June 2025

Market Outlook.

Clouds remain, despite the sharp recovery.

Foreword

Equity markets continued their strong turnaround in May on growing optimism following a 90-day agreement on US-China tariffs. The tariff news-flow culminated at the end of the month with the US Court of International Trade challenging their legality. At the same time, some of the world's biggest companies attempted to offer guidance during a US reporting season whereby "uncertainty" became the buzzword. Between 15 March and 15 May, 381 out of the 451 (84%) S&P 500 companies that held earnings calls, mentioned "uncertainty", according to FactSet Research.

Despite the recovery in markets and fall in volatility from the early-April extremes, the outcomes of President Trump's tariffs aren't fully resolved. The intervention by the courts challenging the legality of the tariffs has further added to the questions that remain unanswered. Thus, policy uncertainty remains a key issue for US corporates. Even tariff levels of 10% would weigh on growth by reducing aggregate demand and/or place pressure on margins. The challenge for many US companies is that the current policy uncertainty makes it difficult to commit to CapEx or confirm decisions regarding hiring and firing. The longer unresolved questions remain, the greater the risk to global growth settings.

At the same time, attention turned to the worsening US fiscal picture as markets reacted to a downgrade from Moody's. This was compounded by a tax bill from President Trump that's likely to add pressure to already stretched fiscal outlook. The Congressional Budget Office estimates that the tax cuts proposed in the "big, beautiful" bill could add $3.8 trillion to the deficit over the next decade. At one point US 30-year treasury yields hit their highest point since 2023, which was a sign that investors see more risk in US debt. A sustained push higher in yields equates to a tightening in financial conditions that could ultimately pose a risk to discount rates and equity valuations.

These challenges come at a time when price/earnings (P/E) multiples for most equity markets have again moved above long-term averages. Elevated equity valuations coupled with an uncertain earnings outlook sees us favour quality credit assets across diversified, actively managed portfolios, given the contracted nature of their income streams.

Beyond the policy uncertainty, the broader corporate backdrop continues to move at a rapid pace on account of technology, which is reshaping the way products and services are created and delivered. Companies like Meta have been highly successful in deploying artificial intelligence (AI) to better target advertising and grow earnings, but the flow through of AI in many other areas remains in the early stages – despite its enormous potential. At the same time, there has also been increasing interest in agentic AI in the hope that it will allow companies to automate specific tasks to sustainably lower costs. Going forward, the speed of technological developments will continue to raise questions as to the relative beneficiaries and losers across and within sectors – a dynamic which is consistent with our preference for active rather than passive exposures across equity allocations.

Another implication of broad-based technological advancement is that it'll help suppress inflation over the medium- to long-term, both here and abroad. Offsetting this could be pricing pressure from decarbonisation, demographics (as the supply of labour falls and populations age) and diminished scope globally to benefit from cheap labour relative to the past. In our opinion, this suggests that inflation is unlikely to revert to the very low levels present in the decade prior to the pandemic. But at the same time, long-term consumer price expectations remain firmly anchored. We, therefore, do not anticipate a major sustained move higher in inflation in the coming years, although we will continue to monitor developments closely.

James Foot, Chief Investment Officer
Commonwealth Private

Global Economics:

Policy uncertainty remains

- US deficit spending is a key focus, with a tax bill that seemingly exacerbates the problem.
- Recession probabilities have fallen.

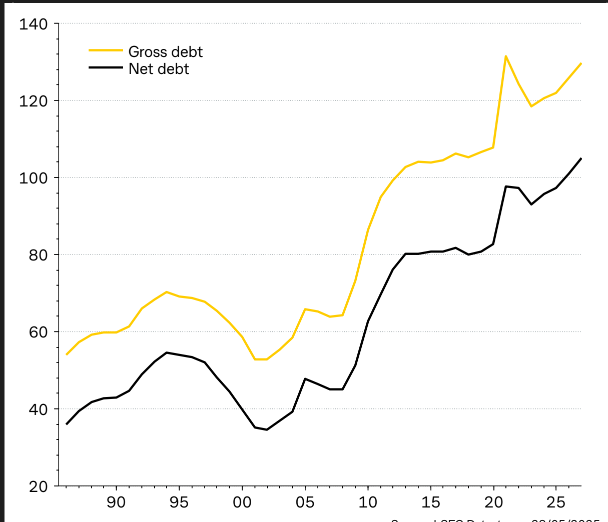
In the last month, tariff and trade-related risks and uncertainties have diminished but not disappeared. The easing of the trade war between the US and China and the 90-day reduction in tariffs have had significant near-term effects on financial markets, but tariff noise is never too far away with President Trump's recent social media post concerning a 50% tariff on the European Union, bringing back concerns on the end game of this trade war.

