MarketSay"

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What You Need to Know - January

Month of January: An eventful start to 2025 saw the inauguration of U.S. President Trump and a flurry of executive orders, a bond market sell-off that saw yields spike to 2023 highs, and challenges to the dominance of U.S. artificial intelligence (AI). Despite a choppy start, equities rose in January, and bonds had positive returns.

Policy Watch: The Fed has remained on hold since November, after becoming more cautious on the progress of inflation and seeing continued strength in the labour market. They continue to flag renewed patience. A trade war has the potential to reignite inflation in the short-term, which the Fed is likely to look through, however the negative impact to growth could see them cutting later in the year. The RBA has pivoted in the opposite direction, taking a more dovish tone and look set to cut in February.

Inflation Watch: In Australia, progress on inflation has gained some steam with the last quarterly number showing more recent price increases running at a rate within the target band. Services inflation remains sticky both domestically and in the US.

Risk Budget: Equity market volatility (as measured by the VIX) peaked around 20 around the US election before moderating. We expect short-term spikes in equity volatility to continue while trade policy remains uncertain and headlines around AI look set to continue.

Our Portfolio: We continued to benefit from a weaker AUD in January, while our position in gold and in alternative credit strategies that benefit from both high running yields and an increase in defaults. Despite a rise in equities across the month, our portfolios largely kept pace with benchmarks during the month.

Outlook: Mega cap earnings have been solid, but outlook commentary has been mixed. We continue to believe that US small-cap stocks have room to play "catch-up" as a potential rotation out of technology stocks and into domestically focused cyclicals could play out. As interest rate cuts have looked more likely in Australia, small-cap stocks have started to rally; we also expect this to continue. Interest rates in the US are likely to remain on hold as the Fed stresses patience in the face of a solid labour market. The repricing of this pause in the bond market, allowing investors to add some duration at elevated yields once more.

How to Position: We have started to fade the rally in the US Dollar as both US economic exceptionalism may have peaked. We switched a portion of our global equity exposure to currency hedged; we also switched our U.S. Treasury position to hedged as well. While picking the bottom for the AUD is fraught with danger, at 61-62 US cents, we believe it is towards the lower end of its trading range. We advocate clients to add exposure to US small caps or equal-weighted passive strategies as the potential for a rotation out of mega cap persists.

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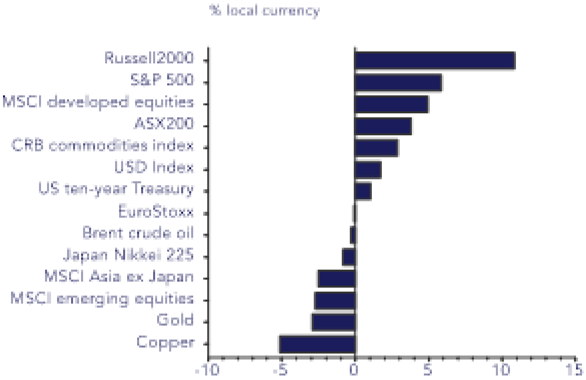
Markets in January

An eventful start to 2025 saw the inauguration of U.S. President Trump and a flurry of executive orders, a bond market sell-off which saw yields spike to 2023 highs, and challenges to the dominance of U.S. artificial intelligence (AI). Despite a choppy start, equities rose in January and bonds had positive returns.

Chart 1: January Asset Class Performance



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

After significant relative underperformance last year compared to the US, investors rotated towards relatively cheaper European markets (6.1%) as views on U.S. exceptionalism were questioned.

The S&P500 rose 2.8% (USD terms), Japanese equities by 0.1% and the rest of Asia-ex Japan by 0.9%. Even though the U.S. posted a positive return, the news on AI competition from China's DeepSeek hit the technology sector, which fell 2.9%.

The U.S. earnings season was largely overshadowed by other events. However, by month-end, just under half of companies (by market cap) had reported earnings, with y/y earnings growth tracking at 12.7%.

Chart 2: Selected Equity Markets Relative Performance (0 = 1 Jan 2024)

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

In January 2025, global equity markets saw varied sector performance. Communication Services led with an 8.7% gain, followed by Financials (+6.5%) and Health Care (+6.3%). Materials (+5.1%), Industrials (+4.6%), and Consumer Discretionary (+4.6%) also posted strong returns. Energy (+2.5%), Utilities (+2.3%), and Consumer Staples (+1.8%) delivered more modest gains, while Equity REITs lagged slightly (+1.5%). The Information Technology sector was the only one to decline, down 1.5%, as investors rotated away from tech-heavy positions.

