Market outlook

The repercussions of two material geopolitical and macro events in November are still reverberating throughout the markets. The ultimate outcome and flow-on impacts of these events will likely determine the direction of markets in 2025, to the extent that they influence earnings outcomes and the direction of inflation and interest rates. The biggest factor to date has been the US election. Trump's win is initially being seen as pro-business and pro-US growth, and this has pushed the market higher. It could, of course, just as easily also turn out to be pro-inflation, pro-trade-war and pro-global economic uncertainty – this all remains to be seen and will play out next year and beyond.

The second is the struggling Chinese economy. China's series of rolling economic stimulus announcements to date have been underwhelming, especially where commodity usage – which is where Australia might benefit – is concerned. We expect more to be said and done in coming months, especially in response the any moves by Trump on tariffs, but it feels as if any recovery, or even just stabilisation, in China will most likely be consumer-focused, which is not steel intensive.

Both events will ultimately need more detail and time for us to be sure of the outcome. On top of increased US fiscal spend in 2025 and beyond, we will need to see the scope and the outcome of any tariffs that are put in place, including any retaliatory action or compromise deals done, and also what red tape actually gets cut in the US. The market's view in all of Trump's plans is that pragmatism will ultimately prevail, as long as it favours the US. The question will then be what will happen to economic growth, especially if it means interest rates don't fall as much as previously expected, and what will that mean for company earnings? As far as the market direction goes, however, US election euphoria has trumped (no pun intended) all else for now. While some consolidation might be warranted after such a big positive reaction, especially in Australia, the equity market will likely continue to take the optimistic view it has done all year, unless or until there is evidence to the contrary. Reality – either way – seems to be for later next year and beyond.

Australia is about to enter its own election year and it is shaping up as a close contest which will no doubt be run on the cost of living theme that resonated so well in the US, as well as the energy transition which will have some direct stock and sector specific potential impacts. Politicians rarely emphasise fiscal austerity these days if they want to get elected, so we expect there will be a decent dose of government and opposition spending promises. These ultimately tend to be pro-growth and consumer friendly, at least in headline. Having said that, elections also have a tendency to cause the economy to slow until the outcome is known and the risk has past.

Near term, the direction of the economy in 2025 and the direction and pace of interest rate changes will be the big market drivers, and this could well be disappointing initially. As we look forward, it is difficult to see what will lift our reasonably cautious consumers and sluggish overall economy in the near term. The messages from recent AGMs and company results are all suggesting caution: caution from the consumer on spending; caution on the prospect of interest rate cuts; caution on house prices; caution on deteriorating credit quality; caution on employment; and continued caution on inflation.

The background to all of this, of course, is a continued rise in the overall market. Despite sticky inflation and interest rates; despite cautious company outlooks in Australia; despite continued weaker outlook for China; and despite continual earnings downgrades. The outcome of all this is a more expensive market. Our equity market is clearly being driven by what is happening in the US, and increased in economic optimism in the US post election is the main outcome. Typically what happens in the US economy is ultimately reflected in Australia's, with a lag, and so we tend to get dragged along either way, but with the overhang of a soft China and the Trump administration's focus on 'America first', we do wonder if that will be a reality for some time here. The risk pendulum is telling us that a lot of good news has already been priced in and not a lot of the potential negatives, which suggests it is going to be increasingly hard for company earnings to surprise on the upside in order to support yet another year of strong market growth.

We think it is fair to say the market is no longer pricing in a soft landing in the US, as was the prevailing assumption throughout 2024, with the continuing market rally. It has now gone straight to pricing in a decent US recovery, despite little evidence of one happening just yet, and that is being translated directly to the Australian market, despite even less evidence of improvement here. If anything, the evidence points to deterioration. The market multiple is currently writing cheques that its earnings are not yet able to pay. 2025 will provide some evidence either way however, until it does, it is hard to see the market taking a materially different view near term, even if a little consolidation is probably due.

Portfolio outlook

While the Fund has been net benefitting from some of the market trends in the last few months (slow Australian consumer, weak oil price, weak China, earnings upgrades in tech and healthcare, rising bond yields, rising US market and sentiment), we continue to battle more and more with stretched valuations. Areas where earnings upgrades are occurring continue to be well supported, almost regardless of valuation, largely because upgrades are few and far between in Australia. The portfolio continues to be positioned in stocks with better earnings outlooks than the market expects, as per our investment process. While we do focus on earnings momentum and the quality of those earnings, we also care a lot about valuations. Valuations rarely tell you when a stock is going to turn, but it does tell you when risk is increasing. The higher the valuation, the more risk to returns when something ultimately goes wrong – and it always does, but rarely in the timeframe you think!

