 20 or so years after its initiation. Certainly, it stands to reason that coming out of an environment of severe resource constraint, with mass starvation and national poverty, less 'mouths to feed' is likely to be a good thing. Although there were pockets of resistance, the policy almost certainly reduced population growth. Estimates suggest some 400 million births were prevented as a result.

Unfortunately for China, it appears that the policy generated some detrimental unintended consequences. The two primary effects that we've identified as causing longer term impacts are cultural change and gender imbalance.

Prior to the 'One Child' policy it was culturally normal for Chinese people to aspire to large families. Certainly, this was in part due to a history of agrarian lifestyles, where more children meant more workers. Additionally, there was also a sense of status and indeed a desire to ensure a continuation of family lines.

Unsurprisingly, decades of this policy and communist propaganda and these cultural instincts have receded. Despite 'One Child' being changed to 'two' (2015) and now 'three' (2021), there has been a notable absence of change in birth rates. In fact, the rate continues to trend down.

Figure 4: Birth rate, China per 1,000 people



Source: FactSet, UNDESA. Data as of 31 December 2024.

The other structural problem created by the policy, interacted directly with the cultural preference for boys over girls. In a usual scenario, the balance between boys and girls tends to be approximately 105 boys for every 100 girls. However, market-based the restriction on children, a bias for boys emerged driving selective abortion and sadly, infanticide. As such, by the mid-2000s, China was producing 120 boys for every 100 girls. The problems this drives, are multiple however, there are two that are critical for this discussion; household formation and social cohesion.

From an economic and indeed demographic point of view, the lack of household formation is the most impactful. With a significant number of men having difficulty to find a partner, compounded by heightened 'bride prices' (effectively dowries), families are tending to be started later, if at all. With some men becoming 'bare branches', the Chinese euphemism for a man not having a family. Furthermore, with the culture now societally and financially adapted to just one child, there is a general lack of impetus for young, growing families; the exact solution the current situation requires.

Property

Another problem with China moving away from a market-based economy, is that certain distortions or excesses are not resolved dynamically. It's only once a government bureaucrat determines there's a problem and its in their best interest to resolve it, that constraints are put in place. Of course, with an industry like construction, there are many supporting businesses and supplies, and so its societal and financial benefits are broadly spread. Which of course, leads to a bias towards oversupply. As a result, there has been a massive overbuild of property. From the data we can obtain, it appears that China has the highest supply of property per capita, in the world. Whilst we have already seen China Evergrande Group and Country Garden (two of the country's largest residential builders) effectively placed on life support, and property prices supported by government packages and direct intervention, the situation has still not stabilised. At the time of writing, there are rumours abound that the giant builder China Vanke may need to be taken over by government. According to Bloomberg, China Vanke faces US$4.9Bb in yuan- and dollar-denominated bonds maturing or up for redemption in 2025—the largest annual debt repayment burden of any Chinese developer over the next twelve months.

Figure 5: Chinese property prices

Sources: National sources, BIS Residential Property Price database

Fair weather friends

That Australia has benefited from China's rise is undeniable. What is also true, is that those benefits have not come unencumbered. China has not been shy to use trade as a form of economic coercion, for political or business behaviour that it has not approved of. Additionally, the country's growing self-confidence has seen it rise to be a disruptive force on the geopolitical stage, supporting Russia in Ukraine and enabling an increasingly despotic North Korea to become a nuclear power. So, a degree of economic humbling could potentially be a force for good.

Our work suggests that this is in fact, counterproductive. Having had a seat at the table, and very much eyeing its ascendancy as driven by destiny, the CCP will not slink quietly into the night as its economy drags it down. Given that the party's legitimacy is driven by an implicit contract of 'you give up freedoms and rights and we'll give you economic abundance", means that there is a big risk of discontent within the population. Something that could easily metastasize into a threat of political upheaval and to the existence of the party itself. As such our concern is that should economic measures fail to improve conditions, authorities will resort to driving nationalism as a way of driving unity. Such an environment could easily see something like the ambition to reintegrate Taiwan, move to being a top priority and make conflict far more likely.

For better or worse

As much as China's increasingly geopolitical assertiveness and long-term strategic threat, are concerns we must not ignore, it is our belief that a healthy China is much better than a wounded China. Like the proverbial cornered animal, we see it as more likely that the country would 'lash out' rather than simply turn inward, in an effort to resolve its problems. Additionally, given our geographic proximity and trade relations, we are better served by a healthy and engaged China.

It is true that in many instances, the CCP has operated within the letter of World Trade Organisation rules, rather than the spirit. That is evident in the simple fact that that despite a polarised political landscape in the US, the desire to address China's trade practices is bi-partisanly agreed upon.

As such, it makes sense that Australia and its allies, seek to encourage constructive cooperation and engagement, whilst seeking to irradicate the country's ability to effect economic coercion, by collaborating on responses and acting in concert.

Of greatest importance is that the Chinese government itself, grasp the seriousness of the problem. That the very features that helped drive the country's rise, have in many ways been sacrificed for ideology, should be an obvious line of investigation and something that should be addressed in the medium term. One clear deficiency in the approach being taken so far seems rooted in ideology, ignoring human behavioural considerations – namely confidence. As such, in the short term, it is crucial that fiscal and monetary efforts become more forceful. Just as various monetary authorities have at times of economic stress come out with a commitment to 'do whatever it takes', so too should fiscal and economic authorities in China. Should they be able to inspire the 'animal spirits' in the economy and be able to drive economic confidence, they have a solid chance of turning things around.

Global economic overview a bull in a china shop

Introduction

Following a turbulent 2022, global markets have spent the past two years staging an impressive recovery. During this period, the global economy has demonstrated remarkable resilience, achieving an elusive "goldilocks" soft landing (no recession) scenario. Inflation has retreated from its post-COVID peaks. Most major central banks have begun easing monetary policy in 2024, while global growth has remained in positive territory.

However, cracks have started to emerge beneath the surface. Stretched valuations, particularly among the so-called 'Magnificent Seven' US stocks, have heightened concerns about market concentration risk, while stalled progress on inflation has resulted in central bank policy rates remaining in restrictive territory for longer than initially anticipated. Meanwhile, as Trump prepares to return to the presidency, his agenda of tax cuts, deregulation, tariffs, changes to immigration laws, and his "America First" policy has the potential to inject both opportunities and uncertainties into an already strong US economy operating at or near full capacity.

China's ongoing property crisis, demographic challenges, and weakening domestic consumption highlight its vulnerability, particularly in the face of potential trade conflicts with both Europe and the US. Europe continues to grapple with muted economic growth, and Australia faces a cost-of-living crisis during an election year, compounded by the Reserve Bank of Australia (RBA) being an outlier from its peers by keeping the cash rate at 4.35% for 13 consecutive months. Despite some of these concerns, a silver lining is that a record-low share of countries are expected to experience a recession over the next two years[21].

This article examines the current state of the global economy and considers how Trump's disruptive nature, combined with economic forces may interact with this delicate position in the year ahead.

The bull

On 20 January 2025, Donald Trump will return to the presidency, better prepared this time around with a strong level of political control. The Republican Party's dominance across the presidency, Congress, and a 6-3 conservative majority in the Supreme Court places Trump in a strong position to advance his agenda. While this consolidation of power promises bold moves, it also introduces heightened geopolitical risks for the global economy and investment markets.

Initial market reactions to Trump's policies reflect this duality. Optimism surrounding anticipated tax cuts and deregulation initially buoyed risk assets, with Bitcoin, small-cap stocks, and other 'risk-on' investments rallying immediately after the US election. However, extended valuations and the potential for policy missteps—such as reigniting inflation or escalating trade conflicts—have left markets vulnerable to reversals, similar to what was witnessed in the final weeks of 2024. With Trump's inauguration just around the corner, the question remains: will his administration ultimately strengthen or weaken the current economic environment?

[21] Source: IMF WEO, Apollo Chief Economist

Key policies and approaches

Trump's leadership style—brash, unpredictable, and transactional—is central to his "bull" persona. His policies, often couched in "America First" rhetoric, have the potential to destabilise global dynamics. His key initiatives of tax cuts and deregulation may offer short-term growth benefits, while tariffs and immigration restrictions could exacerbate inflationary pressures and disrupt global supply chains.

