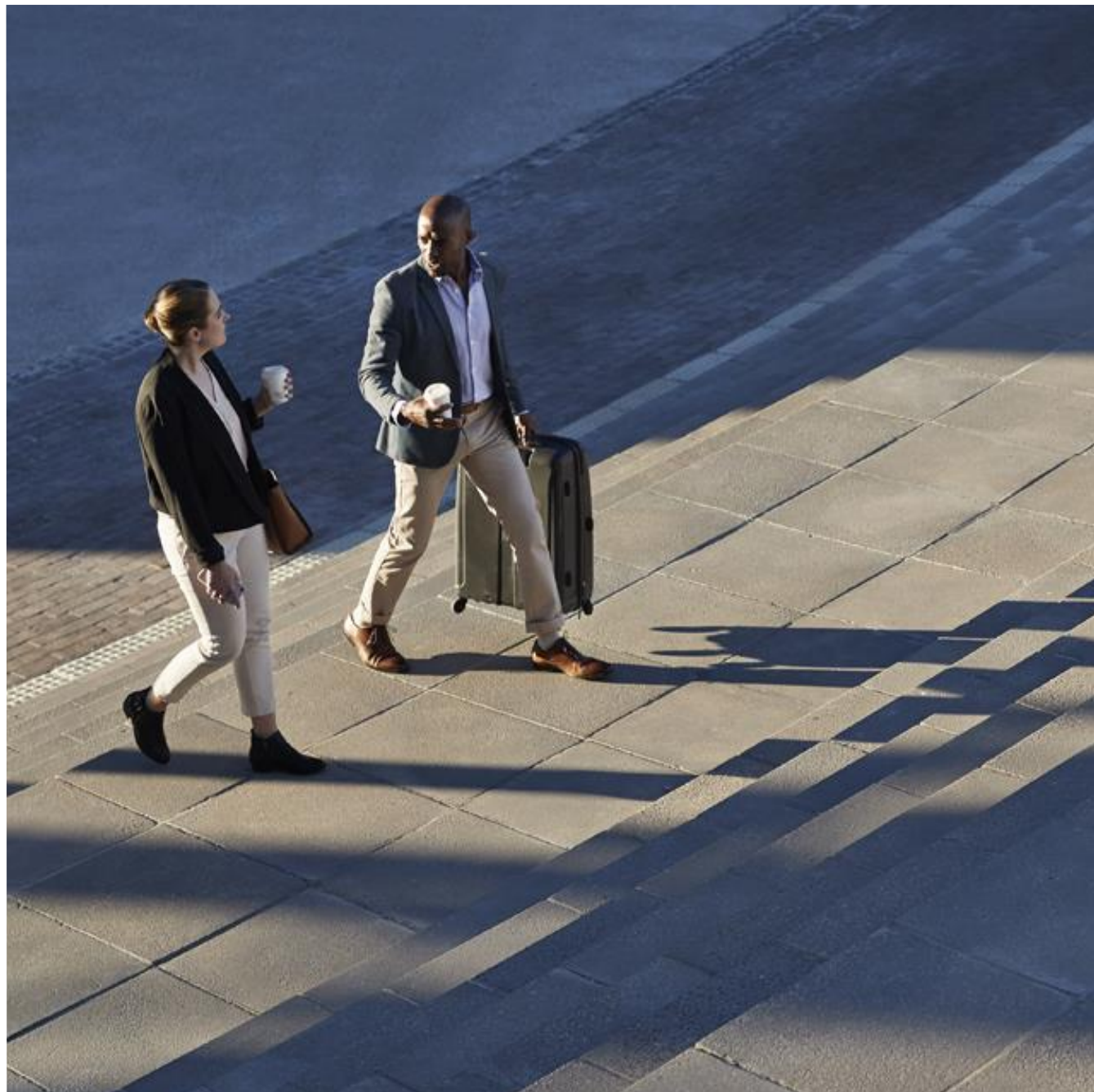


Current as of 1 October 2024



Economic and Market Outlook

October 2024



Contents

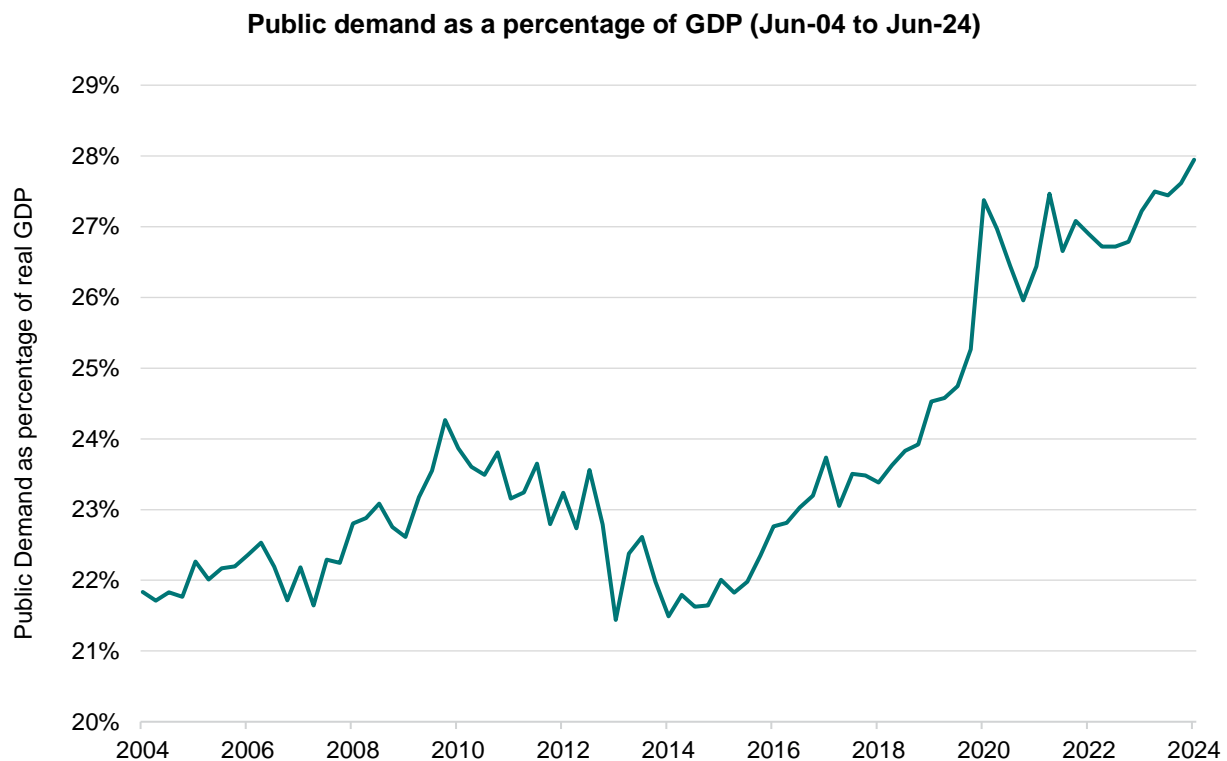
Australian economy	3
International economy	7
Australian equities	13
International equities	21



Australian economy

Part 1: Overview

Government support and immigration are driving our economy. Overall government spending is projected to reach 28% of Gross Domestic Product (GDP) by the end of 2025¹, well above the pre-pandemic average of ~22.5%. Migration-led population growth has been significant with net overseas migration of 388,200² for the first nine months of FY24 likely to see an overall intake well above the Treasury's 395,000 projection for FY24³ in this year's May Budget.



Source: Australian Bureau of Statistics (ABS)

From the Reserve Bank of Australia's (RBA's) perspective, the level of demand remains excessive relative to the supply of goods and services that our economy can generate. The scale of government spending is playing a part here with industry observers in construction noting the crowding out impact of recent infrastructure programs as a driver of higher construction costs. The National Disability Insurance Scheme is another example. Healthcare jobs have been growing at the rate of 5.8% p.a. since February 2020, over double the 2.6% p.a. rate experienced by the broader labour market. This has been a key reason why the unemployment rate of 4.2% remains a full percentage point below where it was in March 2020. The growth in demand for health care workers can be clearly seen when comparing Australia to other developed countries.

