ESCALA PARTNERS

AGENDA 2025

Chief Investment Office

Welcome

Pep Perry
Co-Chief Executive Officer

Torty Howard
Co-Chief Executive Officer

Welcome to the sixth edition of our annual investment publication, Agenda 2025. This document is compiled by our investment team headed by our Chief Investment Officer, Tracey McNaughton.

We have noted previously the futility of writing an annual outlook given its short-term focus and the inherent uncertainty that is always and forever present. In the words of Bob Dylan “there is nothing so stable as change”. Instead, think of this work as an update on the map that will guide you to your investment outcome. We offer signposts to watch out for along the way that may affect your perspective.

2024 was the year of elections. Three billion people turned out from more than 70 countries to vote in national elections last year, making it the most significant year for democracy ever. In our mind, the most important takeaway was the fact that 80% of these elections saw the incumbent party lose vote share. If 2024 was a litmus test on the effectiveness of our political leaders, they fell short.

The maxim “politics don’t drive markets; markets drive markets” generally holds true. This year is different. The vote against the incumbents was a vote for change. Change is what we will get this year with the US at its epicenter. The key election issues in 2024 will feature heavily in this change - immigration, trade, foreign policy, inflation, industrial policy, and security.

The election result in the US was unequivocal for the Republicans. The president-elect has a clear mandate. Immigration, taxes, trade, industrial policy, regulation and energy are all high on the list of Trump ‘to-dos’. Some will be investor friendly. Some will be socially, diplomatically and environmentally unfriendly.

A similar swing to the right was felt in Europe but the mandate for change there is less clear. Uncertainty will feature as a result. A reluctance by the more centrist parties to form a government with the right-leaning populist parties will at best result in policy paralysis. At worst, it will weaken the foundations of the European Union. This doesn’t mean opportunities won’t be present, but they will need to be appropriately priced. European assets could get cheaper in 2025.

How should investors respond to what will likely be a noisy year for financial markets?

Now, more than ever, it is important for investors to have their strategy set and investment plan in place. An eye to the end goal, discipline around risk management and clearly defined guardrails will help keep the political distractions to a minimum.

For our investment team, 2025 will be about focusing on the data and keeping to our proven investment process. Process gives us the space to be comfortable with uncertainty.

We hope you enjoy Agenda 2025 and look forward to engaging in meaningful conversations with you in the days, weeks and months ahead.

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Our Views in Short

Global Growth

Slightly weaker global growth in 2025 will mask large differences as trade tensions and geopolitical risks affect countries in unique ways. The US will lead the way for the developed world while robust growth in India will see South Asia be the fastest growing region.

Inflation

Since peaking in 2022, world inflation has fallen significantly. Further declines are expected but progress will be hampered by a more introverted world where the efficient flow of goods, capital and labour is impeded and where multiple supply chains are built in the name of national security.

Interest Rates

Inflation has peaked and the easing cycle has begun but the prospect of trade restrictions and tighter immigration policy will give central bankers pause for thought before cutting interest rates further.

Fiscal Policy

It is likely the US will lose its last remaining triple-A credit rating in 2025. The size of the federal debt has risen above the size of the economy, reaching a level last seen during World War II. The US is not alone. Political fragmentation is making it harder for politicians to see eye-to-eye on fiscal matters globally.

Bond Yields

Having tamed runaway inflation, most central banks are now aligned in cutting rates. But as we saw in 2024, that doesn't mean smooth sailing. Acute geopolitical uncertainty and structural demands on the public purse mean bond yields will remain elevated.

Equities

Follow the money – invest where governments are spending, companies are investing, and consumers are buying. The US is the clearest and most obvious destination for investors' capital in 2025. A moribund, ageing and over-regulated Europe provides little alternative while Japan is longer-term structurally positive.

Currencies

The U.S. dollar is expected to face upward pressure from tariffs, the strength of the U.S. economy, geopolitical uncertainty and a central bank faced with more inflation pressure than most others.

Alternatives

Investors can benefit from broadening portfolios into private markets. This is particularly evident in the AI theme, where the private sector now makes up over a quarter of all deals and more than a third of all capital raised.

Introverted

Tracey McNaughton
Chief Investment Officer

The election of Donald Trump has put the global economy on a firmer path to higher barriers to trade, weaker global alliances, and stronger nationalistic tendencies. Conflict is going up and cooperation is going down. In this sense, the world is becoming more introverted and anxious.