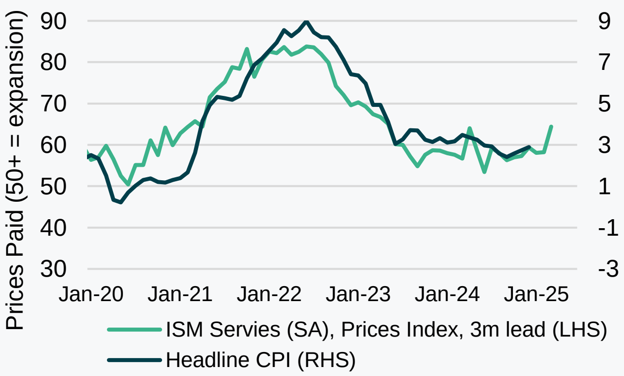
Proposals to extend and expand tax cuts—such as eliminating taxes on tips and overtime, lowering corporate tax rates for domestic manufacturers, and raising the threshold for state and local tax (SALT) exclusions—may buoy corporate earnings and disposable income. However, they risk amplifying fiscal deficits and straining the government's already stretched finances.

Trade policy, a cornerstone of Trump's agenda, represents a significant wildcard. Renewed tariff wars with China, Europe, and other trading partners will almost certainly fragment global supply chains, raise consumer costs, and intensify geopolitical tensions. While there is debate over whether tariffs will be fully implemented or leveraged as negotiating tools, even the mere threat of tariffs is likely to amplify market volatility and weigh on global growth. According to modelling by the Peterson Institute for International Economics, broad-based tariffs—such as a 10% across-the-board increase or a 60% hike targeting China—could shrink US GDP by up to $6.4tr between 2025 and 2028.

Policy sequencing and implications

The sequencing of these policies will be critical. Quick-to-implement tariffs and increased restrictions on immigration would tighten labour markets and accelerate inflation, forcing the US Federal Reserve to adopt a more 'hawkish' stance. Meanwhile, longer-term initiatives, such as tax reform and deregulation, may take years to materialise, creating an uneven economic landscape. This lag between restrictive and stimulative policies risks fuelling inflation, a concern highlighted by the ISM Services Prices Index, which indicates upward price pressures. (Figure 6).

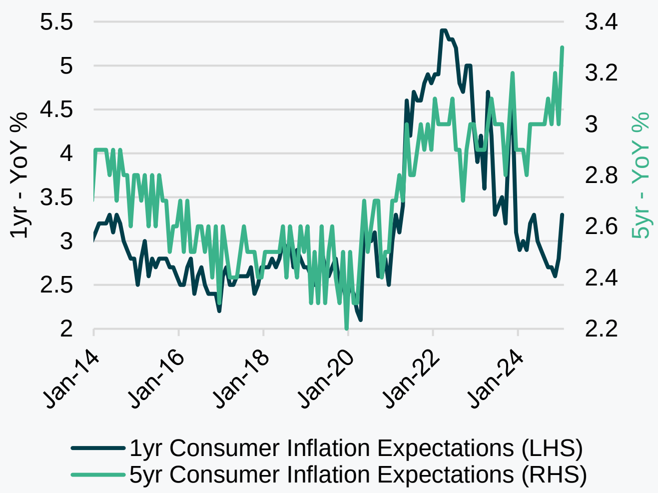
Figure 6: ISM services price paid index leading indicator for CPI



Source: FactSet. Institute of Supply Management, US Bureau of Labor Statistics. Data as of 31 December 2024

This is certainly weighing on consumers' minds, with both the 1-year and 5-year inflation expectations moving higher to close out 2024 (Figure 7).

Figure 7: 1yr and 5yr inflation expectations – Michigan Survey

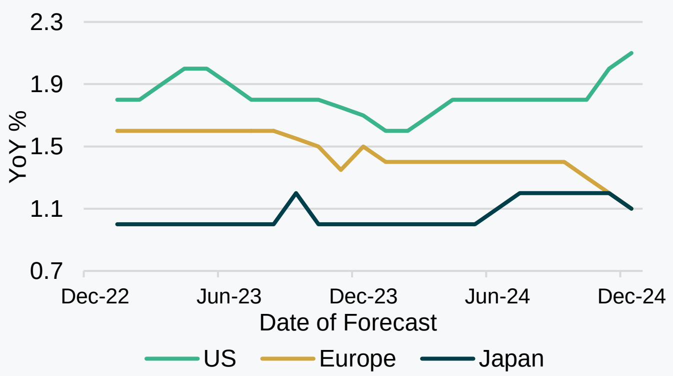


Source: FactSet. University of Michigan - Surveys of Consumers. Data as of 31 December 2024.

The China shop

The global economic landscape in 2024 presents a mix of resilience and vulnerability. While the United States stood out with robust economic performance, other major economies grappled with sluggish growth, structural inefficiencies, and political turmoil. This is illustrated in economists' current forecasts (Figure 8), which show upward revisions for US Real GDP growth but downward trends for Japan, Europe, and other regions. Moreover, key market and economic themes—including elevated valuations in the "Magnificent Seven" US stocks, persistently tight labour markets, the prospect of higher for longer interest rates, and a stronger for longer US dollar—are set to shape investment market performance in the year ahead. An examination of the global economy and investment markets through a regional and thematic lens reveals the risks and opportunities that lie ahead in 2025.

Figure 8: Consensus of 2025 Real GDP growth forecasts



Source: FactSet. Median economist consensus estimate. Data as of 31 December 2024

Regions

United States

Over the last twelve months, the US economy has been the standout global performer. The Atlanta Fed is projecting a robust 3.3% for the final quarter of 2024—well above the Congressional Budget Office's long-term estimate of 2% growth. This strength, however, has come with its challenges. Inflationary pressures, driven by robust wage growth and a tight labour market, have pushed the US Federal Reserve to adopt a more hawkish stance in recent months. This was on display in December, when Fed Chair Jerome Powell and the other FOMC members indicated a more hawkish stance, with only two rate cuts expected in 2025, down from their earlier projections of four.

Asia

China's economy faltered in 2024, with weak consumer spending and a struggling real estate sector dampening future growth prospects. While stimulus measures boosted Chinese equities late in the year, questions persist around the sustainability of this recovery. Rising trade tensions with the US and Europe and structural inefficiencies, including demographic headwinds, further cloud the outlook.

Japan, initially a standout performer, faced shifting dynamics as the Bank of Japan (BoJ) began normalising monetary policy. Higher interest rates and inflation, unusual for Japan, weighed on equity markets, particularly during the short-lived August sell-off.

Europe & UK

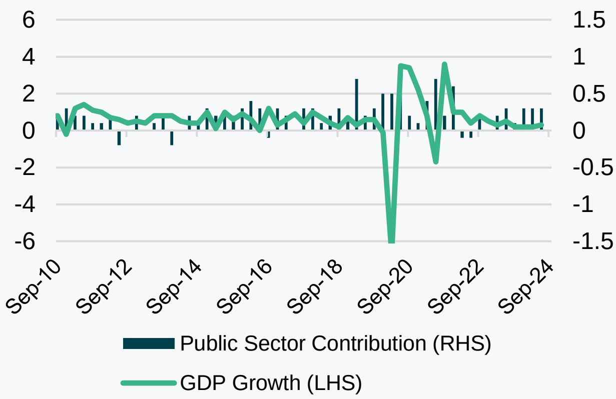
Europe's economic struggles continued in 2024. Despite low unemployment and wage growth exceeding 4%, structural inefficiencies, weak productivity, and demographic challenges hindered progress. Germany's manufacturing sector struggled against Asian competition and subdued demand, while political instability—with governments in Germany and France collapsing due to no-confidence votes—exacerbated uncertainty. Elections in 2025 are likely to add further volatility to these markets.

In the UK, a polarising Labour Party budget stoked inflation fears, prompting speculation that the Bank of England (BoE) may maintain higher interest rates longer than anticipated. Bond market pressures—dubbed a return of the "bond vigilantes"—highlighted concerns about fiscal discipline. The toxic mix of higher yields and a depreciating currency added to the UK's economic woes.

Australia

Australia's economic trajectory remains closely tied to China's fortunes. With China grappling with economic challenges, Australia's export market faces increased pressure. The likelihood of steep US tariffs on Chinese manufacturing worsens this challenge, further straining Australia's outlook. The Australian dollar weakened in Q4, reflecting these external pressures and a soft domestic economy. Growth has been sluggish, with per capita GDP declining for two consecutive years and the public sector accounting for all growth through September 2024 (exhibit 4).