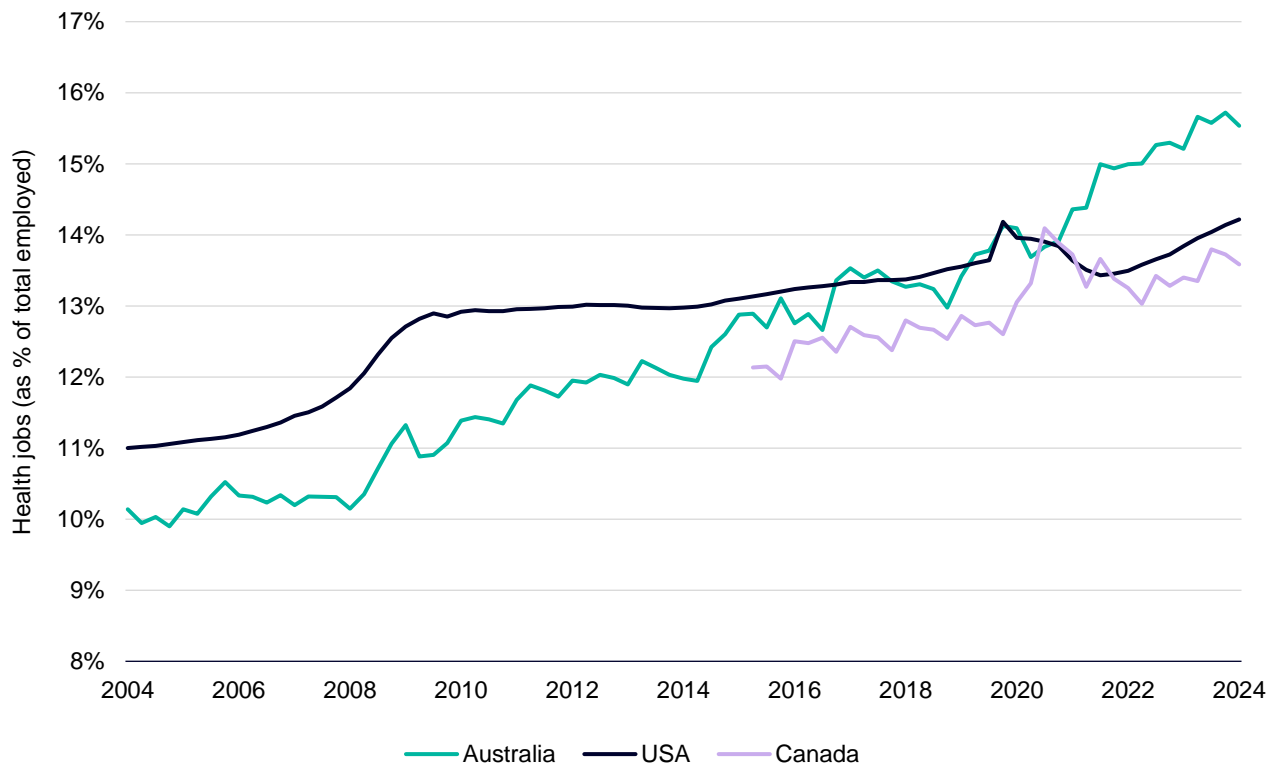
¹ P. Bustamante, 'Expansion in Public Demand to see a tepid recovery in the Private Sector', *Westpac Economics* (23 September 2024), <https://library.westpaciq.com.au/content/dam/public/westpaciq/secure/economics/documents/aus/2024/09/er20240923BullEconomicNote.pdf>, (accessed 26 September 2024).

² 'National, state and territory population – March 2024', *Australian Bureau of Statistics* (19 September 2024), <https://www.abs.gov.au/statistics/people/population/national-state-and-territory-population/latest-release#key-statistics>, (accessed 20 September 2024).

³ 'Budget Strategy and Outlook, Budget Paper No. 1', *Commonwealth Treasury* (14 May 2024), https://budget.gov.au/content/bp1/download/bp1_2024-25.pdf, (accessed 10 June 2024).



Health employment as proportion of total jobs (Aug-04 to Aug-24)



Sources: Australian Bureau of Statistics (ABS), Bloomberg, Statistics Canada, PPWM calculations

The experience for individual households continues to be challenging. Inflationary pressures in some segments including insurance and rent⁴ as well as declining per capita income growth remain headwinds. While Stage 3 tax cuts have provided some relief, bank credit card data summarised in the Westpac Card Tracker⁵ series show clear signs that households are saving these gains rather than spending with sales volumes remaining subdued. It appears likely that it will take time for these drags on household spending to lift.

The RBA is intimately aware of the challenges facing households but is cautious to resort to cutting rates given the conflicting signals. Although headline inflation for August of 2.7% has fallen into the target range of 2-3%, for the first time since 2021, this was mainly because of temporary energy rebates which drove electricity prices down by 14.6%⁶. Unless these rebates persist, we could see a meaningful uptick in inflation on the expiration of this government support.

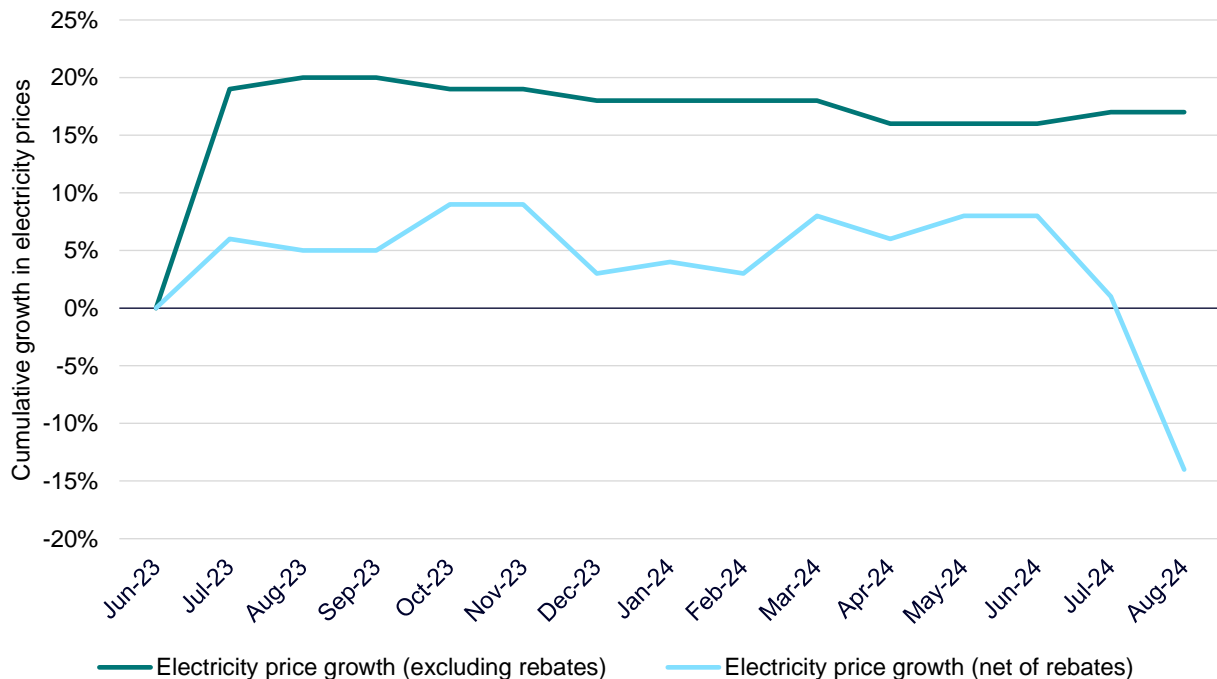
⁴ 'CommBank Household Spending Intentions Index', p. 8, *CommBank* (12 September 2024), <https://www.commbank.com.au/business/latest/spending-intentions.html>, (accessed 14 September 2024).

⁵ M. Hassan, 'Westpac Card Tracker 30 September 2024', *Westpac Economics* (30 September 2024), <https://www.westpaciq.com.au/economics/2024/09/westpac-card-tracker-30-september-2024?ai=1727681647004&cd=69312&cid=edm>, (accessed 30 September 2024).

⁶ 'Monthly Consumer Price Index Indicator August 2024', *ABS* (25 September 2024), <https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/monthly-consumer-price-index-indicator/aug-2024>, (accessed 26 September 2024).



Cumulative growth in electricity prices with and without rebates (Jun-23 to Aug-24)



Source: ABS

Given that underlying inflation still remains well above the target range, we believe the RBA will need to see more evidence of an easing in wage pressures before monetary policy is loosened. At this stage, there does not yet seem to be sufficient momentum for labour market weakness to force the RBA's hand. Job vacancies are certainly declining, falling 29% from their May-22 peak according to the ABS⁷ but remain some 45% above the pre-pandemic level suggesting weakening but still high demand for labour. Meanwhile unemployment has ticked up 0.6% from June 2023 to 4.2% in August 2024⁸. This is still well below the pre-pandemic level of 5.2% at March 2020. Demand and supply remain at a mismatch in the RBA's view and they appear content to let this normalise gradually without intervening and cutting rates.

Conclusion

Taking stock of the Australian economy we are being driven by public spending across both the NDIS, infrastructure and other programs. This coupled with still elevated immigration should keep headline growth positive. Households remain challenged even with relief via the Stage 3 Tax cuts and other government subsidy programs. Elevated underlying inflation and labour market tightening remain obstacles to interest rate cuts. This stands in sharp contrast to the experience overseas and will likely see current conditions prevail until we see more significant job losses or inflation finally eases.

⁷ 'Job Vacancies, Australia, August 2024', ABS (26 September 2024), <https://www.abs.gov.au/media-centre/media-releases/job-vacancies-continue-fall-august-remain-elevated>, (accessed 28 September 2024).

⁸ 'Labour Force, Australia, August 2024', ABS (19 September 2024), <https://www.abs.gov.au/media-centre/media-releases/unemployment-rate-steady-42>, (accessed 20 September 2024).



Part 2: Key economic indicators

Economic snapshot	Last reported result	Date
Growth (GDP)	1.00%	Jun-24
Inflation	3.80%	Jun-24
Interest rates	4.35%	Sep-24
Unemployment rate	4.20%	Aug-24
Composite PMI	49.8	Sep-24

Economic snapshot	2024e	2025e
Growth (GDP)	1.2%	2.1%
Inflation	3.4%	2.8%
Interest rates	4.3%	3.5%
Unemployment rate	4.2%	4.5%
US Dollars per 1 Australian Dollar (\$)	0.68	0.71

Source: Bloomberg.