The shift has been driven by several factors. Decades of free-trade orthodoxy have frayed the collars (and incomes) of the working class. Years of open borders have strained infrastructure and created housing shortages and job insecurity.
Wars on multiple continents have called into question Washington's leadership in world affairs and made energy less affordable for hundreds of millions of people.

A shift to a more introverted world economy will not be done quietly or cheaply. The world is inextricably connected. Trade makes up 58% of global GDP. About 40% of the revenues generated by the largest companies in the US come from overseas. Despite being just 5% of the global labour supply, foreign-born workers are about 20% of the US labour force. The shift inward will be bumpy.

58%

The share of global GDP made up by trade between countries.

WTO

What does it mean to be in a more introverted world?

a. A riskier world

Alliances will be tested. Trump's America First instinct is already making allies of the US feel more anxious about the durability and strength of their relationship – a relationship that has been a defining feature of the global order since World War II. Threats to take over Greenland and the Panama Canal and make Canada the 51st state of America haven't helped.

Global cooperation is under pressure. Governments are becoming more concerned with national interests and less focused on international issues such as security and climate change. An introverted world sees countries pursuing narrow self-interests rather than coordinated responses to global challenges. Multilateral political organisations such as the UN, NATO, G20, the United Nations Security Council and even the European Union are under threat. Data from the World Economic Forum shows global cooperation levels have stagnated since 2020.

National cooperation is also under pressure. Increased political fragmentation has seen a rise in coalition and minority governments. In the 1980 Australian federal election, the combined primary votes for minor parties and independents accounted for just 8%. By 2022, it had increased to 32%, the highest ever recorded. This trend is not limited to Australia. The rise of coalition and minority governments is a global trend. The depletion of political capital that comes with this makes reform harder. And reform is desperately needed, especially on the fiscal front. According to the IMF over 3 billion people are living in countries that spend more on debt interest than on education or health.

3 billion

The number of people living in countries that spend more on debt interest than on education or health.

IMF

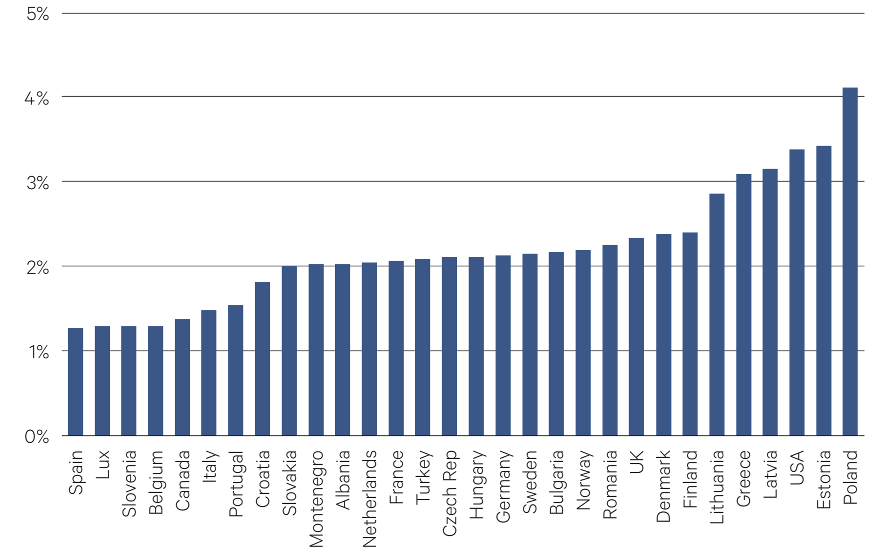
b. A more expensive world

A more introverted world is also a more expensive world.

Political fragmentation and the pursuit of national interests tends to lead to conflict. Global conflict has reached its highest level since World War II. Russia's invasion of Ukraine is approaching the three-year mark and there are ongoing conflicts in the Middle East and in Sudan. In total, there are currently 56 active conflicts worldwide. This requires more spending on defence.