The current average tariff rate of US imports stands at approximately 13.4%, lower than initial "Liberation Day" levels but still much higher than at the start of the year. The headlines around trade negotiations and the perception of pragmatic deal-making by the Trump administration have led to a repricing of risk assets and improved market sentiment as recession probabilities have been reduced. This saw the Consumer Confidence Index leap 12 points in May, with much of the positive sentiment, according to officials, coming from the de-escalation in the US-China trade war.

Concerns about the fiscal outlook for the US also dominated headlines in May with Moody's the last of the credit rating agencies to strip the US of its AAA credit rating, which fuelled the sharp rise in US treasury yields. This move was on the back of the budget reconciliation bill being passed by the House. This package extends expiring tax cuts, enacts new tax cuts and reduces spending, with the net result being an increase to the US deficit by around $275bn, or 0.8% of GDP, next year.

US Public debt

Per cent of GDP



Source: LSEG Datastream 28/05/2025

This increase is slightly larger than originally anticipated, with federal debt as a share of GDP to remain on an upward trajectory, likely reaching around 120% by 2035 from roughly 100% today. As such, we believe the US fiscal outlook warrants keeping a close eye on.

Business activity in the Eurozone unexpectedly contracted in May, as the service sector experienced a sharp deterioration, according to purchasing managers' surveys compiled by S&P Global. Business activity shrank in Germany, while French output shrank for a ninth-consecutive month. At the same time the European Commission reduced its forecast for economic growth in 2025 to 0.9% from the 1.3% it had projected in late-2024. The downward revision reflected rising tariffs and uncertainty surrounding US trade policy.

In China recent indicators offered the first glimpse of the economy following the trade tensions. Industrial output was better-than-expected suggesting that China has averted a significant slowdown from the trade war. However, a decline in retail sales growth supported the view of many economists that Beijing needs to roll out more spending incentives to bolster confidence.

Australia Economics:

RBA cuts with a dovish tilt

- Driven by their inflation outlook and softening domestic growth, the Reserve Bank of Australia (RBA) delivered another rate cut with a dovish tone.
- The challenging policy and global growth environment was also a key factor in the RBA's decision.
- These conditions of slower growth and easier monetary policy are supportive for fixed income as an asset class.

The RBA maintained its easing bias in May delivering a 0.25% rate cut – a largely expected outcome by domestic money markets. However, their dovish tone was not expected and reflected the central bank's higher confidence on the inflation outlook.

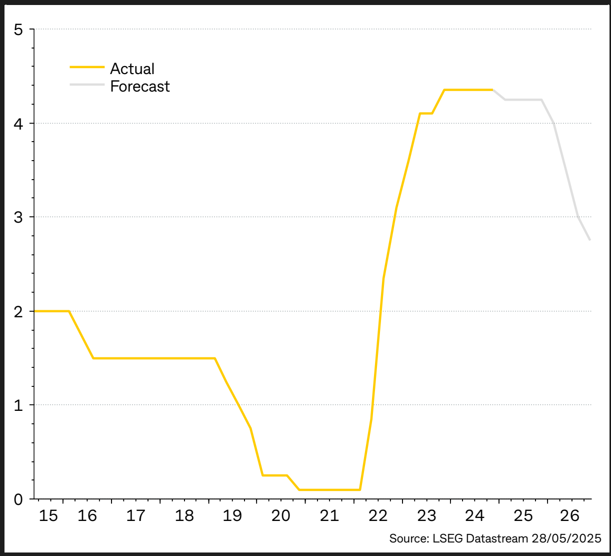
Other recent economic data and forecasts have generally highlighted softening economic domestic activity, with the RBA downgrading their GDP forecasts to 2.1% at year-end due to global uncertainty, and softer household consumption and business investment. The latter was confirmed by the latest private sector CapEx data which showed a decline in the total volume of capex in Q1 2025 led by non-mining investment.