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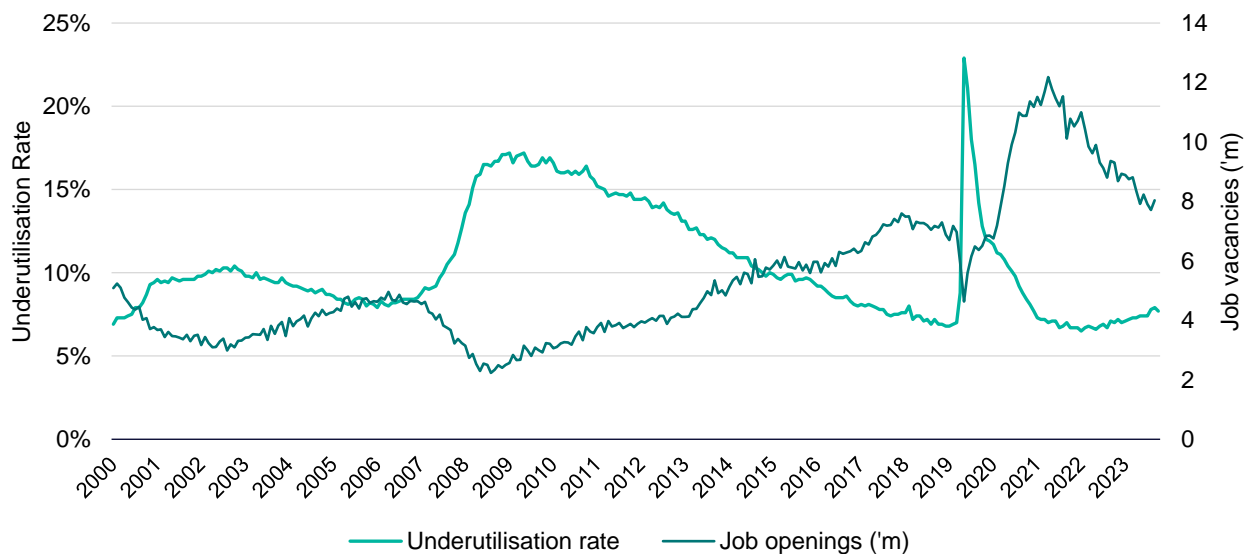
International economy

Part 1: Overview

United States

Signs of weakness in the US labour market have been front and centre in recent months. The unemployment rate now sits at 4.2%, up some 0.8% from its April 2023 low of 3.4%. The underutilisation rate, a broader measure of labour slack that also accounts for people working fewer hours than they prefer, has risen even more sharply from a low of 6.5% in January 2023 to 7.9% as of August. Further, a leading indicator of labour demand, job vacancies, is still declining precipitously and nearing pre-pandemic levels.

US jobs market trends versus US recessions (Jan-01 to Aug-24)



Source: Bloomberg

These considerations all factor heavily into the Federal Reserve's (the Fed's) decision making process for interest rates. Another issue can be seen in survey data with the latest Beige Book by the Fed highlighting acceleration in weakening economic activity⁹. Taking these considerations into account the Fed moved aggressively on interest rates, making a 0.5% cut to take its target rate to 4.875%.

The task was made easier for the Fed by easing price pressures with both headline consumer inflation and preferred core PCE inflation working towards the target of 2% (expressed as an average through the cycle). Easing shelter costs play a prominent role here though there are resurgent risks in terms of goods inflation. US ports stand to potentially be crippled by strike action¹⁰ which could see an uptick in pricing pressures by creating more supply chain congestion. Ongoing geopolitical tensions in the Middle East could also be inflationary if, for instance, a broader conflict ensues in response to Israel's intervention in both Lebanon and, more recently, Yemen¹¹.

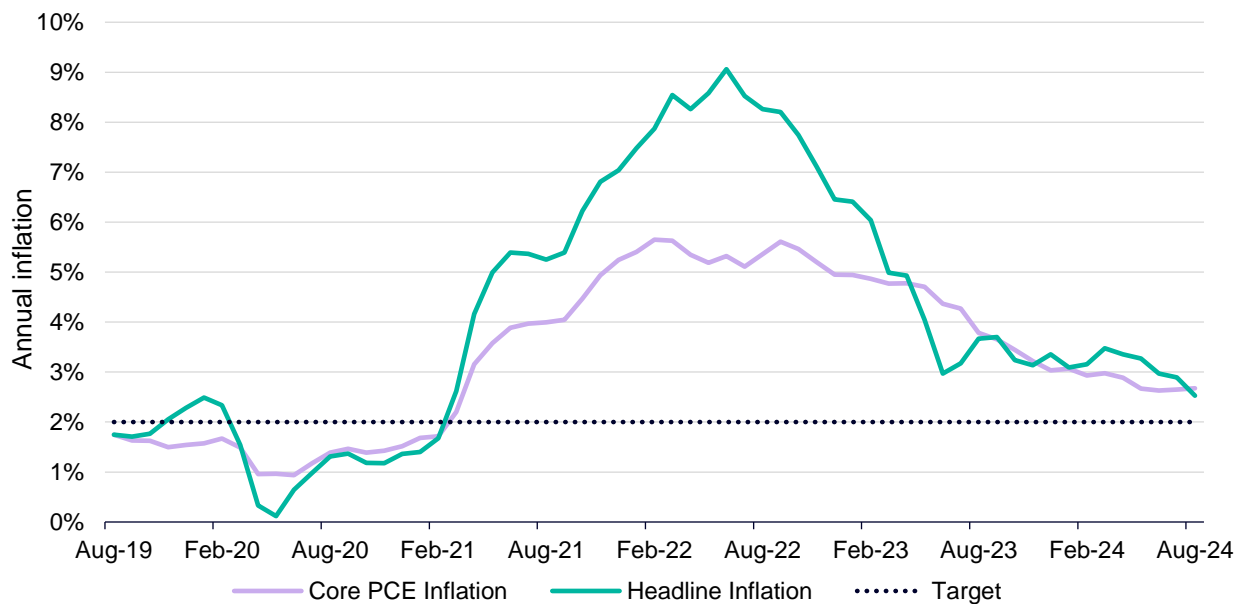
⁹ G. Robb, 'Two thirds of Fed Districts report flat or declining activity, Beige Book says', *MarketWatch* (4 September 2024), <https://www.marketwatch.com/story/two-thirds-of-fed-districts-report-flat-or-declining-activity-beige-book-says-e66a2e97>, (accessed 10 September 2024).

¹⁰ T. Krisher, 'US retailers brace for potential pain from a longshoremen's strike', *AP News* (30 September 2024), <https://apnews.com/article/longshoremen-strike-ports-pay-consumers-automation-october-77289c12bf3c3eff5e42cb6372126576>, (accessed 30 September 2024).

¹¹ 'Hezbollah deputy chief vows to continue fighting after IDF strikes killed Hamas leader in Lebanon', *ABC News* (30 September 2024), <https://www.abc.net.au/news/2024-09-30/israel-bombs-houthi-targets-yemen-as-hezbollah-leader-dead/104411480>, (accessed 30 September 2024).



US inflation measures versus long-term target (Aug-19 to Aug-24)



Source: Bloomberg

Importantly, whilst the Fed is now moving to ease policy and there are growing concerns about potential weakness in economic growth we should not ignore the other side of the policy dynamic. In terms of fiscal policy, the US is still running elevated deficits at some 5.6% of GDP as of June 2024. At these levels fiscal spending will underpin both household and corporate incomes through direct (e.g. outright payments from the government) and indirect transmission mechanisms. This stimulus should minimise the risk of any outright recession because it forms a steady source of spending by both households and businesses. It also stands as a sharp contrast to the conditions prevailing before the last two US recessions with a modest deficit heading into the global financial crisis and a slight surplus ahead of the Dot Com Bubble bursting¹².

In conclusion, a weakening labour market has triggered a forceful monetary response. In addition ongoing fiscal deficits should minimise recession risk by buttressing household and business spending. This sets the stage for, at a minimum, weaker but positive growth coupled with a gradual easing in inflation. Consensus forecasts suggest this is likely to persist in the near term with rates currently expected to fall a further 1.65% by the end of 2025.

Eurozone

In Europe the pace of economic recovery appears to be more problematic than initially anticipated. There are two key factors to this. One is the level of government support has been more lacklustre than elsewhere in developed economies such as the US. In the face of struggling household budgets with inflationary pressures and higher interest rates, this has made a material bounce back in private sector spending more difficult to sustain. This problem is notably pronounced within Germany where growth has flatlined and government fiscal spending has been tightened, exacerbating this trend.

Another challenge has been the rising competitiveness of China in industries traditionally dominated by EU member states such as automobile exports. This has seen the trade balance widen significantly relative to the pre-pandemic era. It also promises to challenge future growth sectors such as electric vehicle (EV) production. EU members are expected to vote on a tariff plan for Chinese EVs and other exports with duties of up to 36% being contemplated¹³. Even with tariff action in place the region lacks an economic subsidy program of similar scale to support productive capacity and price competition with Chinese producers.