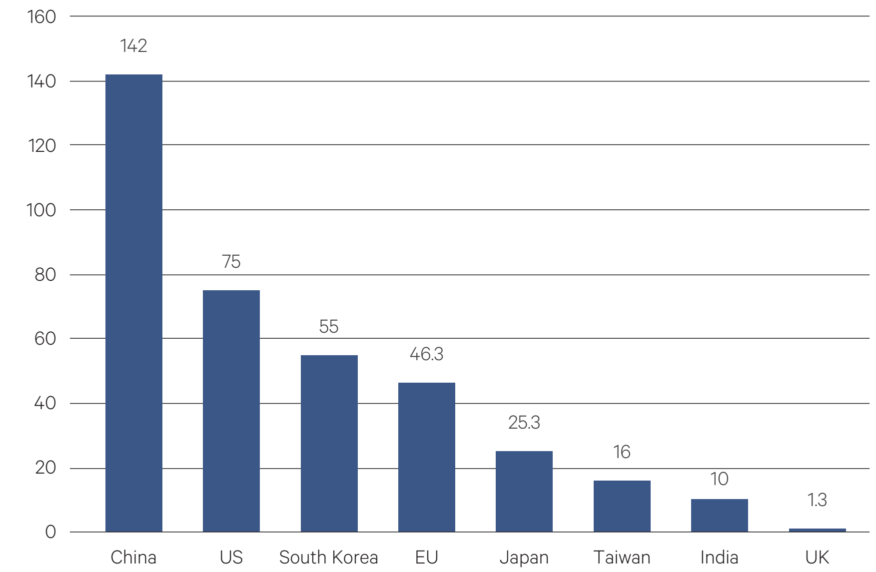
President-elect Trump's threat to withhold support from any NATO country not meeting its defence spending target, along with his skepticism about stationing U.S. forces abroad, will further intensify the pressure on defence budgets. Introversion also leads to trade protectionism and the redesign of global supply chains. Redesigning or duplicating supply chains is expensive. The U.S. government is spending over $1.6 trillion in loans, grants and subsidies to attract business to the US via its CHIPS and Infrastructure Act. China has allocated $142 billion to support the domestic semiconductor industry. The European Chips Act will cost the public purse $46 billion.

Defence expenditure (% of GDP)



Source: North Atlantic Treaty Organisation

Government support for the semiconductor industry (US$ billion)



Source: Bloomberg, data as at 31/12/24

Introverted (contd.)

Who wins in a more introverted world?

a. Diversification

Where once a rising tide lifted all boats, now each boat, faced with its own nationalistic challenges, must navigate its own way through a course of unpredictable seas. Sovereign risk will therefore need to be priced individually, rather than collectively. Investors will need to be more discerning in their choice of where to invest. Regions will need to be broken down into country-specific opportunities.

Economic divergence and country-specific factors will create a varied landscape of opportunities. This is a positive for investors. The more levers to pull, the more opportunities to diversify risk.

> *The more levers to pull, the more opportunities to diversify risk.*

b. Active investment management

The decline in long-term interest rates over the past 30 years or so was an environment where passive investing flourished. Lower interest rates meant lower returns meant investors needed to have a razor-sharp focus on the cost of investing. Ultimately, this trend has left around a third of the US equity market being owned by cost conscious passive investors.

A more introverted world will see a reversal of this trend. Interest rates will be higher as investors demand compensation for deploying capital into a more unsettled, unpredictable environment. A higher interest rate environment, once valuations have adjusted, will be conducive to higher longer-term returns because the starting point, the cash rate, will be higher. Investors will shift to focusing less on the cost of investing and more on risk mitigation and the broader set of return opportunities that comes with active management.

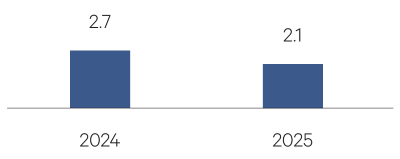
There is no doubt, the introverted world is a riskier world – less unity, less cohesion, more room for missteps. With risk, though, comes opportunity. The declining rate environment of the past few decades forced investors to crowd into cheap passive strategies. A return to a higher rate environment will reward investors for their selection of stocks based on company fundamentals rather than just membership in a passive index.

Global Economy Breakdown

United States

The Trump administration's policies will mostly be supportive of the economy and financial markets. Tax reforms and deregulation are likely to stimulate growth, particularly in domestic and cyclical sectors such as financials. This will be offset slightly by tariffs and immigration restrictions pressuring inflation.

GDP %



Europe

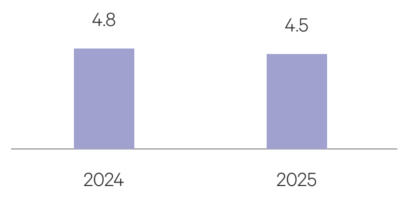
Trade policy uncertainty, a weak China, and political turmoil among the core members will weigh heavily on Europe. The European Central Bank (ECB) is likely to cut its deposit rate further to offset the tariff impact and the continued stagnation of the German economy.