The monthly moves in bond markets masked a volatile month, Australian government bond yields rose over the month by 6 bps to 4.43%. The U.S. 10-year Treasury yield fell by 2 bps to 4.55 bps.

Bonds sold off heavily in January and the U.S. 10-year yield spiked to 4.79%, their highest levels since October 2023, with investors wary of a re-emergence of inflation as well as a lack of budget repair under the new US administration.

Gold prices continue to march higher, reaching USD 2,812 by month-end, rising on geopolitical uncertainty, the potential for the re-emergence of inflation, strong demand from India and central banks. Brent crude was up 3.1% to USD 76.90 per barrel, with uncertainty around how Trump will approach the Middle East, especially Iran.

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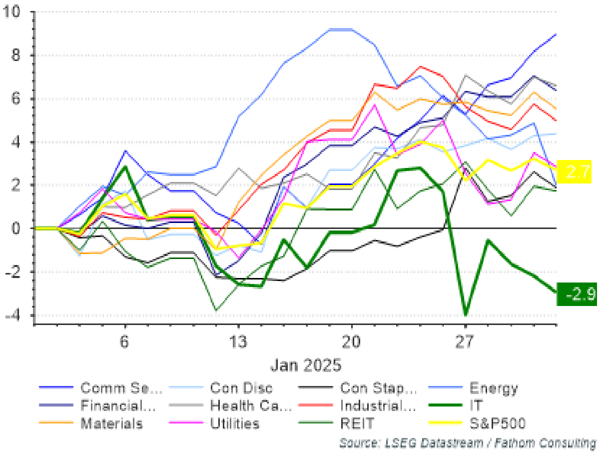
Key Themes

Challenge to US technology mega caps?

The competitive moats of U.S. tech firms were called into question after news that a Chinese AI model, DeepSeek, was trained to be competitive with the likes of ChatGPT at a significantly lower cost than other rivals. This immediately drove investors to question whether the capital expenditure forecasts were overstated.

Chart 3: IT sector underperformance January



While the AI investment thesis has not fundamentally changed, the pace of innovation in this space creates uncertainty over the long-term dominance of U.S. tech. It also highlights again how concentrated and reliant the US equity market has become on the technology sector to drive gains, in particular the dominance of the 'Magnificent 7'.

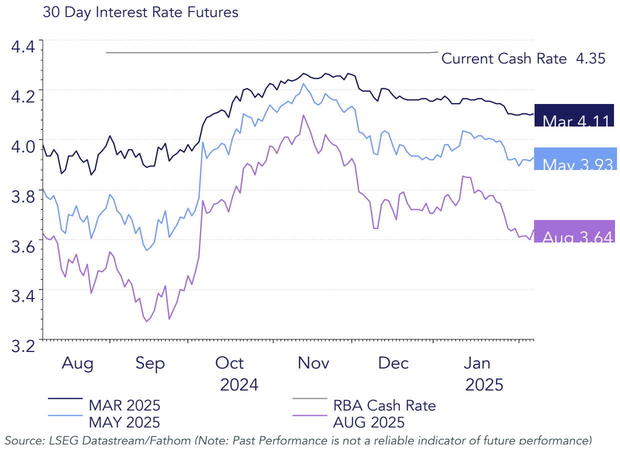
Chart 4: RBA Cash Rate Market Pricing 2025

RBA to cut as early as February?

Recent progress on lowering inflation has dramatically repriced the expectations for RBA rate cuts in 2025. The quarterly CPI print showed that over half the inflation basket is increasing by less than 3% year-over-year (y/y) and under 20% by more than 5% y/y, the lowest since the end of 2021.

While some argue that the RBA should be more cautious and hold rates steady given low unemployment rate, potential for fiscal stimulus post the Federal election and import inflation, the breadth of inflationary pressures has narrowed significantly in recent months. However, a first cut maybe a policy step towards a less restrictive stance given the softer economic activity reading outside of the labour market.