However, the latest labour data was solid with the unemployment rate remaining steady at 4.1% and employment growing by 89,000, albeit this monthly data series is volatile and a lagging indicator. Looking ahead, the RBA expects the unemployment rate to weaken and peak at 4.3%. Should this outcome occur, it wouldn't present a major risk for the economy.

Last month's Federal election, which saw the Labor Government re-elected with a greater majority, means there will largely be policy continuity.

RBA cash rate

Current and consensus forecast



As a result, CBA has not made major changes to its economic forecasts from the election.

Of course, subpar economic growth domestically largely reflects a more challenging policy and growth environment offshore - as noted in the Global Economics section above, the outcomes of tariffs between key countries and the US aren't fully resolved and US policy uncertainty is high on other fronts, including taxation and immigration.

All of this confirms our expectation of further easing from the RBA, with CBA forecasting two additional rate cuts in this cycle taking the cash rate to 3.35%. There's the risk of an additional rate cut this cycle with the timing and likelihood of this depending on incoming economic data and offshore developments.

This environment of positive, but subpar, economic growth and easier fiscal and monetary policy is supportive for fixed income credit as an asset class, at a time when term deposit rates are declining. We discuss this theme further in the Fixed Income section below.

Equities:

Macro uncertainty brings active opportunity

- Markets have rallied back to near all-time highs, as news flow continues to improve.
- In a fully priced and volatile market, active managers are well placed to extract alpha, particularly outside the mega-caps.

Sharp tariff sell-offs, followed by a 'V-shaped' recovery has taken markets back to near all-time-highs. This has come despite the key challenges and concerns principally emanating out of the US described earlier in this publication. Markets look forward, and investors suffer from 'recency bias' which is why the consensus often gets it wrong. Hence as the probability of a US recession faded, tariff/inflation fears receded and rate cut expectations rose, the delta of the news flow turned positive, or 'less bad'. Such macro concerns remain present and real, but within equity markets sentiment improved as worse-case macro scenarios were taken off the table and we had a rally.

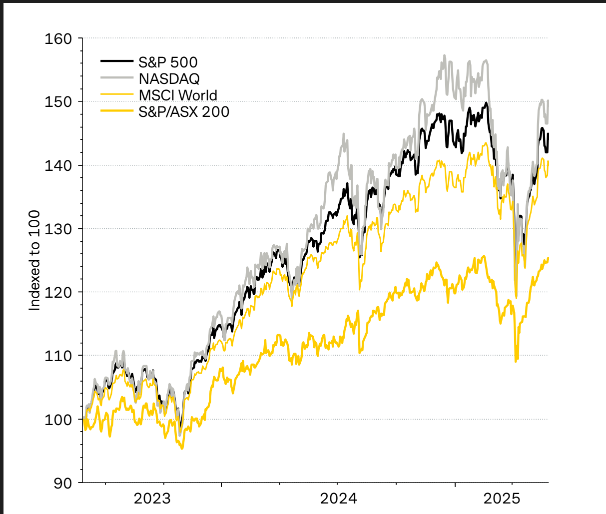
Where to from here?

The bear case has been well covered. Bulls argue improving soft data such as consumer confidence, and a healthy household and corporate sector justify valuations. Forecast US EPS growth of 9-10% in 2025 and 13% in 2026 is robust but also implies margin expansion on already historically high margins.

As markets wrestle with these narratives, we think volatility will remain but don't believe investors should be positioned for extremes, either on the upside or downside.

Rather high market multiples and a low equity risk premium dictate that we should be thoughtful in our equity allocations and portfolio positioning to avoid pockets of overvaluation. This is where nimble active fund managers will play a vital role in portfolios.

Equities Indices near all-time-highs



Source: LSEG Datastream 30/05/2025

We believe investors have become increasingly complacent on the importance of portfolio diversification in recent years as easy gains have come from owning the 'Magnificent-7', overweighting the US relative to the rest of the world, or domestically buying the ASX 200 index, which holds a large weight to the well performed Financials sector. Looking forward, we see a strong case for active management, together with a willingness to move across the market-cap spectrum (into mid or small caps). This dynamic is particularly important locally given the reasonably low-growth sectoral composition of the Australian equity market (dominated by Financials and Materials), combined with full valuations at the index level.