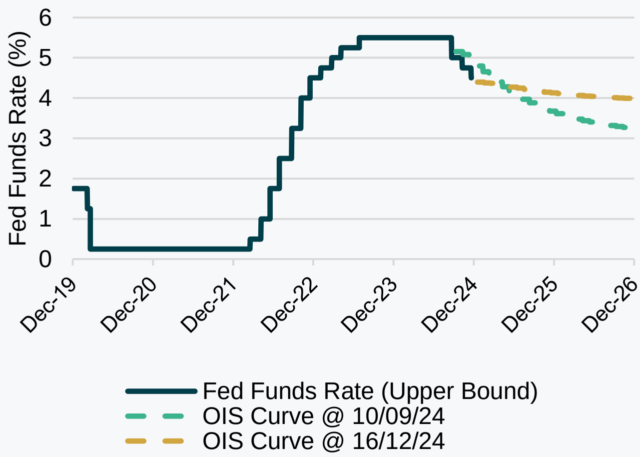
Figure 9: Real GDP: Public sector contribution QoQ %



Source: FactSet. ABS. Data as of 31 December 2024.

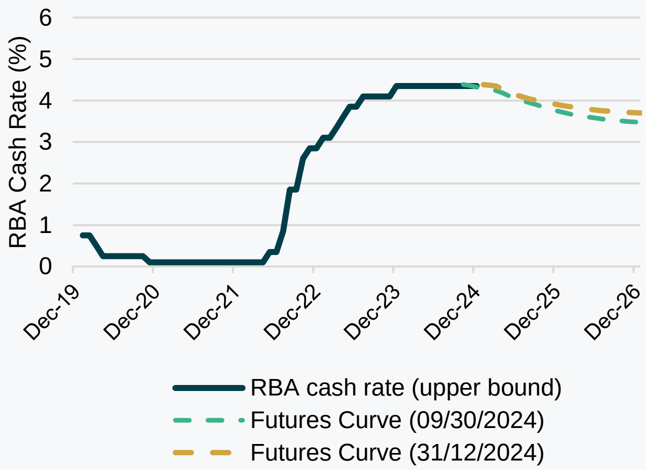
As it currently stands, the Reserve Bank of Australia is now expected to cut rates more aggressively than the Federal Reserve in 2025, placing further pressure on the Australian dollar and adding another layer of complexity as the country heads into an election year (exhibit 5 & 6 – include RBA rates).

Figure 10: Fed funds rate (upper bound) and OIS curve



Source: FactSet. Data as of 31 December 2024.

Figure 11: RBA cash rate and futures curve



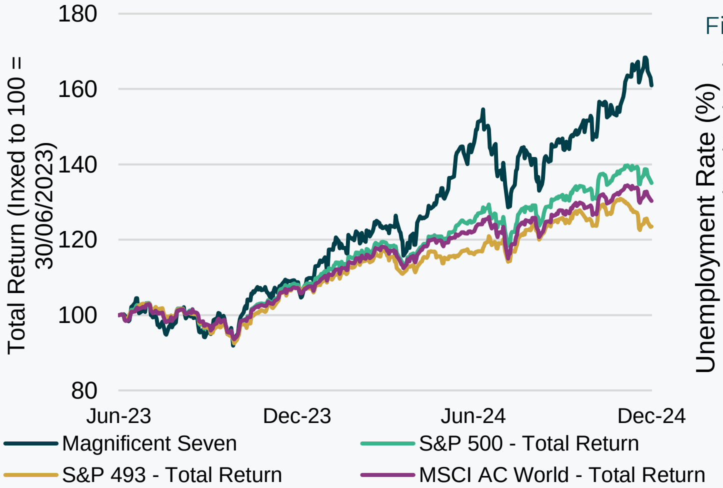
Source: FactSet. Data as of 31 December 2024.

Key economic and market thematics

Lofty valuations

Equity valuations, particularly in the US, remain elevated. The "Magnificent Seven" tech giants that drove much of the market rally over the past two years (Figure 12) are trading at lofty levels. While high valuations don't necessarily predict an imminent sell-off, the heightened expectations for AI-driven companies in 2025 present a significant challenge. This was evident at Nvidia's CES 2025 product launch, where initial excitement from investors saw the stock's share price rise briefly before completely reversing all of those gains and then some, hours later. This sort of good news/bad price behaviour is typical of what you see at the highs in overstretched sector trades.

Figure 12: Magnificent Seven vs the Rest (local currency, total return)



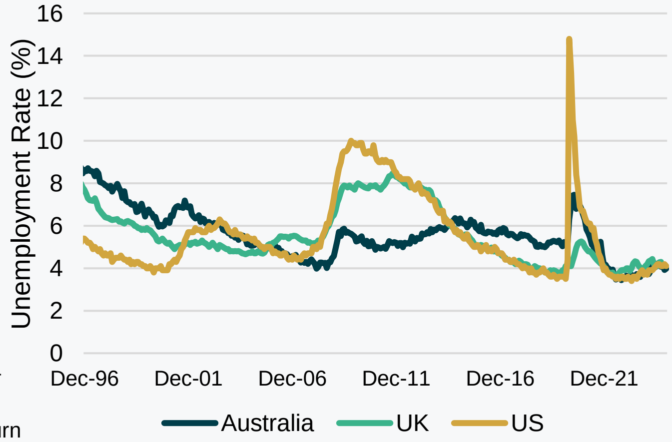
Source: FactSet. Data as of 31 December 2024. Performance is in local currency terms. Past performance does not guarantee future results.

The AI boom, which has driven exceptional earnings growth among these US large cap names, faces increasing scrutiny from investors who want to see tangible returns from the massive capital expenditures these companies have made in recent years, which now exceeds $300 billion annually. Should these companies fail to deliver, equities could face downward pressure.

Labour market dynamics

Globally, tight labour markets have contributed to wage growth and persistent service-sector inflation. In both the US and Australia, unemployment remains near historic lows (Figure 13). While this is positive for economic growth, it complicates central banks' efforts to rein in inflation. Without an easing in labour markets and a reduction in wage price pressures, it is likely that the RBA and Federal Reserve will have to keep interest rates 'higher for longer'.

Figure 13: Unemployment rate, SA (%)



Source: FactSet. Data as of 31 December 2024. ABS, US BLS, Eurostat, UK ONS.

Bond yields

Long-term bond yields have continued their upward march, with US 10-year Treasuries breaching 4.6% towards the end of 2024. This reflects a recalibration of expectations for higher-for-longer US Federal Reserve rates, with the term premium—the additional compensation that bond investors demand for taking on long-term interest rate risk—rising on increased growth and inflation uncertainty. Australia and other developed markets have seen similar trends, as central banks and their respective economies grapple with balancing growth and inflation risks.

What's unusual is the behaviour of long-term rates in this cycle, where rising yields contrast with historical norms. In previous cycles, when the Federal Reserve cut rates, long-term bond yields also declined. However, during this cycle, the Fed has cut the Fed Funds rate by 100bps and the long-end of the yield curve has risen by approximately 100bps. This dynamic could create an atypical equity market cycle, with rising long-end rates potentially muting strong gains in both fixed income and equity markets that generally follow Fed rate cuts and a soft landing (exhibit 14).