GDP %

China

China faces headwinds from the property market collapse, excess debt, and U.S. trade restrictions. The policy response continues to be reactionary and demand-side focused, rather than one where proactive steps are taken to solve structural problems.

GDP %



Japan

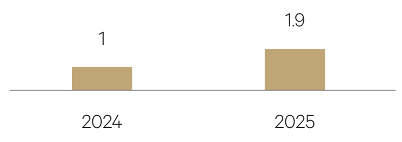
Japan remains an outlier, supported by a virtuous wage-price spiral that will anchor inflation expectations near 2%, allowing the Bank of Japan (BoJ) to further normalise policy. Rates could rise to a 30-year high by year-end.

GDP %

Australia

After experiencing its slowest growth ever outside of a recession, Australia is expected to improve slightly in 2025 but the main support will continue to be public sector spending as the federal election, due in the first half of the year, promises to deliver more cost-of-living support to households.

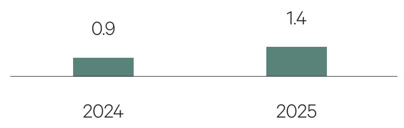
GDP %



United Kingdom

The UK faces sluggish productivity growth, labour constraints, and inflationary impacts from higher taxes under the new Labour government. The Bank of England's (BoE) capacity to ease is constrained despite surging company insolvencies.

GDP %



Source: Bloomberg, consensus data as at 31/12/24

Theme 1: Sports Investing

Stephen Dickinson
Investment Analyst

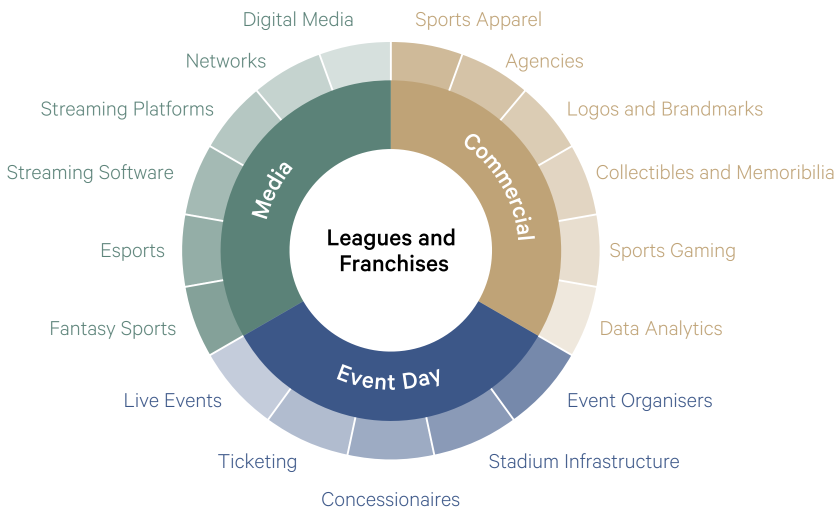
The definition of sports investing has expanded to encompass new revenue opportunities across the value chain. This broad 'sports ecosystem' offers more investment opportunities. Recent estimates value the sports ecosystem at $US3 trillion.

There are a range of newer investment opportunities across this broad 'sports ecosystem'. For example:

- Data Analytics – data tracking enables the creation of a customised game experience for fans – changing the notion of a 'game' from a few-hour contest to encompass interactions between various platforms, partners, and entities.
- Fantasy leagues – the global fantasy sports market is valued at around $30 billion, and it is predicted to grow at a double-digit CAGR over the coming years.
- Esports – these video game competitions have taken off globally. Esports have particularly resonated with younger gamers and viewers, positioning the sector for long-term growth.

