Atchison

Tactical Asset Allocation Outlook

Q4 2024

Identifying Opportunity™

Tactical Asset Allocation

Tactical asset allocation (TAA) is an investment style in which three primary asset classes (shares, bonds, and cash) are actively balanced and adjusted based on market performance to meet stated risk tolerance and investment objectives. The focus is on asset classes rather than specific assets themselves. The strategy blends and augments passive buy-and-hold methods with medium term views on market dislocations and valuation opportunities.

This report should be read in conjunction with our most recent Investment Outlook, incorporating updated capital market assumptions (CMA) which project the returns of asset classes over a ten-year horizon. These serve as key inputs into our strategic asset allocation (SAA) model and can also be termed as ***neutral*** asset allocation positions.

Refer to Table 1 for Summary TAA positions – Q4 2024. The recommendations shown in the summary are Atchison's conviction away from an SAA, therefore should not be interpreted as a recommended percentage change.

Key Take-outs:

- **Australian** market trading at record highs, despite interest rates remaining stubbornly high. Chinese stimulus has bolstered the materials sector, whilst there has been profit taking out of major Australian banks, given their strong performance in the past 12-month performance.
- **US** markets pricing in 2 anticipated rate cuts in 2024. Mag7 earnings moderate but continue to grow at above-average rates. Valuations appear elevated compared to historical levels, and are supported by strong fundamentals, including robust earnings growth expectations into 2025.
- **China** stimulus package including rate cuts and, an 800-billion-yuan ($114 billion) facility to support stock purchases, and discounting home loan deposits caused the CSI300 to lift 23% over 5 days at the end of September 2024.
- **Gold** has recently reached all-time highs, driven by a weaker US dollar, ongoing central bank purchases, renewed interest from ETF buyers, rising fiscal deficits, and global money creation.
- Run-up to the **US Presidential election** on 5 November will impact markets.

Summary of our Q4 2024 TAA:

1. Marginal underweight to Australian Equities - currently trading at record highs end of Q3 2024.

2. Overweight to international equities – maintain neutral exposure to Growth and a modest uptick in Value, as a broadening of earnings has already commenced whilst interest rates moderate downward (particularly in the US). Potential for pockets of value to be noted in Emerging Markets, and particularly China, post stimulus.

3. Reduce alternative exposure – current sleeve is defensive in nature, performing its given function. However, there are opportunities to increase exposure to growth assets over the next 12 to 18 months.

4. Modest underweight to real assets – REITs, listed infrastructure assets.

5. Duration neutral – underweight Australia, whilst keeping a close eye on Japan, United States, and China.

6. Maintain overweight to floating rate notes – overweight investment grade credit and high yield, being selective in commercial mortgage-backed securities (CMBS).

7. Maintain underweight Cash.

Australian Shares:

The domestic economy is trading near record highs, with a shift from banking to the previously underperforming materials sector, spurred by China's recent stimulus measures. To stimulate sluggish economic growth and prevent the collapse of heavily indebted property developers, China's central bank has lowered interest rates - its most significant intervention since the pandemic. Australia's GDP growth for the September quarter has been muted, reflecting the lagging impact of last year's interest rate hikes. Whilst there were no interest rate hikes for the quarter, consumer confidence, services PMI and manufacturing PMI modestly retreated. Contrastingly, increased migration may help ease labour market tightness by expanding the available workforce. However, as more people enter the labour force, this can result in a gradual increase in the unemployment rate, moving it toward its natural or equilibrium level.

International Shares:

United States:

In the US, we expect a soft landing supported by strong consumer and corporate finance, decreasing price pressures, and easing financial conditions. Closing off Q3 2024, the US Federal Reserve reduced the benchmark federal funds rate by half a percentage point to a range of 4.75 per cent to 5 per cent, citing progress on inflation and the balance of risks. Core inflation pressures are easing, and US markets are anticipating an additional 2 rate cuts in 2024. Mag7 earnings have moderated but continue to grow at above-average rates when compared to the remaining 493 companies on the S&P500. Mag7 valuations appear elevated compared to historical levels, but are supported by strong fundamentals, including robust earnings growth expectations into 2025.

United Kingdom & Europe:

The United Kingdom is expected to experience modest growth, supported by consumer spending and business investment. However, challenges such as global trade issues, energy supply constraints, and labour market limitations are likely to weigh on overall economic performance. Inflation may show signs of easing, but cost-of-living concerns persist. Ongoing issues in the public sector, such as healthcare and education funding are expected to impact overall economic sentiment and government policy.