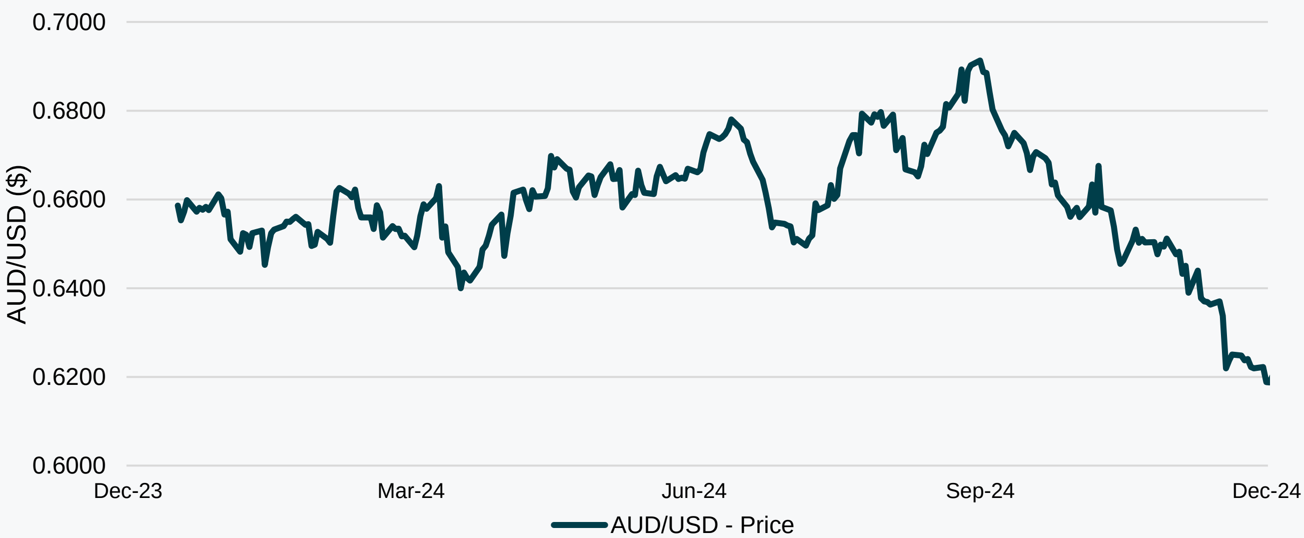
Figure 14: Government benchmarks, 10yr yield

Source: Macrobond. Data as of 31 December 2024.

Stronger-for-longer USD

The US dollar surged in 2024 against most major currencies, including the Australian dollar that depreciated 10.8%[4] in the December quarter alone against the greenback (exhibit 15). While this underscores confidence in the US economy, it poses challenges for emerging markets reliant on dollar-denominated debt and for US multinationals facing currency headwinds on overseas earnings.

Figure 15: AUD/USD exchange rate



Source: FactSet. Data as of 31 December 2024.

A delicate balance

As we look ahead to 2025, markets face a delicate environment. Elevated valuations and the high expectations set during the previous two years' run have tempered investors' enthusiasm. Unlike previous recoveries, a soft landing appears largely priced in, limiting the scope for substantial gains if one is indeed achieved but also reducing the likelihood of a severe downturn absent a recession.

Investors are largely optimistic, and why shouldn't they be? The US economy remains strong, and a healthy labour market and robust consumer spending should continue to provide a solid foundation, with the incoming Trump administration's pro-business policies potentially offering further tailwinds, as long as they don't reignite inflation.

Globally, the picture is more mixed. China, despite its challenges, retains significant fiscal and monetary tools to stabilise its economy. Meaningful policy action from Beijing could shift its potential to be a drag on global growth, to a stabilising force. Similarly, Australia's domestic outlook may improve, with an election year likely to bring fiscal stimulus aimed at addressing cost-of-living pressures, and the prospect of rate cuts from the RBA throughout the year providing further support.

Earnings expectations, particularly in the US, remain elevated, leaving little room for valuation-driven gains unless there is a material change in interest rate expectations. Instead, market performance will likely depend on actual earnings outcomes and could result in leadership rotation across sectors, if last year's winners aren't able to live up to the hype.

Given the numerous risks outlined and the market's apparent pricing-in of predominantly positive outcomes, volatility is expected to continue, potentially leading to more frequent sell-offs if expectations are not met.

Conclusion

As history has shown, markets often surprise investors. The potential for disruption, much like 'a Bull in a China shop', underscores the importance of adopting a measured approach and avoiding knee- jerk reactions to the latest headline or X post. After all, most headlines forewarned of a recession in 2023, and again in 2024, yet no recession materialised. Investors who acted on those predictions would have missed out on the strong absolute returns of the past two years.

Whilst it can be unsettling, volatility is an unavoidable part of investing and are a normal feature of the investment landscape. A well-diversified financial plan, rooted in core investment principles, remains the best defence against market uncertainty. By focusing on fundamentals, avoiding emotional decision-making, and adapting to evolving trends, investors can navigate volatility and position themselves to capitalise on the challenges and opportunities that 2025 will undoubtedly bring.

Australian Equities

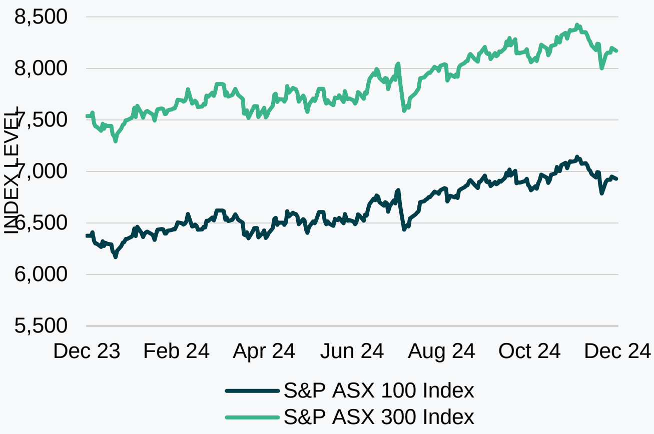
Australian shares experienced a disappointing final quarter of 2024, with a 3.1%[22] retreat in December driving a negative return for the period (-0.8%[23]). Whilst the election of Donald Trump to his second presidential term drove market sentiment higher, concerns relating to the impact of tariffs on our trading partners (primarily China) and softening global growth expectations, weighed on our stock market. Further complicating matters, was an Australian economy that, in aggregate, remains impressively robust, with inflationary pressures receding too slowly for the RBA to begin easing monetary conditions. As markets moved to more fully reflect the "higher for longer" reality of cash rates in Australia, interest rate sensitive valuations became challenged as we came into the end of the year.

Viewed over a 12 month time horizon however, Australian equities performed well, with the ASX 300 index gaining 11.4%; a healthy margin above long term averages (9.4% over the past 30 years). Amongst mid and large-cap companies, performance for the year was uncannily similar with the ASX 100, 200, 300 and All Ordinaries, all delivering returns of between 11.4% and 11.7%. On the other hand, smaller companies continued to lag behind their larger peers, with the ASX Small Ordinaries delivering a relatively smaller 8.4% for the 12 months. From the perspective of investment styles, Value continued its recent trend of underperformance, as its bias towards traditional industries and business models pales against the continued momentum of tech linked sectors. Value's decline (4.6%[24] for the quarter), dragged 12 month performance down to a meagre 3.5%. This contrasts starkly with the experience of Growth which managed a return of 2.9%[25] for the quarter, in spite of headwinds from higher interest rate expectations, rounding out 2024 with an impressive gain of 19.5%[26].

When we look at the market through a sector 'lens', the divergence in performance between best and worst, is meaningful. For the quarter, Financials ex-REITS performed best, gaining 5.9%[27]. In stark contrast, Materials fell 11.8%[28]. Looking across 2024 as a whole, again Materials was the worst performing sector (-13.8%[29]) however, Energy wasn't far behind with a return of -13.6%[30]. At the other end of the pack, Information Technology stormed ahead, gaining 48.5%[31] over the year, most of which came in the first 9 months of the year.

[22] As measured by the S&P/ASX300 – Total Return index
[23] As measured by the S&P/ASX300 – Total Return index
[24] As measured by the MSCI Australia Value - Net Return index
[25] As measured by the MSCI Australia Growth – Net Return index
[26] As measured by the MSCI Australia Growth – Net Return index
[27] As measured by the S&P/ASX 300 Financial ex A-REIT (Sector) - Total Return index
[28] As measured by the S&P/ASX 300 Materials (Sector) - Total Return index
[29] As measured by the S&P/ASX 300 Materials (Sector) - Total Return index
[30] As measured by the S&P/ASX 300 Energy (Sector) - Total Return
[31] As measured by the S&P/ASX 300 Information Technology (Sector) - Total Return index

Figure 16: Australian shares – Large companies



Source: FactSet, Perpetual Private

Australian equities – Manager insights and outlook

Coming into the quarter, we had witnessed broadly weaker earnings outlooks from Australian companies post the August reporting season. Sustained cost pressures and a slowdown in demand were largely to blame for these weaker outlooks. At the same time, bond markets were also pricing 100bps of rate cuts by the RBA over the next 12-month period, something we viewed as overly optimistic given core inflation remains above the central bank's target. Nearly all sectors (aside from Materials and Energy) were trading at or near peak 12-month valuations (on a forward P/E multiple basis). Against this backdrop, coupled with softer global growth expectations, we remained alert to the possibility of a sell-off in the domestic equity market. Despite our concerns, we remained neutral on style – noting that if the RBA did in fact cut rates aggressively (not our base case), this would favour managers with a growth bias, but also noting that in a market that appeared fully priced, it may also favour managers with a more value-oriented approach. From a market capitalisation perspective, our view remained unchanged that stocks outside of the Australian large cap market are, in aggregate, trading at attractive valuations and active managers in this space should be able to capitalise and generate alpha in volatile markets. At the sector level, key overweights included Tech, Healthcare, and Consumer Discretionary stocks, while key underweights were in Financials and Materials.