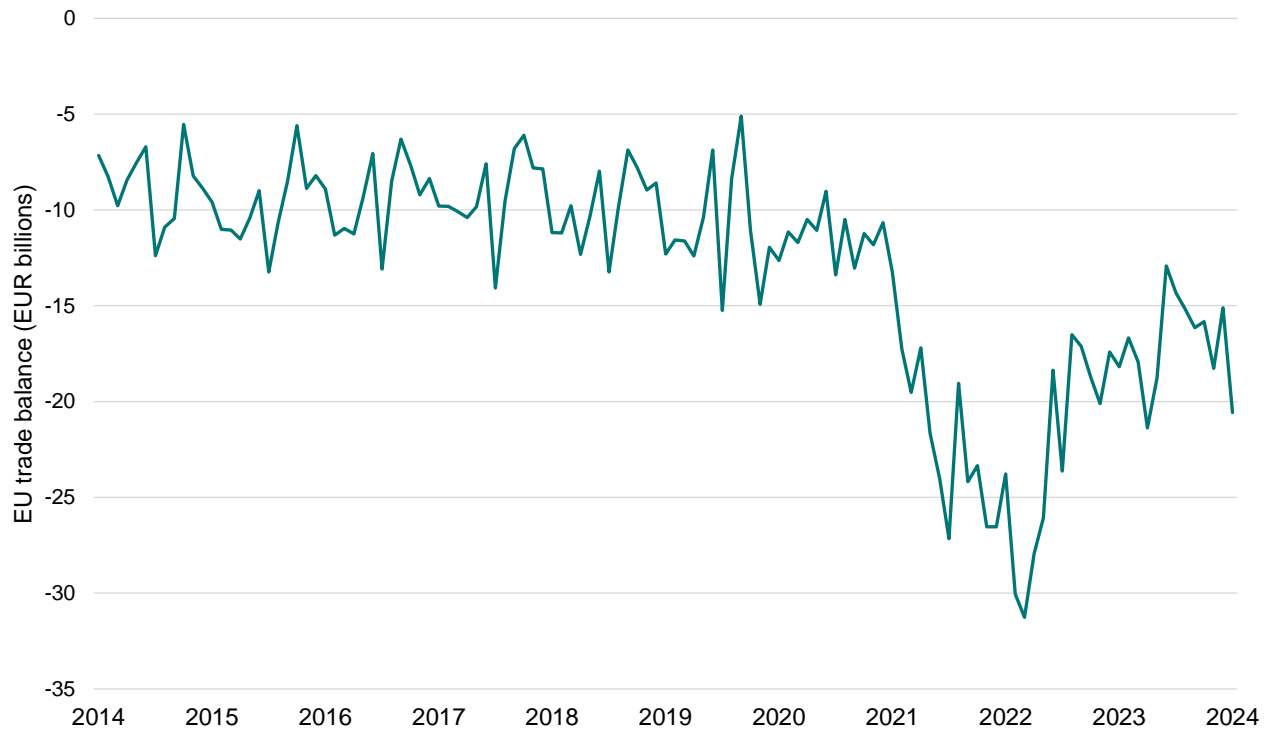
¹² Bloomberg consensus forecasts, accessed 30 September 2024.

¹³ S. Tanna, 'EU to vote on Oct 4 to finalize tariffs for China-made EVs, Bloomberg News reports', *Reuters* (28 September 2024), <https://www.reuters.com/business/autos-transportation/eu-vote-oct-4-finalize-tariffs-china-made-evs-bloomberg-news-reports-2024-09-28/>, (accessed 28 September 2024).



The Biden Administration made headlines and sparked considerable private investment with its *Inflation Reduction Act* with actual manufacturing investment of US\$89 billion, an uplift of 305% on the two years prior to its passage¹⁴. Europe lacks a similar impetus and until that becomes evident higher competition could drag on economic recovery by lowering export growth.

EU trade balance with China ex Hong Kong (€ billions, Jul-14 to Jul-24)



Source: Bloomberg

Inflation for the region is tracking lower consistent with economic weakness. Headline inflation decelerated to 2.2% for the year to August and retail sales were flat for the year to July, down 0.1%. In response to this economic weakness the European Central Bank (ECB) is moving to support the economy with further interest rate cuts. Another 0.25% cut in September took its Deposit Rate to 3.5%¹⁵, down from a recent peak of 4%. The ECB has been more reluctant than the Fed in laying out a clear easing policy with services inflation (predominantly driven by wage growth) remaining a point of concern. The bias for more cuts, however, appears intact given a still subdued economic outlook by ECB officials. Pessimism on the domestic demand front was the driver of recent downgrades on the Bank's economic forecasts¹⁶. Overall we would anticipate further gradual easing by the ECB to be a useful tailwind for the region.

In summary Europe's growth outlook has softened. The lack of near-term catalysts may also contribute to further forecast downgrades by the ECB. Rate cuts will be the leading policy tool in the near-term and act as a tailwind. We remain cautious on how effective these cuts will be. Much lower rates in the pre-pandemic era, even a negative rate experiment, failed to engender a growth uptick and these conditions may well recur without more substantial reforms in our view.

¹⁴ G. Cortés and S. Kimball, 'How the Inflation Reduction Act sparked a manufacturing and clean energy boom in the U.S.', *CNBC* (20 August 2024), <https://www.cnbc.com/2024/08/20/inflation-reduction-act-sparked-a-manufacturing-clean-energy-boom.html#:~:text=Actual%20manufacturing%20investment%20has%20totalled,sectors%2C%20according%20to%20the%20data,> (accessed 1 September 2024).

¹⁵ 'Monetary Policy Decision', *European Central Bank* (20 September 2024), <https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.mp240912~67cb23badb.en.html#:~:text=Accordingly%2C%20the%20deposit%20facility%20rate,effect%20from%2018%20September%202024,> (accessed 21 September 2024).

¹⁶ *Ibid*



China

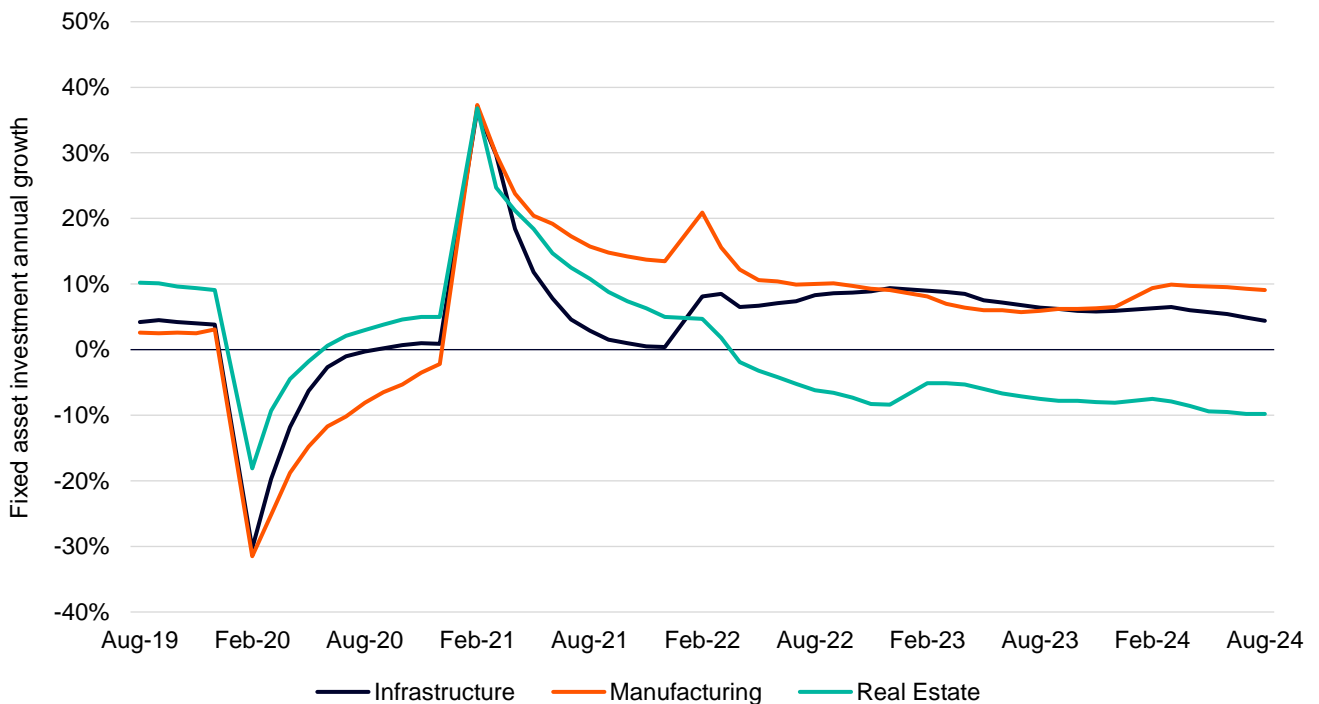
The problems in China's economy have been well documented. The collapse of giant property developers such as Evergrande sent shockwaves through its residential construction industry. Construction starts by floor area of apartments have fallen sharply. Prices are in decline as the oversupply of apartments is made clear. This in turn has meant indebted households, who can no longer count on property prices rising, have curtailed expenditure to reduce debt. The slowdown in China's growth rate has been plain to see, only countered by manufacturing overproduction.

Chinese authorities' solution to all of these challenges lies in a new series of policy announcements with the promise of more to come to "stabilise the property market". Policies announced in late September include easing lender restrictions and cutting interest rates marginally. A new facility to support buying local shares (on leverage) was also announced leading to a material rally in domestic share prices.

At face value this policy recipe appears to follow the same old formula of loosening financial conditions and increasing fixed asset investment. This would be sensible if capital costs were too high or credit hard to access. Growth in outstanding credit to non-financial corporates has moderated (6.9% over the year to March) but is far from unobtainable. The problem in China does not appear to be one resolved by making capital "cheaper" with no real signs of this being a constraint on businesses.