The Eurozone is expected to see moderate growth of around 1-2%, driven by a recovering global economy and increased consumer confidence. Germany may experience a rebound with growth close to 1.5%, fuelled by a revival in manufacturing and exports. France is projected to maintain a steady growth rate of about 1.5%, supported by strong domestic consumption and investments. Italy is expected to grow around 0.5-1% due to ongoing structural issues and high public debt. Portugal is likely to grow at a robust pace of 2%, benefiting from tourism. Spain may lead the region with growth around 2%, driven by strong consumer spending and employment gains. Overall, inflation is anticipated to stabilise across the region, with most countries hovering around a growth rate of 1-2%, as central banks navigate the balance between growth and price stability and tackling inflation.

China:

To round out Q3 2024, China's stimulus efforts have been comprehensive. The stimulus package included rate cuts and, crucially for markets, an 800-billion-yuan ($114 billion) facility to support stock purchases, highlights Beijing's renewed urgency to address deflation and a troubled property market in the world's second-largest economy. China faces significant structural headwinds to growth yet continues to achieve economic expansion ahead of developed economies, though at a much slower rate than in the past. The country has set a GDP growth target of 5 per cent for 2024, but many economists have downgraded their forecasts to around 4.5 per cent due to recent disappointing data. The housing sector remains the primary area of weakness, now contracting and negatively affecting consumer sentiment as house prices fall. However, infrastructure investment remains robust, providing some support to the economy. China's export sector is also expanding, though its sustainability is uncertain due to slowdowns in Western economies and geopolitical concerns around trade imbalances. It remains unclear whether China will continue with domestic stimulus or be content with a modest approach to growth in the coming 12 months.

Emerging Markets ex China:

India's economic outlook for 2025 remains positive, despite global challenges. We anticipate GDP growth to be around 6.5% for the fiscal year 2024-25, driven by increased private consumption, ongoing structural reforms, increased exports, along with improved output in sectors including manufacturing, technology, and services.

Mexico has lost momentum in recent quarters, projecting annual growth of 1.5% into 2025. However, low unemployment, easing inflation, and supportive fiscal policy will help sustain domestic demand, along with a strong US economy, and the benefit of near shoring. While increased protectionism under a Trump presidency might negatively impact trade and investment.

Duration:

We advocate for an active and flexible investment strategy that can adapt to various economic conditions, aiming for strong risk-adjusted returns and consistent income. We believe in limiting exposure to ultra-long maturity bonds as inflation remains above target. Despite recent market rallies, risks to the economy may be underestimated, yet fixed income markets maintain attractive opportunities. We note that previous rising U.S. Treasury yields did not hinder equity gains, suggesting a muddied bond-equity correlation. In Australia, RBA's hawkish stance and ongoing inflation concerns complicate the landscape. Duration exposure should focus on diversification rather than bond type, as we anticipate the Fed to continue its approach of further rate cuts in Q4 2024. Given the current market conditions, we prefer an underweight duration position due to rates volatility and the potential for negative carry.

Floating Rate:

The floating rate market is expected to remain attractive, particularly due to its resilience in high-interest-rate environments. With central banks likely maintaining elevated rates through much of 2024, floating-rate instruments like bank loans and floating-rate notes (FRNs) offer potential benefits by adjusting their interest payments in line with prevailing rates. This makes them an appealing option for investors looking to mitigate interest rate risk while benefiting from rising yields. Leveraged loans and collateralized loan obligations (CLOs) are projected to see continued demand, as they offer both higher yields and protection against fluctuating rates. However, market risks persist, particularly regarding refinancing challenges as debt matures in 2025. Heightened rates may increase default risks for speculative-grade loans and bonds, especially if global liquidity tightens. As refinancing needs grow, credit conditions could remain strained, adding pressure to the floating-rate loan market. Despite these risks, the overall outlook remains positive, particularly for instruments like Treasury floating-rate notes and investment-grade FRNs, which offer better credit quality and flexibility in this environment.