Throughout the quarter, demonstrating notable strength were CBA (+13%), insurance companies (QBE +16% and IAG +15%), and wrap platform providers (HUB24 +19% and Netwealth +16%). Notably, CBA now represents close to 10% of the S&P/ASX 300 benchmark index, being the largest stock in the index. Despite trading well above consensus analyst share price targets and having to grapple with continued cost pressures and competitive industry dynamics, the banks, and in particular CBA, have proven to be incredibly resilient over the last year. It is for these reasons that our bottom-up fundamental managers have in aggregate maintained an underweight to the Financials sector.

As a result, CBA was the primary detractor for the period. Healthcare and Technology sectors also both surged close to 2% higher for the period and our positions benefited from an overweight allocation to and strong stock selection within these sectors. Of note, we were substantially overweight to Sigma Healthcare, which was up over 80% for the quarter on the back of the proposed merger with Chemist Warehouse that was approved by the ACCC late last year. Similarly, our overweight to Technology One was another key contributor – the stock was up 32% for the quarter having delivered a strong full year result with profit jumping 18% and strong growth from their UK business. Over the period, we also saw considerable weakness from the Materials sector, which was down 12%. Despite seeing relative value in certain names within the materials sector, the combination of geopolitical concerns, and in particular concerns for Chinese growth and the impact that will have on Australian mineral exports, has driven softer commodity prices and weaker forecasts for Australian mining names. BHP represents close to half of this sector, and the stock was down 14% for the period. Our portfolio was underweight materials, contributing positively to our relative performance.

Our outlook from here remains broadly unchanged. We anticipate ongoing volatility, which should favour active managers using a bottom-up, fundamental strategy. Additionally, we maintain a modest preference for small and medium-sized (SMID) companies, believing there are more opportunities to capitalise on inefficiencies in this segment of the market. Against the backdrop of interest rates having stabilised and several rate cuts from other major central banks, we believe our portfolio is well positioned for a rotation away from the safety of large cap stocks (in particular the major banks) and into SMID-sized companies with longer-term growth tailwinds, trading at more attractive valuations. From a sector perspective, we remain notably underweight to Financials and Materials, while overweight to Tech, Healthcare, and Consumer Discretionary sectors.

International Equities

International equities, buoyed by continued US outperformance, rounded out an exceptional year (+20.2%[32]) with a respectable quarter (+1.3%[33]). Indeed, the year would have ended even more strongly, had it not been for Federal Reserve guiding interest rate expectations higher in December. That much of the economic optimism associated with President Trump's election victory had been priced into market valuations in the weeks coming into the vote, meant that US markets lost momentum coming into the end of the year. As has been the case for the past couple of years, AI linked technology companies were the primary drivers of market performance. Indeed it is instructive to examine the outcomes for the three main US share indices, whereby the technology-heavy Nasdaq market delivered 6.4% for the quarter and 29.6% for the year, whilst the more broadly spread S&P delivered 2.3% and 24.5% over the same timeframes.

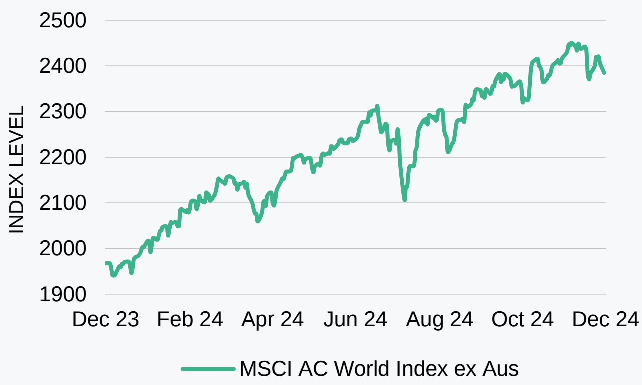
Trailing further behind was the Dow Jones Industrials, with a return for the quarter of just 0.5% and a relatively limp 12.9% for the year. Viewed through another lens, we can see that aside from a period of strong performance around 2022, Value as an investment style continues to meaningfully lag Growth. If we view this on a global basis, Growth outperformed value by 8%[34] (-2.1% vs +5.9%) in the December quarter, and by 14.7%[35] (13.7% vs 28.4%) for the year.

Considered from a sectoral point of view, Consumer Discretionary was the best performer over the quarter gaining 7.7%[36], with Tesla rocketing by 54.5%, off the back of founder Elon Musk's association with the Trump victory. As was the case in our own domestic markets, Financials also enjoyed strong conditions, gaining 5.8% as interest rates remained elevated, and whilst businesses and consumers remained strong. Also enjoying the ongoing technological tailwinds, were Information and Technology, and Communication Services (includes Meta – Facebook's parent company), delivering 5.4%[37] and 6.0%[38] respectively. Tied to concerns around global growth and China's slowing demand for commodities, the Materials sector saw the worst performance for the quarter (-11.2%[39]) and year (-3.8%[40]). Meanwhile, Healthcare continued to suffer from cost pressures born out of the pandemic, receding by 9.4%[41] for the final 3 months of the year. Of course, all sectors were impacted by Jerome Powell's comments in December however, traditional income generating businesses in Real Estate (-7.3%[42]) and Utilities (-6.3%[43]) bore the brunt, as their cost of capital rose and their relative attractiveness waned.

[32] As measured by the MSCI All Country World index in USD terms
[33] As measured by the MSCI All Country World index in USD terms
[34] As measured by the MSCI World Index Value - Net Return index in USD terms
[35] As measured by the MSCI World Index Growth – Net Return index in USD terms
[36] As measured by the MSCI AC World - Consumer Discretionary - Net Return index in USD terms
[37] As measured by the MSCI AC World - Information Technology - Net Return index in USD terms
[38] As measured by the MSCI AC World - Communication Services - Net Return index in USD terms
[39] As measured by the MSCI AC World - Materials - Net Return index in USD terms
[40] As measured by the MSCI AC World - Materials - Net Return index in USD terms
[41] As measured by the MSCI AC World - Health Care - Net Return index in USD terms
[42] As measured by the MSCI AC World / Real Estate -SEC - Net Return index in USD terms
[43] As measured by the MSCI AC World - Utilities - Net Return index in USD terms

Across Developed markets, Europe (-2.9%[44]) and the UK (-0.2%[45]) saw the most challenging conditions in the final three months of 2024. Europe continues to suffer from a structural lack of dynamism whilst facing the Ukraine/Russia war on its doorstep, with the UK is still searching for its economic balance post BREXIT. Similar to the US, Japanese shares delivered robust returns, producing 5.3%[46] gains for the quarter and 20.9%[47] for the year. Meanwhile, the Hang Seng in Hong Kong, enjoyed a remarkable year in spite of a decline of 4.9%[48] in the final 3 months. Indeed, its performance of 22.7% for the year in Hong Kong Dollar (HKD) terms, is enhanced when we consider that HKD significantly appreciated in 2024. In Australian dollar (AUD) terms, it produced an outstanding 35.9% in returns. Indeed, currency impacts were meaningful for global equity investments with US dollar strength adding 10.8% to AUD returns over the quarter and 9.3% over the year.

Figure 17: International shares (local currency terms)



Source: FactSet, Perpetual Private

International equities – Manager insights and outlook

The most notable news during the quarter was the (re)election of Donald Trump as the next President of the USA. With it came much speculation around what his policies and approach could mean for global growth, inflation, the path of interest rates and subsequently equity markets.

Following the shift we saw across markets in Q3 2024, we were optimistic that a ‘regime change’ for equity market leadership was only ‘moments’ away from being realised. Unfortunately, the status quo resumed in Q4 2024, with ‘growth’ and ‘sentiment’ factors / styles leading the way over the period. After a short breather, large and mega cap stock outshone their smaller and mid cap names.