There remains a marked reluctance to consider policies that would support domestic consumption within China. The focus, currently, remains on building national champions in high technology sectors such as semiconductors, a more targeted approach to the country's traditional export-led focus. More traditional sectors such as infrastructure and manufacturing should benefit from the current policy stimulus as cheaper financing costs support credit growth and ultimately additional production. These sectors have been doing much of the heavy lifting in the post-pandemic period as real estate adjusts to falling out of favour.

China fixed asset investment trends by sector (Aug-19 to Aug-24)



Source: Bloomberg

The policies announced to date should, on balance, support the supply side of the economy in manufacturing and infrastructure spending and act as a tailwind towards achieving the government's 5% economic growth target. There has been heightened speculation that more might be introduced on the fiscal policy front including government payments to households. We remain cautious however. There have been several "false dawn" moments in recent years and we would need more concrete evidence to be constructive in our China outlook.



At present we anticipate a continuation of the recent slower economic growth to persist. Inflation arguably offers some of the most telling signs on this front with consumer inflation only up 0.6% for the year to August and producer prices remaining deflationary. Domestic demand by businesses and households is too weak to absorb the country's industrial capacity, hence the widening trade balance against the rest of the world. Rising tariffs pose a risk to this strategy and there are signs that this trend is extending further with recent US announcements targeting green technologies such as electric vehicles (EVs)¹⁷.

In summary while the latest speculation over Chinese stimulus may presage more concrete initiatives what has been announced remains lacklustre. The likely near-term trajectory is one of growth grinding lower coupled with subdued inflation and more of the same in focusing on export-led growth though struggling against the headwind of rising anti-China trade sentiment.

Conclusion

Policymakers globally have moved to a firm support footing led by interest rate cuts from the major central banks. This will be a tailwind for growth into 2025 and help foster activity for interest-rate sensitive sectors such as real estate. The prospect of more material fiscal stimulus out of China could be a source of additional upside. As it stands, we should likely see the current pace of weaker growth persist in the near-term with inflationary pressures also softening. Outlier events such as Middle East tensions or US port strikes may cause a resurgence in inflation that complicates this outlook and bear ongoing monitoring consequently.

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Date	2024e	2025e
Growth (GDP)	3.00%	Jun-24	2.6%	1.8%
Inflation	2.50%	Aug-24	2.9%	2.2%
Interest rates	4.87%	Sep-24	4.5%	3.4%
Unemployment rate	4.20%	Aug-24	4.1%	4.4%
Composite PMI	54.4	Sep-24		

Eurozone

Economic snapshot	Last reported result	Date	2024e	2025e
Growth (GDP)	0.60%	Jun-24	0.7%	1.3%
Inflation	2.20%	Aug-24	2.4%	2.1%
Interest rates	3.50%	Sep-24	3.4%	2.5%
Unemployment rate	6.40%	Jul-24	6.5%	6.6%
Composite PMI	48.9	Sep-24		

¹⁷ J. Jett and J. Wu, 'Biden's new tariffs on China are mostly symbolic. Here's why', *NBC News* (27 September 2024), <https://www.nbcnews.com/news/world/china-tariffs-biden-symbolic-industrial-overcapacity-rcna172215>, (accessed 28 September 2024).



China

Economic snapshot	Last reported result	Date	2024e	2025e
Growth (GDP)	4.70%	Jun-24	4.8%	4.5%
Inflation	0.60%	Aug-24	0.5%	1.4%
Interest rates	1.56%	Sep-24	1.9%	1.6%
Unemployment rate	5.30%	Aug-24	5.2%	5.1%
Composite PMI	50.3	Sep-24		

Japan

Economic snapshot	Last reported result	Date	2024e	2025e
Growth (GDP)	-1.00%	Jun-24	0.0%	1.2%
Inflation	3.00%	Aug-24	2.5%	2.0%
Interest rates	0.25%	Sep-24	0.3%	0.7%
Unemployment rate	2.57%	Jun-24	2.5%	2.5%
Composite PMI	52.5	Sep-24		

Source: Bloomberg.

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Australian equities

Overview

The Australian market performed strongly in the three months to 30 September, rising 7.8%. For the year to 30 September the market rose 21.8%. This continued to be driven by strength in the banking sector up 40.2% for the year to September while the resource sector only rose 11% over the same period.

S&P/ASX 200 total return (Sep-23 to Sep-24)



Source: Bloomberg

Outlook

Recommendation: *Remain underweight.*

The Australian market has continued performing strongly into the September quarter. We are increasingly concerned however at the extent to which prices have outpaced fundamentals. Earnings growth expectations have been progressively revised downwards over the course of 2024. We believe a meaningful period of stronger-than-expected earnings expansion is required to justify prices at current levels and it is difficult to see substantial catalysts at present. In addition, the RBA remains restrictive in its monetary policy setting which will keep financing costs elevated in the near term domestically and be a headwind to corporate profitability.

On the positive side the prospect of more meaningful stimulus in China should be a net win for our commodity sector as higher credit activity typically leads to more demand for iron ore and other resources. The labour market remains resilient despite weakening over the course of the year with unemployment still well below pre-pandemic levels. This is a tailwind to the banking sector as it should reduce loan impairments on their residential lending. These factors support modest earnings growth but not the more robust expectations currently factored in by the market.

Accordingly while we see some cause for optimism, we believe current valuations are excessive and on balance we believe it is prudent to remain underweight.



Table 1: S&P/ASX 200 valuation metrics as at 30 September 2024

Metric	Latest	Long-term average	Price move to revert to long-term average
1-year Forward P/E ratio	18.1x	14.3x	-20.9%
Average 2 and 3-year forward P/E ratio	16.8x	13.2x	-21.2%
1-year Forward Dividend Yield	3.5%	4.6%	-23.7%
1-year Forward Price to Cashflow ratio	14.2x	10.0x	-30.0%
Price to Book ratio	2.4x	2.1x	-11.2%

Source: Bloomberg.

NB: Dividend Yield price move calculated after converting yield into Price to Dividend ratios.

Sector view

The major Australian sectors have seen valuations become even more stretched over the past quarter. Only the resources names sit near to their long-term average following a sizeable drop in the price of iron ore as well as broader commodity price weakness. Elsewhere, even after allowing for sector heavyweights such as Goodman Group, we are seeing increased risks emerge where optimism over near-term fortunes has become excessive. The major banks are the clearest example but the bullish sentiment has continued to spread elsewhere, even though earnings expectations by contrast remaining subdued.

The market excluding resources now trades almost 30% over its longer-term average suggesting sizeable downside in the near-term unless we see a material improvement in earnings growth.

Forward P/E ratio for Australian market decomposed by sector (May-05 to Sep-24)



Source: Bloomberg, PPWM calculations

The degree of investor exuberance across the board is clear when drilling down to individual sectors as highlighted below with most trading well above their long-term average valuations.



Table 2: S&P/ASX 200 Sector Forward Price-Earnings Ratios as at 30 September 2024

Sector	Forward PE Ratio	Long-term average	Price move to revert to long-term average
Banks	17.8x	12.5x	-29.4%
Resources	14.1x	12.6x	-10.2%
Retail	23.6x	16.7x	-29.3%
A-REITs	19.2x	14.4x	-24.9%
A-REITs excluding GMG	15.5x	13.9x	-10.0%

Source: Bloomberg

Banks

Recommendation: *Retain underweight position.*

The outlook for bank sector returns appears poor. Valuation is the key concern with the entire sector trading at or near record valuations from a forward Price-to-Earnings (P/E) ratio perspective. It might appear that the space has acted as a safe haven for investors concerned about weak commodity prices¹⁸ but even if so, prices have far outpaced any fundamental improvement in these businesses. We struggle to identify the growth that would warrant current valuations. Even dividend support appears limited with the sector trading at historic lows on a forward dividend yield basis.

Australian bank sector forward dividend yield (Jun-05 to Sep-24)



Source: Bloomberg

On the positive side Australian borrowers have remained resilient in the current high-rate environment. This has reduced loan impairments on bank asset books which remain below pre-pandemic levels. In particular, residential mortgage lending has outperformed with below-average arrears due to strong employment growth.

¹⁸ A. Macdonald, 'Did China fire the bazooka to stop the big bank run?', *Australian Financial Review* (24 September 2024), <https://www.afr.com/chanticleer/did-china-fire-the-bazooka-to-stop-the-big-bank-run-20240924-p5kcyh>, (accessed 25 September 2024).



The challenge though remains the muted outlook for growing profits. We can see this in the current consensus figures with sector earnings expected to be flat to negative over the next few years and likewise for dividend growth. This is because net interest margins are not expected to expand meaningfully and cost savings are unlikely to be overly significant.

In conclusion as valuations remain near record highs and the outlook for earnings growth remains muted, the risk of bank stocks derating over the next 12 months is elevated in our view and accordingly we remain underweight.