Banks are a prime example. It is increasingly difficult to justify bank valuations on a standalone basis. Commonwealth Bank (CBA) surpassed healthcare company CSL's earnings multiple in November. Both are great franchises, but surely CSL's global growth prospects over time must be far greater than CBA's domestic growth opportunity. The difference is

Top five active overweight positions as at 30 Nov 2024	Index weight %	Active weight %
Aristocrat Leisure Limited	1.7	2.9
ResMed Inc	0.9	1.9
Goodman Group	2.6	1.9
Rio Tinto Limited	1.7	1.7
Medibank Pvt Ltd	0.4	1.7

Asset allocation	30 Nov 2024 %	Range %
Securities	98.3	90-100
Cash	1.7	0-10

that CBA is currently getting small earnings upgrades while CSL is not. That dichotomy will ultimately resolve itself one way or another over time but the more CBA climbs, the greater the becomes risk if it misses expectations. Just looking at valuation, however, does not tell us if it will miss expectations. The Fund has been gradually lowering its exposure to banks over the last quarter as their valuations became more stretched, but the scale of the reduction has been tempered by the fact that the Bank sector is one of the few in our market getting earnings upgrades.

Tech is another area which looks notionally expensive but is getting some upgrades. We are remaining disciplined on valuation in that sector, especially where we see the market getting ahead of itself on earnings expectations. But overall Tech earnings prospects continue to look reasonably robust, as do some parts of Healthcare which we have recently added to. Insurance is a rare sector that is not overly expensive but continues to have a positive earnings outlook. Historic earnings volatility tends to keep Insurance valuations low but the current operating environment and the changes insurers have made to risk tolerance and pricing suggests there is still further upside from here. Resources is a sector that is not apparently expensive, however it is also a sector with earnings risk. We struggle to see much change to that in the near term and continue to expect that any Chinese recovery – should there be one – will not be commodity-intensive. As such we remain underweight Resources with a preference for specific commodities like Copper (in the longer term) and Aluminium.

The consumer continues to struggle in Australia and ongoing company announcements on performance to date have been more negative than positive. That said, expectations are quite low too. The end of year is always a critical period for consumer stocks (see below) but – with a few honourable exceptions – we anticipate underwhelming outcomes in the new year and remain underweight the Consumer sector.

BTW

Black Friday is everywhere. It exploded into our retail consciousness a year or two back but many Australians are still left a bit bemused: what is Black Friday and why are we celebrating it?

Black Friday has been a thing in North America for years. It is the Friday following Thanksgiving, which is the last Thursday in November. It used to be (and maybe still is?) that most US discretionary retailers would trade at a loss all year and make its entire yearly profits in the period between Thanksgiving and Christmas. Hence Black Friday: the retailers are finally trading in the black. Traditionally, American families would get together and eat lots of turkey on Thanksgiving, play football (or at least watch a game) and go to bed early so they could wake up at dawn to line up at the local mall when it opened so they could race in and grab some bargains. Not so much these days. In the early days of online shopping, Black Friday was followed closely by Cyber Monday, the online equivalent. However Cyber Monday is now a bit passé as the Black Friday sales are now overwhelmingly online.

Why Black Friday is so big in Australia is more of a mystery. We don't believe our retailers are quite as extreme as to suffer losses for 11 months of the year; in any case our financial year is typically July to June, so the end of year dynamic is quite different. It's most likely just a good excuse for another sale – and it's a call to action to which Australian consumers have clearly responded, to the extent that it has become the biggest individual discretionary retail event on the Australian retail calendar, eclipsing even Christmas and the Boxing Day sales.

It must be quite a conundrum for the retailers themselves though: why would you hold a big sale just weeks before the biggest gift-giving event on the calendar and forego sales at full price? Essentially, because everyone else is doing it. Not participating would most likely result in your hoped-for buyers already having spent their money elsewhere, so the full-price sales you were holding out for might not happen. Instead, people who are well-organised enough have the perfect opportunity to save a bit of money on their Christmas presents.

But everyone likes a bargain, or at least a perceived bargain, so the better retailers just suck it up, smile and discount away, counting on a happy customer being a repeat customer. And Black Friday here has become more than just a day: ads promoting it started in early November. Amazon's Black Friday promotion ran for two weeks! Some retailers even missed the day itself, like this self-aware one from Supercheap Auto. Its sale started very early and finished on a Saturday, six days before the actual Black Friday! But much as we hate aping US trends, it does feel like Black Friday has become a fixture on the retail calendar and is here to stay.

Travellers' Tales

Stephane's personal carbon footprint is pretty hefty at the best of times but even by his standards he gave it a nudge in November, spending much of the month on the road across three continents [at this point we should note that Alphinity buys carbon credits at the end of each year to offset our carbon emissions, which are mostly from air travel and the power used in the office]. He started off with a quick trip to China to get a lay of that land in its post-stimulus environment.