This all points to a great set-up for non-consensus active managers.

Fixed Income:

Global yield curves steepen

- Recent steepening in global yield curves, notably the US Treasury (UST) market, reflect bond investors seeking a higher term premium.
- Continued declines in the RBA policy and short-term interest rates have important implications for the attractiveness of TD rates.
- The prospective environment of subdued growth and easier monetary policy is supportive for fixed income.
- The same may apply if the government's move to tax unrealised capital gains in superannuation (super) balances above $3 million proceeds as planned.

Yield curve steepening has been a key theme in global bond markets. This is especially true in the UST market with long-dated bond yields pushing higher over May despite the rebound in global sentiment and risk assets. Several factors have underpinned this including key central banks and investors de-risking from US assets, the US Federal Reserve moving to a "wait and see" position pending the short-term inflation picture and ongoing concern over the US government fiscal position. The latter culminated in Moody's downgrading the sovereign rating of the US to Aa1, thereby joining S&P and Fitch.

Consistent with our expectations, AUD short-term rates have moved lower driven by further policy easing from the RBA and an associated dovish tone. As noted below, this has important implications for the relative attractiveness of TD rates compared to alternative fixed income products.

Looking ahead, an environment of slower global growth, easier fiscal and monetary policy and relatively low real bond yields is supportive for fixed income credit as an asset class, and credit spread markets generally, even though global credit spreads have rallied back to long-term averages or below, from their April wides.

Yield curves steepened in May

Spread between 2-year and 10-year UST yields

As TDs approach maturity and investors are confronted with reinvestment risk, a key focus area for investors is consideration of alternative fixed income investments. This includes funds which exhibit materially higher yields and return potential above short-term AUD rates, but maintain measured, but actively managed, interest rate and credit exposures.

Meanwhile, we are closely monitoring the Government's plan to impose an additional 15% tax on earnings in non-indexed super balances above $3 million, which includes the imposition of a new tax on unrealised capital gains. If implemented, for cashflow management reasons, those super-based investors that are captured may consider changing their investment vehicle and/or rotating from longer-term growth-oriented investments into more income-based products, such as fixed income.

Real Assets:

Real Assets build on solid foundations

- Real Assets such as Property and Infrastructure can provide long-term investment stability.
- It can also provide a hedge against the inflationary-based erosion of asset value.

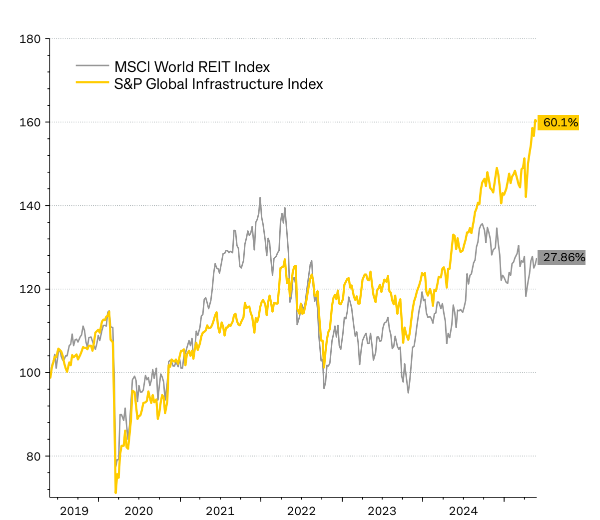
Property: Returns from global listed property securities in May were positive, increasing by circa 2.5% (FTSE EPRA Nareit Developed AUD hedged), as improving sentiment and risk appetite pushed global equity markets higher.

As noted in our prior quarterly updates, commercial property valuations and returns have been challenged over the past few years, as rising interest rates have added to holding costs and reduced the attractiveness of commercial property compared to other investments. Since Q4 2024, direct commercial property fund valuations have stabilised, and started to increment positively, as economic conditions are broadly positive, expectations for central bank interest rate cuts converged. Noting also the significant number of commercial properties that are available for sale, we expected transaction activity to increase significantly in the first half of the year. While transaction activity did pick up in late-2024 and into early-2025, that momentum stalled as US policy and inflationary concerns clouded the picture. However, the transactions that were announced were overall supportive of the valuations in direct property funds, and the potential remains for an uptick of transactions before the end of the Australian financial year.