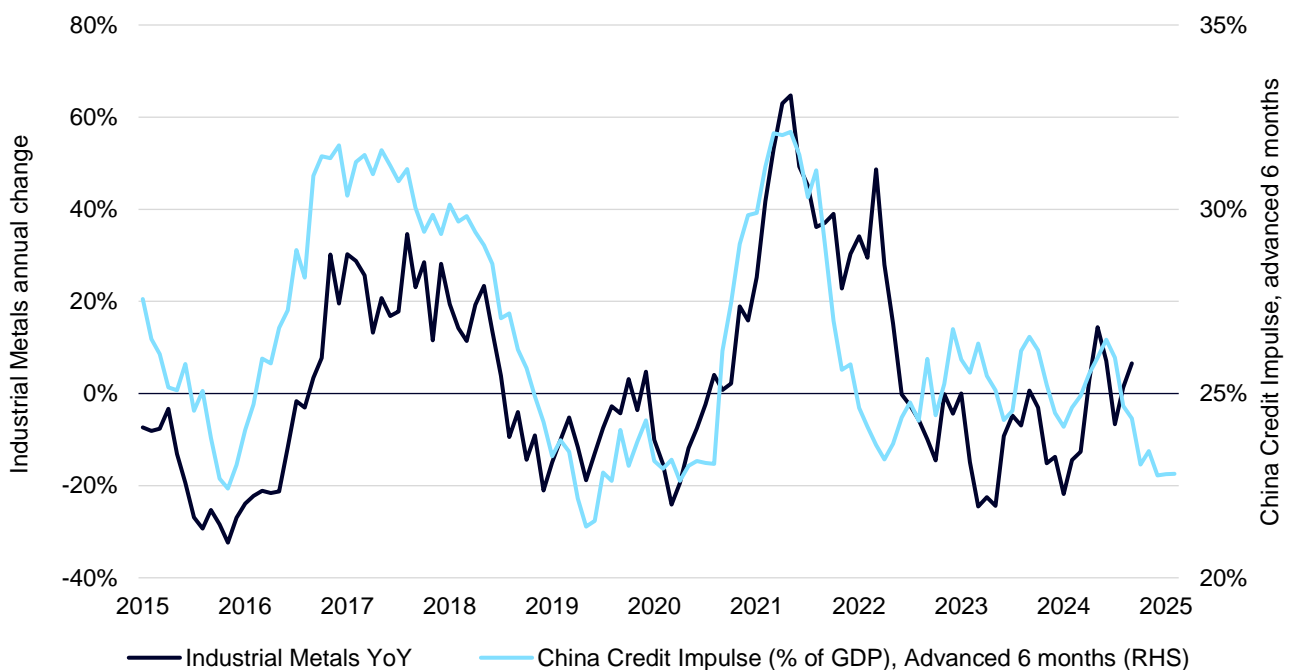
Resources

Recommendation: *Maintain underweight.*

Mining stocks continue to face a troubled outlook but with some potential cause for optimism. On the negative front, key commodity iron ore, has seen spot prices decline over 22% over the past year. The recent rally in the Australian dollar which has risen 6.3% over the same period compounds this challenge as it reduces the Australian dollar value of miner profits and ultimately the dividends that can be distributed to shareholders.

The near-term pressures on iron ore pricing appear intact at first glance. Investment in the Chinese property sector continues to weaken with overall floorspace under construction falling 12% over the year to August. In addition the credit impulse, a leading indicator for metals prices, has softened over the past year which would ordinarily suggest weaker credit growth, less demand for resource materials and consequently lower prices.

Industrial metals price growth versus Chinese credit impulse (2015-2025)



Source: Bloomberg.

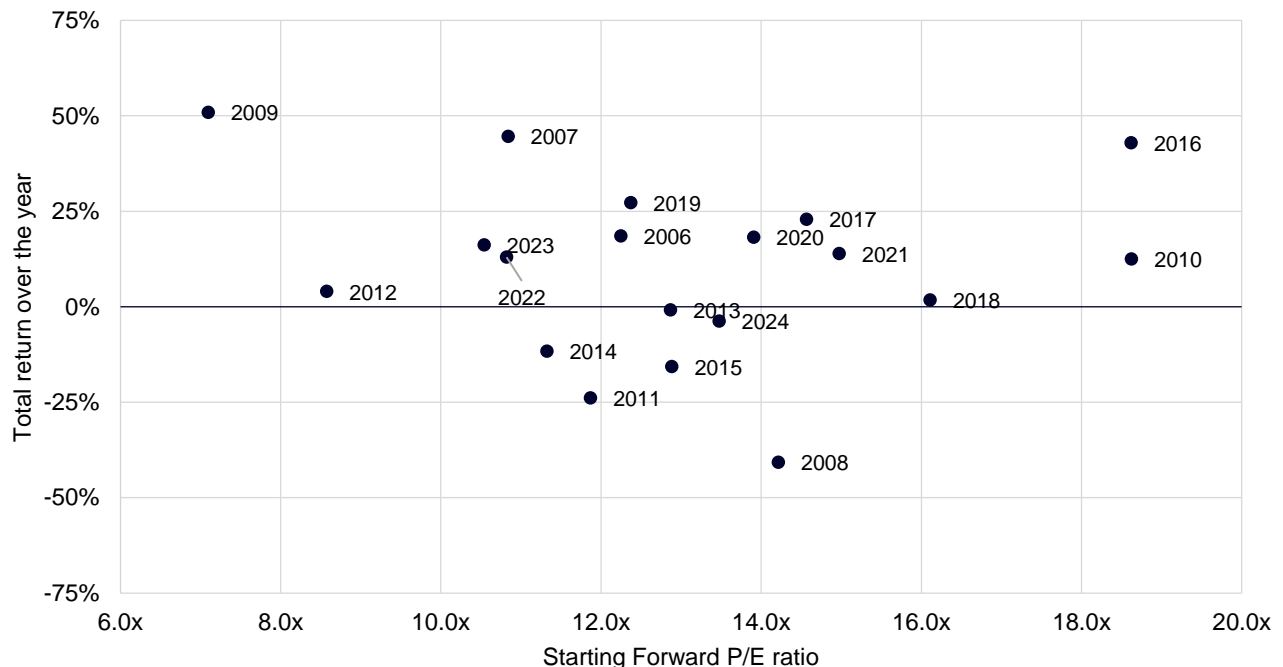
The counterpoint however lies in recent policy announcements by Chinese authorities that are geared towards encouraging credit growth. These include cuts to reserve ratios (how much capital Chinese banks are required to retain against their loans) as well as key central bank lending rates. There is increased speculation that further initiatives may be underway including a possible government spending package¹⁹. If true this would present a meaningful shift in policy stance and scale, both steps Chinese authorities have been reluctant to pursue. Given many “false dawn” moments in recent years we would need to see more concrete signs before forming a constructive view on earnings growth.

¹⁹ A. Gluyas, ‘China pledges more stimulus, driving asset prices higher’, *Australian Financial Review* (26 September 2024), <https://www.afr.com/markets/commodities/cba-says-another-wave-of-china-stimulus-is-imminent-20240926-p5kdng>, (accessed 26 September 2024).



Finally at a current forward P/E of ~14x, valuation is not providing a clear support as these levels have seen mining stocks still perform poorly over the next year as shown below examining history since 2005. For example a forward Starting P/E of 18.6x at the start of 2016 presaged a total return of 43% over the year while in 2012 a ~9x P/E preceded a total return of a mere 4%. Since commodity prices can be so inherently volatile it is difficult for valuations to be overly informative.

Starting Forward P/E ratio versus total return over next year (2005-2023)



Source: Bloomberg; Note 2024 return reflects first 9 months of the year.

Accordingly while we acknowledge the rally to end the September quarter we feel more fundamental support is required before a more robust outlook can be sustained. Downside in the short-run still appears the likelier course in our view and hence we retain our underweight positioning.

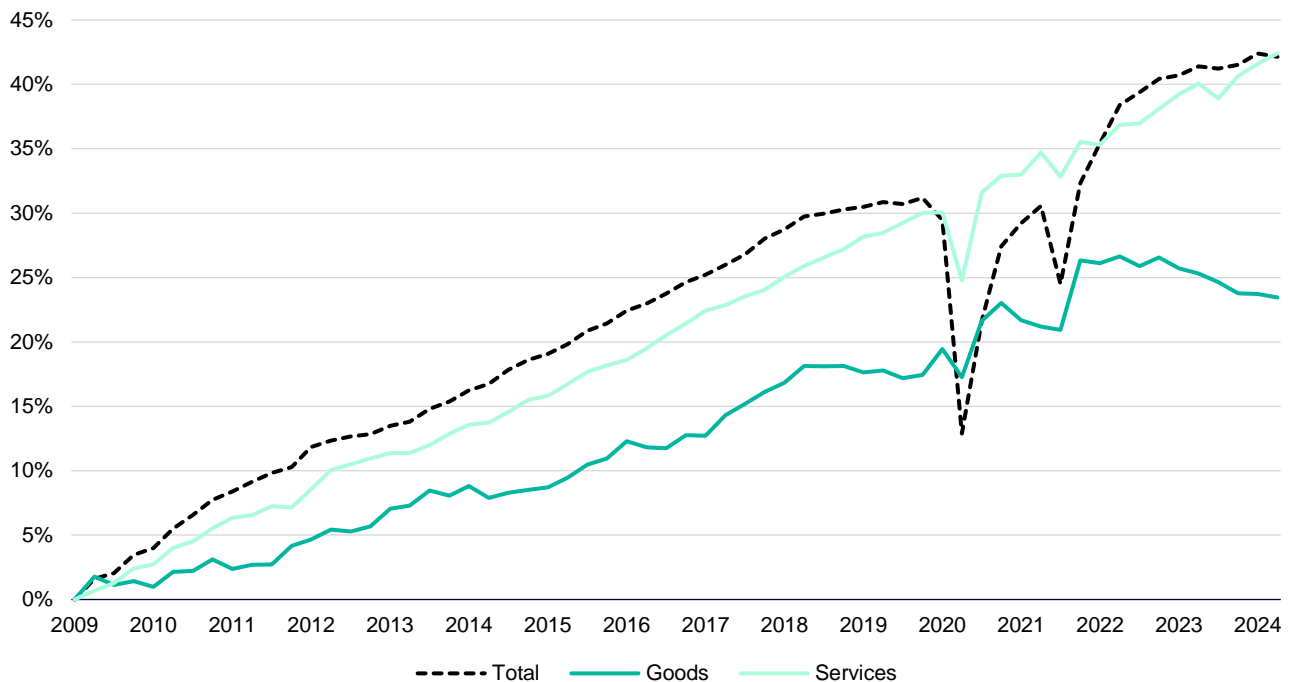
Retail

Recommendation: *Retain underweight position.*

In retail names the consumer clearly remains pressured. Not only has per-capita GDP been in decline over the past year but we have seen a commensurate drop in volumes as households struggle with keeping up with higher prices as companies rely on the pricing lever to maintain margins. In addition, the pivot to spending on “experiences” (e.g. recreation or travel) following the pandemic period remains well intact.