A cursory glance across equity markets is unlikely to clearly reveal the dispersion we are seeing across geographies, sectors, styles and segments, however a deeper dive clearly demonstrates ‘shifting sands’ over rather short horizons. To us, this may be a sign that equity markets lack a clear direction, despite a reasonably robust macroeconomic environment. Following the rally over the last 24 months, valuations are significantly higher than they have been for some time, and as we move through 2025, we expect markets to be laser focused on whether revenue / earnings support current valuations. The first test of this is underway as we prepare this commentary, with earnings season for most US companies taking place through January and February 2025. Given these dynamics, we are focused on the nexus between valuations and revenue/earnings outcomes. As markets extend the rally, we consider corporates' 'margin for error' in terms of revenue and earnings outcomes to narrow markedly. Misses are likely to see the trend of sharp drawdowns on specific stocks continue. We believe that avoiding names where this risk is elevated will be key to delivering strong outcomes.

From a cross-asset perspective, we wouldn’t be surprised if equity markets started paying greater attention to bond markets and yields, at least in the near term. Through the course of H2 2024 markets priced a significant number of rate cuts through 2024, and 2025. As we suggested last quarter, the number and magnitude of aggregate rate cuts this cutting cycle is likely to be less than initially anticipated for several reasons (macroeconomic environment, fiscal policy expectations, etc.). Initially, markets took a rather nonchalant attitude to the risk around the expected path of interest rates, however we expect that to change as the spread between bond yields and earnings yield on equities widens.

We watch with interest as to how markets evolve and react over the course of 2025. Despite a return to previous programming in Q4 2024, we remain optimistic that 2025 will see a broadening of the equity market rally, supporting exposures which have been unloved for some time and offer attractive relative value.

[44] As measured by the MSCI Europe - Net Return index in EUR terms
[45] As measured by the FTSE 100 - Net Return index in GBP terms
[46] As measured by the Nikkei 225 Stock Average - Net Return index in JPY terms
[47] As measured by the Nikkei 225 Stock Average - Net Return index in JPY terms
[48] As measured by the Hang Seng Index - Net Return index in HKD terms

Real Estate

(Listed property securities)

Real estate assets experienced a challenging quarter, to close out what had been a relatively constructive year. The contrasting combination of soft economic conditions in some regions, and resilient conditions in others, generated negative valuation implications for property investments globally.

Australian and US assets enjoyed the most favourable outcomes, gaining a healthy 17.6%[49] and 6.6%[50] respectively over the year. Whilst both countries experienced drawdowns close to 6.5% in the December quarter, this can almost entirely be attributed to rising expectations for future cash rates, with both arguably facing the 'problem' of too much economic strength and thereby not benefiting from more favourable valuation conditions. Across Europe, tepid growth weighed on asset values, and whilst a comparatively easier monetary environment softened the blow, the drawdown for the quarter was still the worst of the regions we monitor giving up 10.9%[51]. Meanwhile a flailing Chinese property market continues to cast a dark shadow over dollar-based Asia, with both Singapore and Hong Kong experiencing a continued failure for demand to meet supply. Having fallen 10.5%[52] in the period, and 10.8% for the year, Hong Kong real estate has generated negative annualised returns for more than 10 years. Singapore, being one step removed, experienced a drawdown of 8.2%[53] for the year, a slight improvement from Hong Kong's -10.8%[54] return.

Fortunately, Australian investors benefited from a significant improvement in market function in our domestic "A-REIT" market, whilst currency effects (primarily AUD weakness) meaningfully altered investment outcomes, with US dollar-based returns being enhanced by close to 10% over both the final quarter of 2024 and the 2024 calendar year.

Figure 18: Australian Real Estate Trusts (A-REITs)

Source: FactSet, Perpetual Private

[49] As measured by the S&P/ASX 300 A-REIT – Total Return index
[50] As measured by the FTSE EPRA Nareit USA Net Return index in USD terms
[51] As measured by the FTSE EPRA Nareit Europe – Net Return index in EUR terms
[52] As measured by the FTSE EPRA Nareit Hong Kong - Net Return index in HKD terms
[53] As measured by the FTSE EPRA Nareit Singapore Net Return index in SGD terms
[54] As measured by the FTSE EPRA Nareit Hong Kong - Net Return index HKD terms

Figure 19: Global Real Estate Trusts (G-REITs)

Real Estate – Manager insights and outlook

As we entered the final quarter of 2024, we pointed to the level of returns generated in the sector as being surprising and unlikely to be repeated despite being in the midst of a broadly positive environment. The volatility that occurred over the quarter may be recognition that markets had moved too far and too fast in pricing the more positive macro environment, which partially unwound, as perceptions of the direction of interest rates changed. While prices declined, we didn't see anything to change our view of the trajectory of the various sectors, nor evidence of individual corporate distress that would suggest that this would become a significant event.

No sector demonstrated this volatility more than self-storage. What would generally be considered a less-cyclical asset, was the worst performer among key sub-sectors of the REIT universe. The prevailing narrative suggests that higher rates leads to less housing transactions and hence less demand for storage. This played out similarly across regions although UK and European companies fared worst. To a lesser extent, this dynamic also showed up with declines in industrial names including Prologis (US) and Segro (Europe/UK) through the presumed impact of rates on retail spending. We do see the industrial sector as slowing after a period of rapid, and unsustainable, rent growth so there may be more reasons for their weakness. Data centres continued to perform well, beneficiaries of the ongoing spending on Artificial Intelligence.

We continue to view the economic environment as positive for REITs but recognise that the sector has had strong price appreciation of a magnitude that is unlikely to be repeated in 2025. REIT prices will remain sensitive to interest rates but for now we do not see this macro-driven shift in pricing as a cause for concern. We continue to monitor our managers as they seek to exploit supply and demand imbalances and manage sector exposures through this period of adjustment. In order to capture some of these medium-term opportunities as the real estate cycle evolves, we expect more emphasis on office, healthcare, seniors living and data centres with less industrial and retail as the new year progresses. For our managers, the focus remains on identifying high-quality companies that are exposed to rising rents and growing demand for their properties.

Alternatives

Growth alternatives

The December quarter presented a mixed picture for growth alternatives, with traditional asset classes continuing their rally while unlisted assets experienced more subdued performance.

Within Infrastructure, we observed softening demand, with deals taking longer to attract buyers and pricing becoming less aggressive due to the higher cost of debt. However, Infrastructure's role in the portfolio remains clear; to provide consistent and stable cash flows, and inflation-hedging properties. We are comfortable with our exposure to regulated assets and grateful for their contribution during the recent inflation spike. We are actively seeking to increase our exposure to volume-linked assets with strong cash flow profiles that can deliver attractive returns in the current environment. The most notable news story through 2024 were the issues facing Thames Water (UK water utility), and the UK water sector more broadly. The UK regulator, Ofwat, passed down its latest regulatory guidance during December 2024, with management teams and asset managers currently working through the outcomes. It is widely expected that a number of water utilities will appeal the regulatory guidance.

Looking back over 2024, there were several notable trends in M&A and deal activity. This included deal volume increasing on 2023 levels, but still not back near 2021/22 levels and acquisition multiples have rebased as higher interest rates began to bite. We hope to see deal activity continue the momentum that began in H2 2024 as we move into 2025.

Also of note, 2024 was a record year for private equity backed companies declaring bankruptcy. According to S&P Global Intelligence, 110 sponsor backed companies filed for bankruptcy during the year, a record high over the last 15 years. Unsurprisingly, most bankruptcies took place in sectors which PE has favoured in recent years, such as consumer discretionary, health care and IT. We remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. On the latter, sponsors appear determined to invest in their internal capability to drive operating performance in investee companies.

Real Estate markets continued to exhibit turbulence, with transaction volumes remaining weak despite a modest pickup. Sentiment among institutional investors towards real estate allocations remains tepid. However, we expect that cap rate expansion has hit its cyclical peak, which led to increased deal activity later in the year, which we hope will continue into 2025. We are particularly focused on opportunities arising from the current market dynamics. As some investors seek liquidity, we are seeing real estate funds being offered at attractive discounts to their prevailing net asset value (NAV). The breadth of our relationships with real estate managers positions us well to understand the underlying pool of assets and underwrite these opportunities at attractive valuations/entry points.

We continue to observe dispersion within equity and credit markets, as well as divergence in the macroeconomic conditions across different economies. While our credit-based exposures have performed well in recent quarters, tightening credit spreads have reduced the attractiveness of new opportunities in this space and we expect to be reducing exposures throughout 2025.