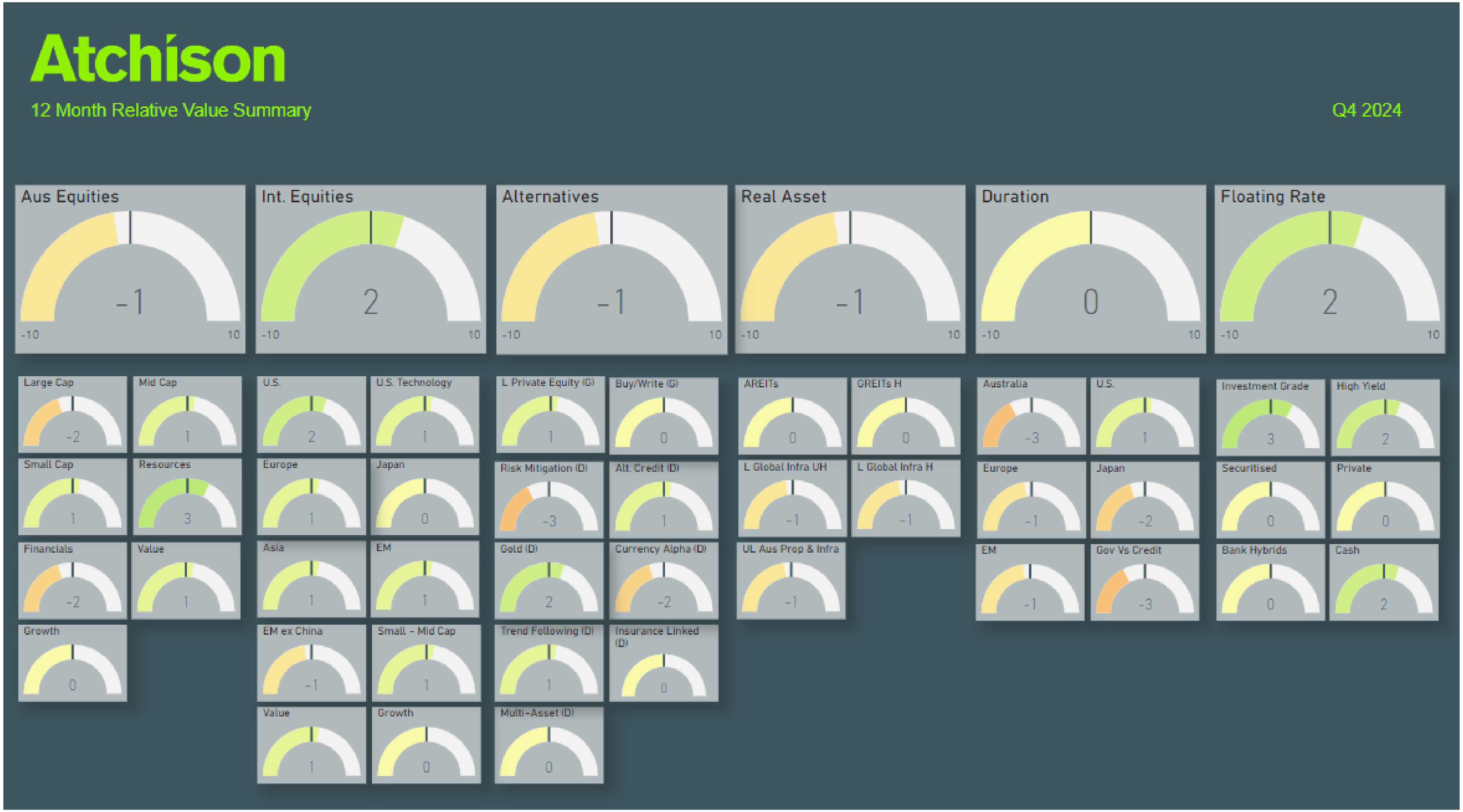
Real Assets:

Optimism is growing as global interest rates are anticipated to ease in 2025, offering relief to property owners and investors – this is reflected with AREITs and GREITs being two of the strongest equity sectors year to date. However, challenges like refinancing risks, reduced savings, increased cost of living, and shifts in space usage due to hybrid work remain prominent. In the infrastructure sector, growth is projected to be driven by significant investments in clean energy, transportation, and digital infrastructure. Major projects such as offshore wind farms and high-speed rail initiatives are expected to boost infrastructure output, particularly in energy-related sub-sectors. Global infrastructure spending will remain robust, with some regions facing investment gaps to meet long-term goals, such as achieving universal access to electricity and water.

Alternatives:

This sleeve has performed as expected, providing pops of alpha and uncorrelated returns relative to common asset classes including Equities and Fixed Income. The sleeve is predominantly defensive in nature, but given the current market environment we do see opportunities to adjust this sleeve and gain greater exposure to more growth like alternative strategies. Areas of interest / potential change include, listed private equity, gold, buy/write, trend following, insurance linked, currency alpha.

Table 1: Summary TAA Positions – Q4 2024



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