Cumulative growth in real household spending by type (Mar-09 to Jun-24)



Source: ABS, PPWM calculations

Exuberance over potential interest rate cuts, coupled with better-than-expected results in the FY24 reporting season, has seen valuations rise materially. This backdrop suggests sizeable downside for the sector if valuations revert back to their long-term average which would see a decline of ~20% from current prices.

There are cases where individual companies have clearly gotten stronger over this period by leveraging their scale to grow market share. JB Hi-Fi is one example with the company trading to a record high valuation last seen prior to the global financial crisis where it was a much smaller, faster growing business. This ability to grow share has helped offset a sector that has otherwise experienced declining volumes.

The other factor supporting the sector has been record levels of population growth in recent years. The overall pool of demand has grown even if individual households have struggled. This has been an important tailwind supporting the total quantity of goods sold. It may pose a headwind in the near term however when the government's mooted caps take effect²⁰ in FY25.

In summary, while retail stocks have fared better than expected in FY24 reporting we continue to see near-term challenges for the sector. Valuations are trading at extreme levels relative to the potential issues posed by weaker net migration as well as subdued household spending. Given these factors the probability of underperformance is high and we therefore retain our underweight positioning.

Australian Real Estate Investment Trusts (AREITs)

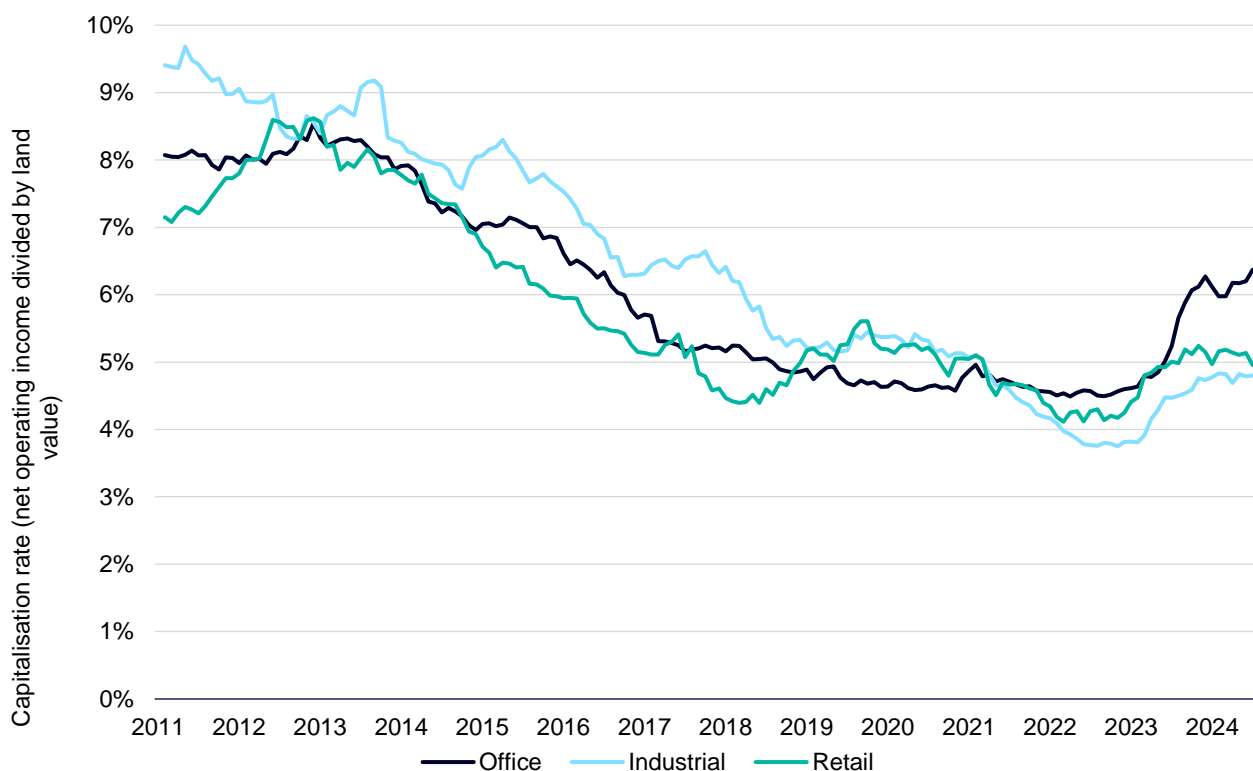
Recommendation: *Maintain neutral*

The listed property sector is showing signs of stabilisation. Capitalisation rates (the rental yield paid on the real estate) have been largely steady in recent months as transaction activity improves, supporting current valuations.

²⁰ "Migration Program Planning Levels", Department of Home Affairs, 23 September 2024: <https://immi.homeaffairs.gov.au/what-we-do/migration-program-planning-levels#:~:text=2024%E2%80%9320permanent%20Migration%20Program%20planning%20levels,the%20Skill%20and%20Family%20streams.>



REIT sector cap rates (Mar-11 to Aug-24)



Source: Bloomberg

In the office sector we are still seeing signs of weakness. Like-for-like income at Dexu for example rose 2.5% for the year on an underlying basis²¹ with incentives (inducements to attract new tenants) anticipated to stay elevated in the near term. Higher quality office assets continue to see a migration of new tenants from inferior sites. The prospect of easing financial conditions if rate cuts commence in late FY25 should stabilise asset valuations and provide a tailwind to share prices.

In the industrial space, we are seeing a meaningful split emerge between traditional exposures e.g. logistics, warehouses and “New Economy” use cases such as data centres. Goodman Group has a foot in both camps. Data centres now account for 40% of work in progress for new developments with additional approvals for new sites being anticipated in FY25²². In logistics we are seeing some signs of softening after an extremely strong run up in recent years. This has contributed to a fall in asset valuations albeit substantially more modest than the office experience. Overall the case for industrial exposure remains intact with elevated demand conditions and limited, new supply underpinning strong rental growth versus other sectors and expected to persist in the near term.

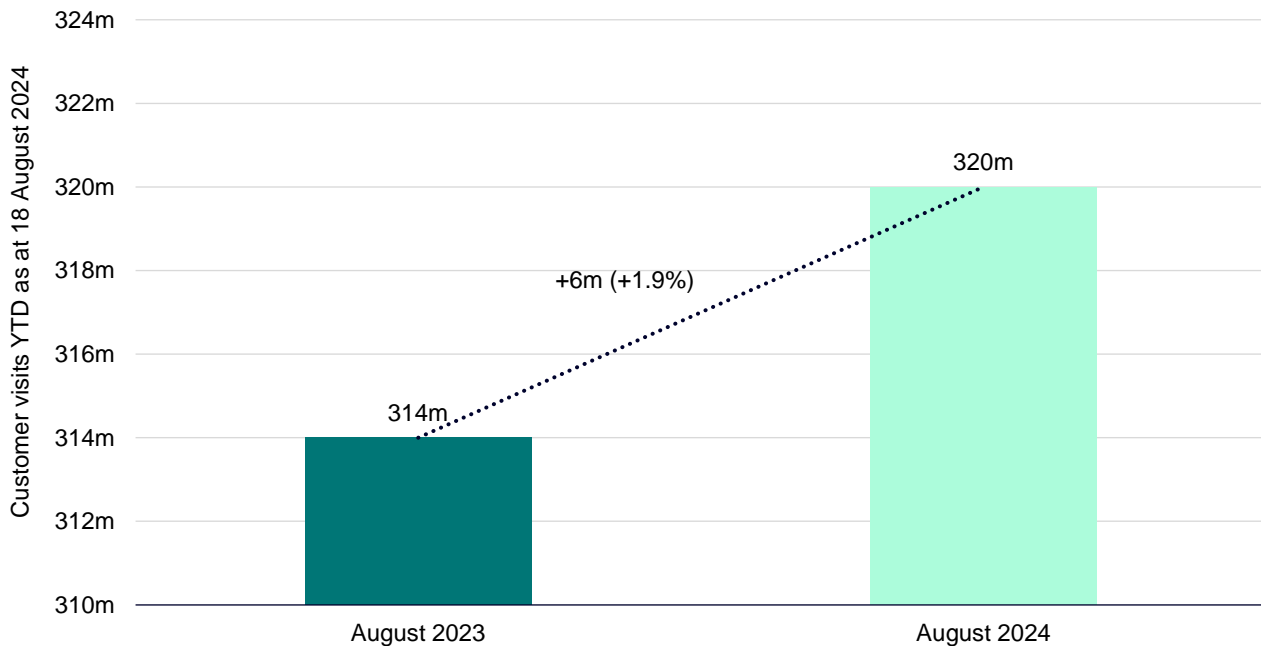
Finally in retail property bifurcation trends are also evident. Stronger performance from wealthier consumers has helped support “trophy” sites such as Scentre Group’s Westfield shopping centres relative to more incidental, discretionary retail. Resilience in customer visits have helped make these sites more a combination of both goods and services sales with the focus on creating attractive “experiences” paying dividends for tenants. Examples include the Olympics, live concerts and partnerships with popular brands such as Disney.