The evolving market dynamics, including shifts in inflation, interest rates, and economic indicators, require us to continuously reassess our outlook and portfolio positioning. During the quarter, we focused on refining our pipeline of potential investments for the coming 6-9 months, actively conducting due diligence on a number of differentiated ideas that have limited correlation with our existing exposures.

Income alternatives

Market sentiment remained positive over the final quarter of 2024, with strong credit formation supported by investor demand. M&A activity picked up towards the end of the year, but the refinancing of existing deals remains the bulk of activity in 2024. Looking ahead, we are more positive on credit formation despite having recently witnessed a marginal uptick in credit defaults. Spreads compressed further over the quarter as tighter margins incentivised further refinancing of debt positions and maturity extensions.

Default rates, while marginally higher, are still below the long-term average. Outside of an exogenous shock, we believe private credit markets will continue to remain healthy. Interest rate cuts by the ECB and US Fed have been broadly supportive of this trend. For now, falling interest rate costs are a net positive for corporate earnings and thus accretive to credit quality.

We have observed an increase in lender-on-lender violence and liability management exercises. Lender-on-lender violence refers to situations where senior creditors, or groups of creditors, alter debt agreements in ways that are disadvantageous to other lenders in the capital structure—typically through priority-shifting amendments or by sidelining certain creditors in restructuring processes. This trend is more prevalent in the US than in Europe, prompting us to remain cautious, particularly given how much yields have fallen. On a more positive note, the restructuring of defaulted companies has generally been efficient, which highlights the resilience and functionality of the private credit market.

Asset-backed finance continues to be an attractive opportunity within private credit, providing higher relative spreads with high quality collateral. Within this space, we continue to favour more traditional segments of the market such as mortgages, equipment or invoice financing but have remained cautious of the newer structures backed by more esoteric asset types (e.g. art and timberland). While we appreciate the creativity of the financing solutions, we do not believe the collateral has been appropriately tested in a market downturn and thus we remain cautious.

Over the recent quarter, our research efforts have focused on alternative income solutions such as royalties and insurance. It should be noted that these opportunities are assessed on a case-by-case basis. Given a large component of the Income Alternatives portfolio is sensitive to credit markets we have focused on investment opportunities which are less correlated to credit. Within credit we are exploring specific opportunities in asset backed loans and middle market lending.

Fixed Income

Fixed income markets faced headwinds throughout the quarter, as interest rate increased through the length of the US and Australian yield curves. As has been the case since central banks increased interest rates in 2022, longer-term inflation expectations has remained frustratingly above target and thus interest rate cuts globally have arrived later than expected and smaller in magnitude. The December quarter typified the broader pattern of the past few years, with periods of lower interest rate expectations, acting as the countertrend against a broader 'higher for longer' thematic. That the US 10-year benchmark rate moved up by nearly 0.79%, from 3.78% to 4.57% over the quarter, does place emphasis on clearly diminishing expectations for more aggressive rate cuts in the near future. Indeed, in Australia we faced similar market conditions with our own 10-year benchmark gaining 0.39%, from 3.79% to 4.37%.

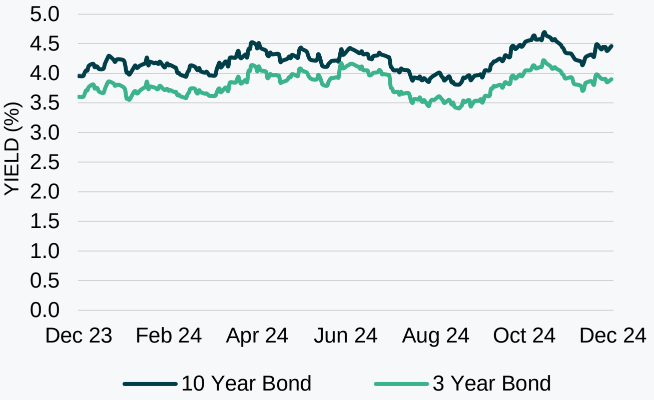
The implication of higher rates being priced in over the year, meant that for government bonds, returns were broadly below the level of income generated, as lower capital values dragged on performance.

The trend of credit outperforming duration continues, as the higher yields commanded for credit risk, combined with lower degrees of interest rate sensitivity, has led to a more healthy level of total return. If we reflect on the Australian debt markets, bank bills did the best over the December quarter, gaining 1.1%[55]. However, over the year, Credit performed best gaining by a solid 5.4%[56] (vs 4.5%[57] for bank bills).

The trend of credit outperformance is not unique to Australia. Given that the US dominates global credit markets and the US economy remains strong, means that credit has been enjoying highly complementary conditions with interest rates being high enough to generate meaningful yields, whilst corporate defaults have remained stable. As such, we have seen a 4.0%[58] return from global High Yield bonds for the three months to December 31st, and 13.1%[59] for 2024. Even the broader credit markets have generated healthy outcomes, with a return of 3.9% for the quarter and 7.8% for the year.

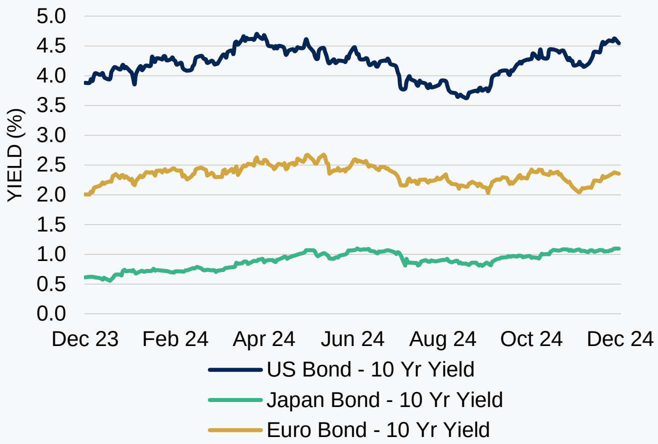
55 As measured by the Bloomberg AusBond Bank Bill index
56 As measured by the Bloomberg AusBond Credit (0+Y) index
57 As measured by the Bloomberg AusBond Bank Bill index
58 As measured by the Bloomberg Global High Yield index (Hedged to AUD)
59 As measured by the Bloomberg Global High Yield index (Hedged to AUD)

Figure 20: Australian government bond yields



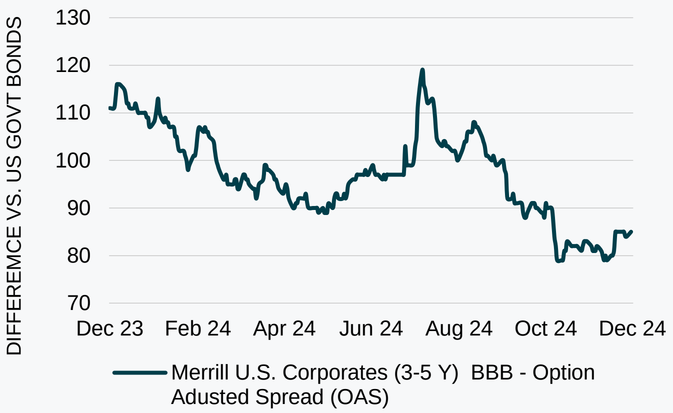
Source: FactSet, Perpetual Private
Note: Bond prices are inversely correlated with bond yields.

Figure 21: Global government bond yields



Source: FactSet, Perpetual Private

Figure 22: Global credit markets



Source: FactSet, Perpetual Private

Fixed income – Manager insights and outlook

In our previous commentary we noted that the US elections had global inflationary implications tied to expectations of US fiscal stimulus and trade tariffs. The advent of a Trump victory is consistent with a bullish inflationary scenario which may limit the ability of central banks to cut interest rates further.

Post US election, market sentiment has shifted from positive to negative with government bond yields rising over the quarter. At the current time of writing, Trump has yet to be inaugurated as the US president while the plans for trade tariffs are in the very early stages of discussion. Given the lack of key details, we believe markets may have overreacted.