Despite current uncertainty referred to above, we believe that the investment case for long-term investment in commercial property remains sound, and that further value can be created by the careful selection of high-quality individual assets and those that present value-add opportunities.

Real Asset investment returns

USD Total Return



Source: LSEG Datastream 29/05/2025

In listed property markets, valuations have been held back by economic uncertainty and investor sentiment, with current security prices implying that underlying property portfolio valuations will be marked down from current levels. However, with direct property valuations having stabilised at lower capitalisation rates compared to listed markets, and with the potential for listed property securities to increase earnings as interest rates fall, listed property securities continue to present a good case for investment.

Infrastructure: Returns from listed infrastructure securities added 1.3% (FTSE Developed Core Infrastructure 50/50 100% Hedged to AUD Net Tax Index), however, over the year to date, listed infrastructure has out-performed equities as well as experienced lesser volatility. While we don't expect listed infrastructure to out-perform equities in bull markets, this performance reflects the solid grounding of real asset investments, particularly in periods when inflation concerns are prevalent. We continue to maintain our positive outlook for infrastructure assets as part of a long-term investment portfolio.

Alternatives:

Lower volatility with long-term return drivers

- Hedge Funds aim to provide absolute returns with low correlation to traditional asset classes.
- Alternative Credit offers enhanced yields.
- Private Equity offers access to value-added opportunities and participation in developing businesses and technologies.

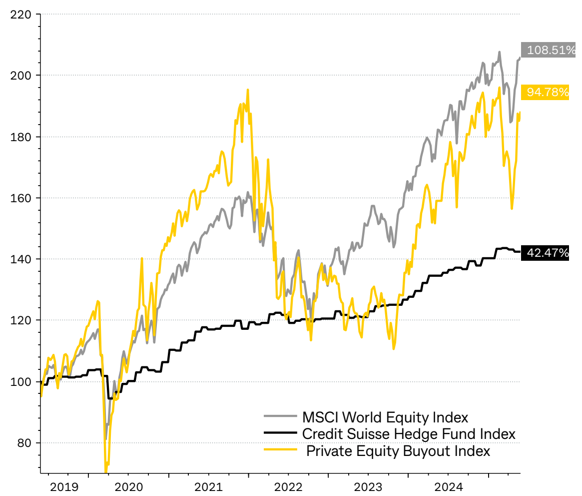
From the extreme movements in early-April 2025, equity and bond market volatility continued to abate in May, as reflected in the narrowing of credit spread benchmarks for US and European high-yield bonds, collateralised loan obligations (CLOs), and to a lesser extent US liquid corporate loans. However, these spreads are still wider than the historically low levels of the second half of 2024. Overall, private credit funds have demonstrated sound performance over the year to date.

The calming of markets in May was due in part to the US pause on the majority of its proposed trade tariffs, and market expectations that the Fed would reduce its cash interest rate to support the US economy, if needed. However, as noted in the Foreword above, risks to the US economy, and by extension the global economy, remain.

One aspect of uncertainty in the US is whether corporates have sufficient confidence to continue to execute their growth plans, or whether they will hold back capex and hiring. From a credit perspective, holding back expenditure in the face of uncertainty demonstrates fiscal responsibility. From the lending side, the recency and impact of the previous rate hiking cycle, and the degree of uncertainty regarding economic conditions continue to guide lenders to be cautious in their provision of credit.

Alternative investment returns

USD Total Return



Source: LSEG Datastream 29/05/2025

In our view, this prospective caution from both borrowers and creditors, combined with the context that corporate conditions continue to be relatively benign (interest rates not too high, persistent economic growth), and that high-yield and structured credit spreads remain above their historically low levels, indicates that these market segments currently present sound investment opportunities.

Given the fast-moving nature of markets and US policy, we believe that such investments are best accessed via active managers which can: (a) provide a well-diversified portfolio of credit investments, (b) select sound credits which are not directly exposed to policy risks (such as tariffs), or which may be impacted as a secondary effect of such measures (consumer discretionary), and (c) actively reposition the portfolio according to credit fundamentals, relative value between issuers and credit segments, as well as capitalise on opportunities created by broad market movements.