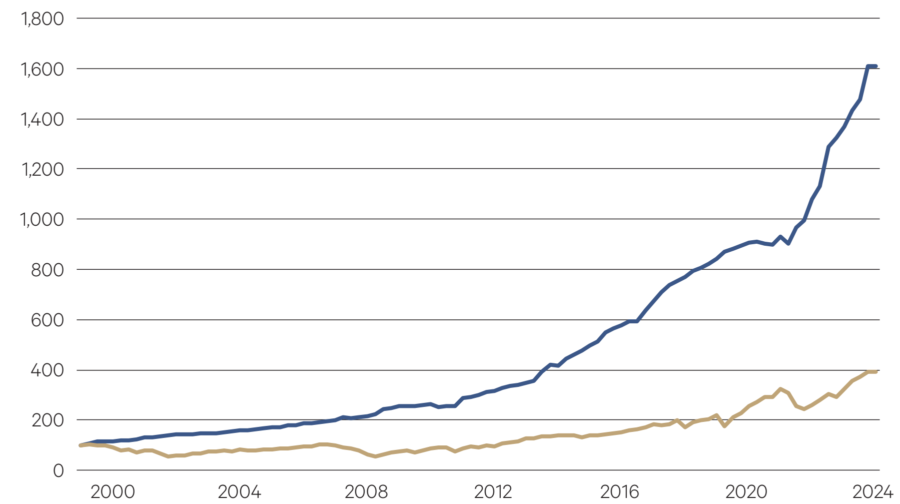
Unlike many other sectors, investments in professional sports have been non-cyclical in nature. This resilience is attributable to the unique, recurring revenue streams including media rights and corporate sponsorships – deals which are often locked in for multiple years.

Primary revenue streams for leagues and franchises from sports IP



Source: Goldman Sachs Investment Banking

US growth of Ross-Arctos Sports Franchise Index (RASFI) vs S&P 500, indexed to 2000



RASFI S&P 500
Source: University of Michigan Sept 2024, Bloomberg

Where to invest?

With the evolution of the sports ecosystem, the potential for monetising the unique IP that sports offers have increasingly attracted institutional investors over the past two decades.

In debt, investors can access opportunities through public debt markets, the broadly syndicated loan (BSL) market as well as private credit. Many European football clubs own their own stadium and some partner with investors to finance new construction or renovation in private credit markets. In the US, a range of sports leagues – the NFL, NBA, and MLB – tap into private credit markets.

Private equity (PE) firms are increasingly participating in sports investing. With major leagues like the NFL now allowing private equity ownership and adjacent opportunities like stadium infrastructure. For example, today, 63 teams in North American sports leagues are PE-backed.

63

The number of teams in North American sports leagues that are PE-backed.

Andalusian Credit Partners

Why now?

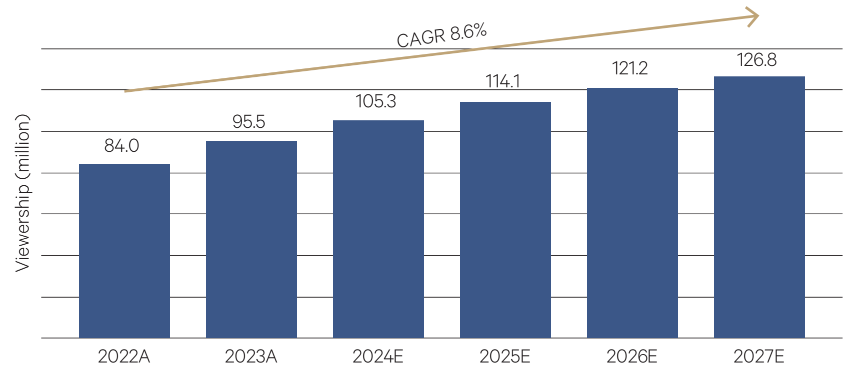
The interconnection between sports, technology and digital platforms is reshaping the business of sports leagues and opening a new realm of possibilities. For example, in golf, the Tech Golf League (TGL) recently created by Tiger Woods and Rory McIlroy, is played indoors where real golf elements are combined with virtual reality.

In cricket, the evolution of shorter formats has seen unprecedented growth both at home and abroad. In 2023, the ICC Men's Cricket World Cup registered 16 billion viewing from global viewers over the course of the tournament. The average Indian Premier League (IPL) team valuation has grown from $67 million in 2009 to $1+ billion today – outpacing the growth of NBA and NFL team values.

Digital platforms remain critical partners for sports leagues looking to expand their fan base in new geographic regions and reach a younger audience.

One of the best examples of a sport going global is Formula One (F1), which now runs 24 races across 21 countries and five continents watched by an average of 70 million people per race. As a comparison, the Super Bowl has an audience of 110 million.

US digital live sports viewership



US Digital Live Sports Viewership
Source: Forbes, Wall Street Research

Technological advances are unlocking further opportunities for personalised viewing experiences and enhanced fan engagement, alongside storytelling content that brings fans inside the locker room. Netflix's Formula 1: Drive to Survive, Quarterback, and Receiver; Amazon's All or Nothing; and Apple TV's Lionel Messi: The Greatest, have also found success in repurposing sports content into formats catered to younger audiences.