Directionally, realised inflation has continued to fall with prints coming in within the targeted 2% to 3% p.a. band. This is consistent across US (2.8% over the year to December) and Australia (2.7% over the year to September) which continues to exhibit a downward trend. In-line with our previous outlook, consumer spending has continued to moderate while corporate defaults have ticked up marginally. Rate cuts implemented over the quarter by the US Fed and ECB are likely to support corporate balance sheets going forward as they flow through to the interest costs. We expect default rates to remain steady over the coming year

Credit spreads are at historical lows and have tightened marginally over the quarter despite the increases in corporate default. Credit issuance over 2024 was strong and continued to be supported by investor demand. The beginning of the rate cutting cycle is a net positive for corporate defaults but provides investors with lower absolute yield particularly for floating rate securities. Barring a substantial deterioration in economic conditions we expect this environment to persist for some time.

From a portfolio perspective, we remain broadly neutral on rates. We think at current yield levels, markets have overreacted to an incoming Trump presidency. However, given the magnitude of moves, we prefer to take a more considered approach and wait for more information before taking a directional view. Specific to credit we continue to retain a short duration bias has benefitted from cash rates remaining higher than previously expected.

Australian Cash Rate

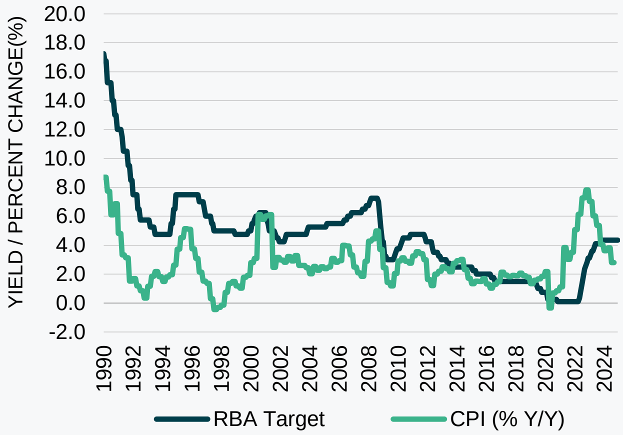
For the thirteenth consecutive month, the Reserve Bank of Australia (RBA) maintained the official cash rate at 4.35% in December, in line with market expectations. This decision reflects the RBA's continued focus on addressing inflationary pressures while managing a fragile economic recovery. Headline inflation eased to 2.8% year-on-year in September, largely due to temporary government subsidy effects, though trimmed mean inflation remained elevated at 3.5%[60]. The RBA has reiterated that inflation, while declining, remains above its 2-3% target range, with core measures unlikely to reach the midpoint until 2026.

Economic indicators during the quarter presented a mixed outlook. GDP growth slowed to just 0.8% year-on-year—the weakest pace since the early 1990s outside the pandemic period—hampered by weak household consumption and restrictive financial conditions. However, the labour market has remained resilient, with unemployment at 4.0% in December, only marginally higher than the post-COVID low of 3.4%. Wage price growth has continued to moderate, reaching 3.5% year-on-year, its slowest pace since 2022. Nonetheless, persistently low productivity growth remains a concern, potentially constraining the degree to which monetary policy can ease in the future.

Australian cash rate – outlook

Looking ahead, the RBA appears cautious as it assesses the timing for rate cuts. While markets are pricing in a >50% chance of a 25-basis-point cut at the February 2025 meeting, May seems a more likely starting point for monetary easing, given the need for greater clarity on inflation trends and future economic conditions.

Figure 23: Long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

Underlying inflation remains above the target range, indicating that inflationary momentum persists despite significant declines in headline figures. The RBA will closely monitor consumption trends, wage growth, and productivity as it evaluates when to cut policy rates. Risks around household spending recovery and geopolitical uncertainties add to the complexity of the outlook.

Globally, central banks have started cautiously easing policy, reflecting improved confidence in inflation moderation. The RBA is expected to adopt a similarly gradual approach, aiming to bring the cash rate near the estimated neutral level of 3.60% by late 2025. The Board remains committed to achieving price stability and full employment while staying adaptable to evolving domestic and international risks.

[60] Australian Bureau of Statistics

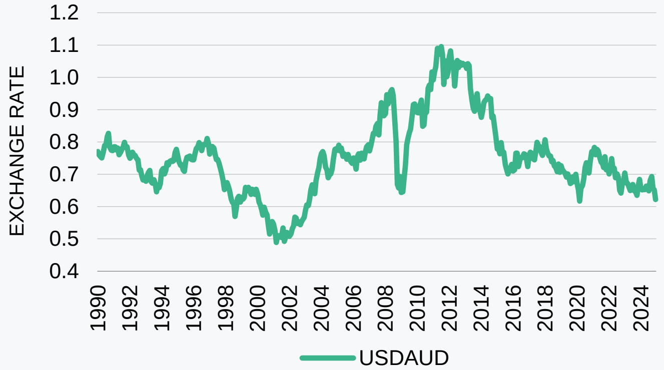
Australian Dollar

The Australian dollar (AUD) depreciated sharply during the December quarter, falling against most major currencies and losing 10.8% against the surging US dollar (USD). After reaching a high of US$0.69 on 1 October, the AUD declined steadily, breaking below US$0.62 by year-end. This marked a sharp reversal of earlier gains and was driven by both global and domestic factors.

The strength of the US economy and the Federal Reserve's hawkish stance were key contributors. At its December meeting, the FOMC signalled a slower pace of rate cuts in 2025 and a higher terminal rate, significantly boosting demand for the USD. This pushed the DXY index—a measure of the US dollar's value against a basket of major currencies—to year-to-date highs, adding further pressure on the AUD.

Weakness in China's economy exacerbated the decline. Earlier optimism surrounding Q3 stimulus measures dissipated as subsequent economic data disappointed. Given Australia's reliance on exports to China, muted Chinese growth has been a significant drag on the AUD.

Figure 24: Australian dollar US dollar (daily) long term



Source: FactSet, Perpetual Private.

A meaningful increase in Chinese stimulus will likely be necessary in 2025 to support Chinese domestic consumption and stabilise their housing market, which could provide a tailwind for the AUD.

Adding to the uncertainty, the incoming US administration's potential imposition of tariffs on Chinese goods may weigh on global trade, indirectly impacting Australian exports and further challenging the AUD.

Australian dollar – outlook

The AUD is expected to face continued pressure as we enter 2025. A strong USD, supported by higher yields, robust economic growth, and a more hawkish Fed, will likely cap any near-term recovery.

Domestically, the RBA's measured tone reflects concerns over weak growth and low productivity, limiting the potential for monetary policy to support the currency. While the AUD's long-term undervaluation on a purchasing power parity basis may eventually bolster its value, this is unlikely to influence the currency in the short term.

China remains a pivotal factor for the AUD's performance. Without significant economic stimulus to boost consumption and the struggling housing market, Australian exports will likely continue to face headwinds.

However, the extreme bearish sentiment surrounding the AUD could provide upside potential. Even modest positive surprises—such as stronger Chinese stimulus or stronger than expected global growth—may trigger a rally. The combination of global headwinds, geopolitical uncertainties, and soft domestic conditions suggests a volatile period ahead for the AUD as we enter 2025.

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Andrew provides investment research, portfolio construction and bespoke investment advice for Perpetual Private's clients.

Andrew works closely with advisers by providing specialist investment knowledge on Perpetual's investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally.

Having spent 15 years in London, Andrew returned to Melbourne with a wealth of international experience to benefit Perpetual's clients and partners. Having started his career working on private equity transactions and stock market listings, he then spent time working on equity trading desks, before moving into investment management. In his role as a Portfolio Manager for Barclays Investment Solutions, Andrew managed money across multiple asset-classes on behalf of various client groups, before focusing on the charity and not-for-profit segment. With responsibility for as much as £3bn in assets, he developed a strong reputation for delivering robust investment performance linked to his comprehensive understanding of global investment markets.

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Hugo is an Investment Specialist at Perpetual Private, where he joined the Investment Research Team in October 2023. He supports the Head of Managed Accounts and Perpetual Private Investment Directors by developing and maintaining investment content and collateral. He also helps communicate Perpetual Private's investment offerings to advisors and intermediary sales teams, representing the Multi-Manager and Direct Equities teams.

Before joining Perpetual, Hugo gained valuable international experience working as a Research Analyst for a wealth management firm in Vancouver, Canada. During his four years there, he focused on strategic and tactical asset allocation for high-net-worth clients across diverse asset classes and client profiles. Prior to his time in Canada, he held roles in Sydney at BT Financial Group as a Customer Relations Consultant and TP ICAP as a Trainee Broker.

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