Chart 5: RBA Cash Rate Market Pricing 2025



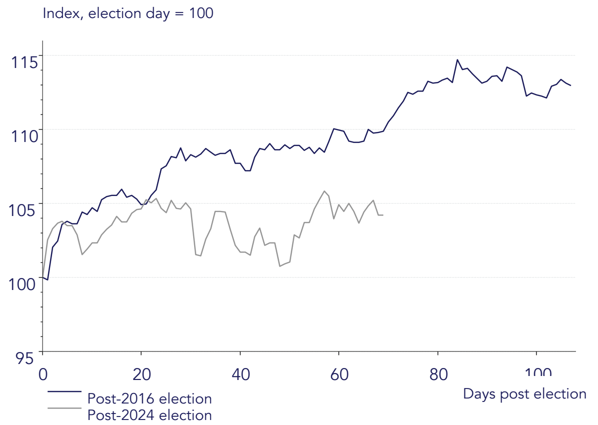
The RBA is unlikely to rush through numerous cuts. We believe they will take a cautious approach and prefer to verify the path of inflation in the quarterly reports.

Outlook

Despite the numerous executive orders signed by President Trump on his first day, there was some relief that tariff policy was not as aggressive as feared. However, tariffs returned to the agenda at the month's end after President Trump used emergency measures to enact 25% tariffs on Canada and Mexico and a 10% tariff on China, causing heavy sell-off. We believe Trump plans to use tariffs as a primary negotiation tactic to exert influence and to "get a better deal" for the US to achieve other policy goals. The economic benefits from tariffs are fairly limited and could be damaging to the US economy.

Several unknowns remain, including potential retaliatory tariffs, expansion of tariffs to other markets like Europe, or the duration of these tariffs given their link to non-economic parameters. However, what is certain is that "American First" policies, which boost U.S. exceptionalism, only increases global growth and trade uncertainty.

Chart 6: US S&P 500 following Trump election



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Despite the strong rally through November, largely on the relief of a clean and clear election result, gains since then have been fairly muted. We would expect increased equity market volatility as policy uncertainty persists.

When tariffs are introduced, typically, it is the end consumer of taxed goods that ends up paying higher prices – which, all else being equal, is inflationary. In 2018, the U.S. Fed staff prepared a scenario analysis that assessed the implications of broad-based 15% tariffs. The conclusion was that the Fed can lessen the hit to activity and the labour market with minimal inflation consequences if they 'look through' tariff impacts.

They noted, however, that this only holds if inflation expectations are firmly anchored and pass-through is short-lived. We have already seen a key measure of inflation expectations spike – with the University of Michigan survey showing investor expectations of rising inflation in the next year.

Inflation expectations, signs policy uncertainty is weighing on activity, and the extent firms can pass costs downstream will be important to the Fed's response. The FOMC is rightly cautious about whether those conditions will hold in the current environment. For now, with the economy in good shape, uncertainty elevated and little scope to be pre-emptive, the FOMC will remain on the sidelines.

Chart 7: Uni of Michigan inflation expectations

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

How to Position

With the drop in the AUD to the low 60s vs the USD, we took the opportunity to hedge some of our global equity exposure. We also topped up our existing gold position as we expect trade uncertainty to continue for the foreseeable future.

Equities: US dominance being challenged?

European equities have outperformed US equities to start the year, as investors have rotated away from technology stocks into markets and sectors with cheaper valuations. It is hard to see this outperformance continuing, given the European economic outlook and risks associated with trade tariffs. We instead see opportunity in US in equal weighted, small and mid-cap US stocks where we have had exposure for some time.

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Cash Rates: RBA to cut in February?

Markets see a cut in February as a certainty after inflation data shows recent price rises at a run rate well within the RBA's target band. It is unlikely that the RBA will wait until the next meeting in April, as this will be very close to the federal election. It is then hard to see the RBA cutting just once, and quarterly cuts upon validation that inflation is headed sustainably within the target band seem more likely. We would expect deposit rates to be cut immediately after a rate cut.

Corporate Bonds: Spreads are tight, but conditions remain solid

The stabilisation of bond yields at higher levels has given investors another opportunity to add duration to their portfolios. We favour doing this through the corporate bond market, where running yields are higher and investors can selectively take more risk to generate higher returns.

Alternatives: Volatility brings opportunities

In the past 2-3 months, we have seen our positions in Alternatives appreciate significantly. Returns have been strong across private equity, currency strategies and our allocation to gold. We expect further solid gains from both our allocations to gold and private equity.

Currencies: AUD bottom hard to pick, but close to bottom

US tariff impact on Australia is expected to be limited given the US runs a trade surplus with Australia, however, the AUD is likely to be negatively impacted from a slowdown in trade or a prolonged trade war between the U.S. and China. All else being equal, it is difficult to predict where a bottom for the AUD vs USD may be, however, we believe 61-62 cents is a reasonable place to take some profits on USD positions and implement some tactical hedging.

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13 February 2024

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