After spending a couple of days at meetings in Beijing he went to the lithium-rich province of Jiangxi, a few hours west of Shanghai by high-speed train, where he met with some vertically integrated lithium producers and refiners. The lithium price has fallen by 85% from its peak in late 2022, and this has meant a world of pain for producers. That fall has been caused by both sides of the supply/demand equation: larger-than-expected supply growth in South America, Australia and Africa while demand growth has shifted lower thanks to a pause in EV adoption and a technology shift towards less lithium-intensive batteries. As they say, nothing fixes high prices like high prices! Many miners are now making operating losses and numerous lithium projects have been forced to close, in Australia and elsewhere. Stephane drove past battery giant CATL's brand new $US500m lithium refinery plant (pictured here) which started production early this year only to be mothballed a few months later. The shiny new pieces of equipment were unattended except by one lonely security officer who tried to chase Stephane's vehicle away. We shouldn't feel too sorry for CATL though as it is the world's largest battery maker, and that sum only amounts to about a quarter of 1% of CATL's total market value.

The nearby mine (below) is essentially a big mountain of leopidite – one of the minerals from which lithium can be extracted – which is gradually being carved away. Note the blue sky: it is something you rarely used to see in China but the big effort it has made towards replacing coal power with renewables has had a huge impact on air quality there. Having said that, the air was still hazy, a function of the vast amount of industrial activity in that region.

After China, Stephane put in a brief appearance at the office before heading off to the US to see energy and industrial companies in Houston and then south to Chile and Peru to visit resource assets. He was in the US in the days just after the election so emotions were still quite raw, although being Texas he encountered much more jubilation than depression! Speaking with people he met, from company execs to taxi drivers, the view was that people had been quite unhappy with the direction of the country under Biden and saw Harris as a continuation of the same, whereas returning Trump represented an opportunity to bring about the radical change needed. There seemed to be little appreciation of just how strong the US economy is, with the stock market booming and unemployment close to an all-time low; the Trump narrative of the US being a 'failing nation' clearly cut through. And even among people with Hispanic heritage, resentment about people pouring over the border was profound, and Harris' prior responsibility for the border counted against her.

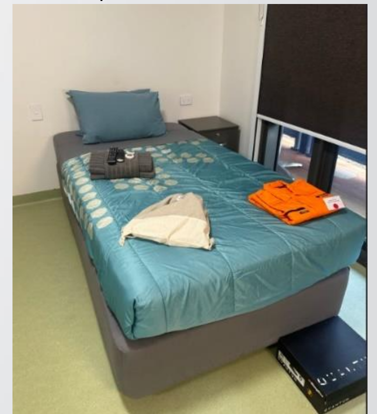
In Chile, it was all about resources and he spent both quality and quantity time at operations and with management of portfolio holding Capstone Copper. He also met with more lithium producers, who were just as depressed as their Chinese counterparts.

Chile is a strangely-shaped country: incredibly long (more than 4000km) but incredibly narrow (170km on average). Getting around can a challenge so while he was there he had to spend a lot of time on planes and buses. He flew from Houston into Chile's capital, Santiago, then had to fly 1300km back north to Antofagasta, the gateway to the Atacama Desert, which is where a great deal of the mining activity takes place. The Atacama is amazingly rich in resources but not always an easy place to mine as access to water can be tricky. Most of the miners have large desalination plants in order to provide the water they need. He went to a number of Capstone Copper's assets there, including the well-established Mantos Blancos copper mine near Antofagasta (pictured below) and the jewel in Capstone's crown, the Mantos Verdes mine near Copiapo, about 500km back towards Santiago.

While in the region, he took a personal day and rented a car in order to do some sightseeing in the non-mining parts of the Atacama. It is an enormous place – more than 100,000 km² – of bleak beauty, and is apparently the driest non-polar desert on earth. The Atacama is so inhospitable that simulations of what a Mars expedition might be like have been performed there. It has a long range of high mountains, and Stephane was driving at altitudes as high as 5000m. There isn't a lot of wildlife there but he was very excited to meet a few flamingos and llamas. There weren't many locals around but they probably would have been as bemused at his reaction as we generally are when we see offshore tourists encounter kangaroos in the wild for the first

Meanwhile, Monique headed back to Western Australia, this time to Karratha to see Woodside Energy's Pluto Liquid Natural Gas (LNG) plant. It was hot – over 40º – and there were flies everywhere so she donned a fly net mask (pictured) and made her way around the existing LNG plant and the new one that is being built nearby for Woodside's Scarborough gas project which is due to come online in 2026. She also got to see first-hand the extent to which Woodside is using new technologies, including drones and robots, to undertake some of the more remote and/or hazardous work and reduce the amount of time workers are needed to be exposed to risks.

While there she went to see some nearby indigenous rock art, some of which dated back 40,000 years. However, just like Chris found at the Ferrari head office last month, photos were prohibited so we are unable to share anything she saw. Dinner on the beach at sunset provided an opportunity to mingle with management and ask questions. Watching people trying to eat and drink while wearing fly masks was quite a sight.



While the prospect of staying in a mining donga had made her a little nervous in the lead up to the trip, Monique found the donga basic but comfortable. They were left her some bright orange overalls to wear (definitely not a prison outfit!). The donga exceeded her expectations, which demonstrates the great benefit of having low expectations!

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