²¹ “FY24 Annual Results Press Release”, Dexu, 20 August 2024: https://data-api.marketindex.com.au/api/v1/announcements/XASX:DXS:2A1541795/pdf/inline/2024-annual-results-release?_gl=1*1td8d95*_ga*Mjq2MDEzODE1LjE3Mjc0MDEyMDI.*_ga_R504V9JPBH*MTcyNzYxNzkxMC40LjEuMTcyNzYxODIyOC40Ni4wLjA.

²² “FY24 Annual Results Press Release”, Goodman Group, 15 August 2024: https://data-api.marketindex.com.au/api/v1/announcements/XASX:GMG:2A1541007/pdf/inline/goodman-30-june-2024-full-year-results?_gl=1*1qlq4q9*_ga*NzI3MzQwNTk2LjE3Mjc0MDEyMDI.*_ga_R504V9JPBH*MTcyNzYxNzkxMC40LjEuMTcyNzYxODIyOC40Ni4wLjA.



Scentre Group YTD customer visitations (Aug-23 vs Aug-24)



Source: Scentre Group HY24 Investor Presentation

Meanwhile, Viva Energy, operator for Coles Express and other convenience sites has flagged cost-of-living pressures as a drag on performance²³ particularly in lower socio-economic segments. More defensive “essential” retailer locations typically tenanted by one of the major supermarket chains have also seen resilient performance as discretionary tenant performance diverges amid weaker retail sales.

Finally overall sector valuations have become more stretched after elevated share price performance in the quarter. This has been in response to easing financial conditions with long-term bond yields declining in response to rate cuts globally as fixed rate assets become more attractive options. Looking at the sector outside of Goodman Group which trades more as an operating business rather than a “pure play” REIT, we find valuations are more expensive but not yet excessive relative to other sectors suggesting a headwind rather than major impairment to future returns.

In summary, we see signs of resilient performance particularly amongst leading REIT operators that is supportive of underlying earnings and distribution growth over the medium term. Valuations have become more stretched following the quarter’s ~14% return but looking through the Goodman figures we believe these are not unreasonable. We see sufficient cause for optimism to maintain a neutral stance on the sector. More is needed on the interest rate outlook to justify an outright overweight posture with the exact timing of RBA rate cuts still difficult to anticipate given labour market resilience.

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²³ “HY24 Results Release”, Viva Energy, 26 August 2024: https://data-api.marketindex.com.au/api/v1/announcements/XASX:VEA:3A648697/pdf/inline/viva-energy-results-half-year-ended-30-june-2024?_gl=1*tbym7i*_ga*NjU1NTk4OTM2LjE3Mjc3MDk4NTI.*_ga_R504V9JPBH*MTcyNzcwOTg1MS4xLjEuMTcyNzcwOTg2My40OC4wLjA



International equities

Overview

Global share markets rose 2.3% in the three months to 30 September and were up 23.2% for the year to 30 September. A rising Australian Dollar was a tailwind in the September quarter of 2.1% and 6.1% for the year to September with the hedged benchmark rising 29.3% by contrast.

MSCI World ex Australia net total return index (Sep-23 to Sep-24)



Source: Bloomberg

Outlook

Recommendation: *Downgrade to underweight.*

Global markets continue to surpass expectations with a meaningful acceleration in earnings growth anticipated from 5.2% in 2024 to 10.5% p.a. over 2025 and 2026. The key driver has been the anticipation of continued spending on artificial intelligence initiatives with technology stocks leading the market in growth expectations.

In the September quarter the prospect of easing interest rates helped stoke a rotation in sector leadership with previously out-of-favour niches such as real estate outperforming the broader market. Interest rate cuts can be a potent tailwind by lowering financial costs for companies, a major benefit for more leveraged segments such as real estate. They can, also, be a signal where the reason for the cuts is genuine “bad news” for corporate earnings. This is not yet the obvious case for the US where a concerning upward trend in unemployment must be balanced against resilient signs of growth. This is exemplified by wages growing above the pre-pandemic rate²⁴ as well as US economic growth which rose at an enviable 3.1%²⁵ for the year to June, well ahead of most developed economy peers.

The exuberant forecasts by investors have underpinned strong equity returns over the past year and seen valuations continue to stretch further. Higher valuations in themselves are not always a useful timing signal as equity markets can still run further due to strong profit growth or excessive investor exuberance as occurred in the Dot Com Bubble. That being said, the balance of risks today is skewed to the downside. To not believe so requires a narrative that US equities in particular will trade at a higher valuation than history on a permanent basis.

²⁴ “Wage Growth Tracker”, *Atlanta Fed*, 13 September 2024: <https://www.atlantafed.org/chcs/wage-growth-tracker>

²⁵ “US gross domestic product”, *Bureau of Economic Analysis*, 26 September 2024: <https://www.bea.gov/data/gdp/gross-domestic-product>



In conclusion, already expensive stocks have largely become more expensive over the quarter. While easing interest rates are a potential tailwind and economic data is mostly positive, we feel valuations have become overly exuberant. Consequently we shift to an underweight stance with risks now tilted to the downside.

Valuations

The US continues to lead in global equities now accounting for almost 73% of the value in developed markets²⁶, and, even after including emerging markets it still represents most of global market value at 65.5%²⁷. Looking forward, the US has become further overvalued relative to a longer-term average multiple of 17x. On a near term basis this implies a fall of almost 28% to get back to fair value and even looking further out to 2026, a decline of almost 10% would be necessary.

This view must, however, be measured against the potential for higher growth with almost 12% p.a. expected from 2024 to 2026. The growth outlook is dominated by major tech companies including Nvidia as well as online advertising names, Alphabet and Meta which are expected to benefit from accelerating demand for artificial intelligence, cloud computing and more.

Table 4: S&P 500 fair value estimate ranges (2024-2026)

2024 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = 5460
Consensus	242.4	4120.8	-27.9%
If 10% below	218.2	3708.7	-35.1%
If 10% above	266.6	4532.9	-20.7%
2025 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = 5460
Consensus	275.7	4687.1	-18.0%
If 10% below	248.1	4218.4	-26.2%
If 10% above	303.3	5155.8	-9.8%
2026 calendar year forecast	EPS earnings estimates (US\$)	S&P 500 fair value estimate	Upside/(downside) S&P 500 = 5460
Consensus	303.0	5150.5	-9.9%
If 10% below	272.7	4635.4	-18.9%
If 10% above	333.3	5665.5	-0.9%

Source: Bloomberg, PPWM calculations.

The expensive valuation backdrop in the US is not as widely echoed in other markets. Australia is a notable exception discussed in more detail above. Meanwhile other major markets only trade at slight premiums or even discounts to their 15-year average. The All-Country World Index (excluding the US) which includes both developed and emerging market countries is only trading at a 5.6% premium for instance. The risk-return backdrop is skewed more favourably in these markets towards attractive forward returns and suggests, on a relative value basis, potentially tilting away from the US towards other geographies.

²⁶ MSCI World ex Australia Index (USD), MSCI, 31 August 2024: <https://www.msci.com/documents/10199/49479550-e805-4895-ba73-2893b1f3d60b>

²⁷ MSCI ACWI ex Australia Index (AUD), MSCI, 31 August 2024: <https://www.msci.com/documents/10199/0f8162fc-490b-4a00-9f1b-61d6e33cbd75>



Table 5: Major share market forward P/E ratios (spot versus 15-year average)

Region	Forward P/E	15-year Average Forward P/E	Potential upside/downside
All Country World (ex-US)	13.3x	12.6x	-5.2%
Australia	17.9x	14.6x	-18.1%
Europe	13.6x	12.8x	-6.3%
Emerging markets	11.7x	11.0x	-6.3%
Japan	14.5x	14.0x	-3.4%
UK	11.8x	12.1x	+2.6%
China	9.1x	10.4x	+14.8%

Source: Bloomberg.

Conclusion

Recommendation: *Downgrade to underweight.*

Unlike the Australian market we still see pockets of value in global equities particularly outside the US. That view must be weighed against the reality that the fortunes of the US market will determine the likely path for international stocks. It is there we believe that valuations have become too stretched against historical norms and a backdrop of global uncertainty. The addition of falling interest rates may be a tailwind in the near term but must be balanced against the growing concern of underlying economic weakness in the US labour market for instance. We believe the risk of disappointing lofty investor expectations is currently heightened and warrants more defensive posturing. Consequently, we choose to reduce our exposure by taking an underweight stance to global equity markets.

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