Many emerging sports are at an earlier stage of their global and digital expansions – which may offer equity investors robust growth opportunities at attractive entry points. Elite women's sports are projected to surpass $1 billion in total revenue in 2024 for the first time – roughly 300% higher than 2021.

$67 million to $1 billion

average growth in IPL team valuations.

Forbes

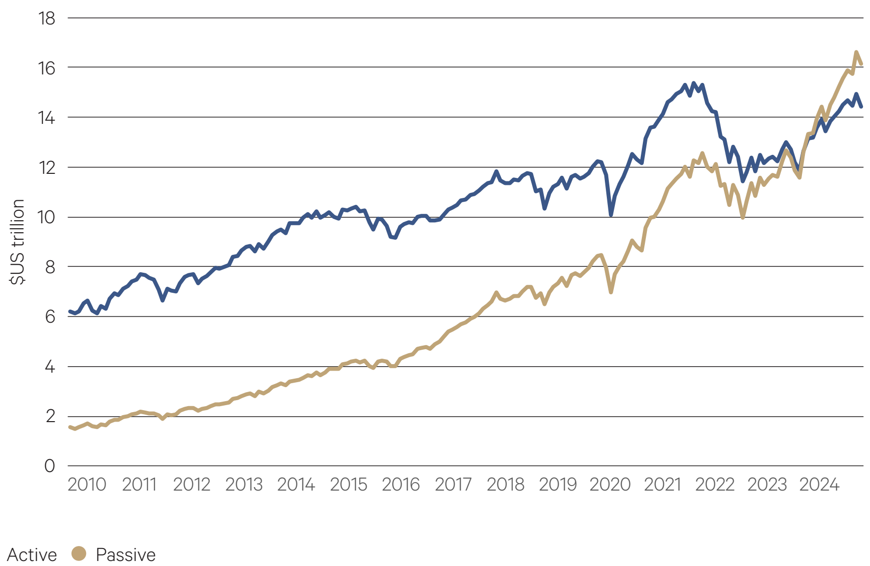
Theme 2: Peak Passive?

David Bruty
Investment Analyst

Early last year, Morningstar proclaimed a seismic moment in the US funds management industry; passive assets had overtaken active assets for the first time.

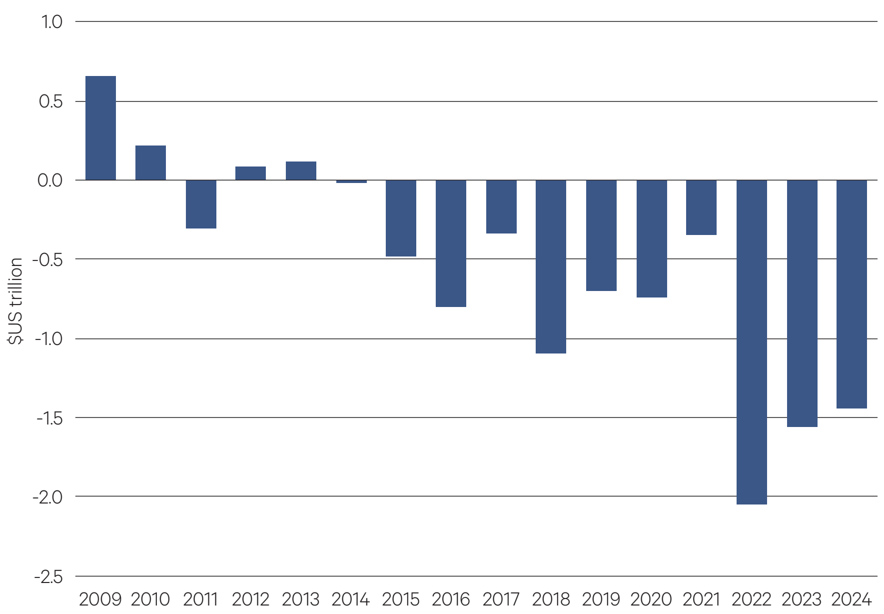
Passive funds align their portfolio weights with benchmark indices. Active managers analyse fundamental data and aim to outperform an index. Passive investing was popularised by John Bogle of Vanguard in the 1970s and have steadily taken market share from active since; passive's rise is not a fad but a long-established trend that has been helped by the structural decline in interest rates.

US active and passive assets



Source: Morningstar

Global active – passive fund flows



Source: Morningstar

US$9 trillion

Passive fund flows have outpaced active funds by more than US$9 trillion in the last decade alone.

Morningstar

Understanding the appeal of passive funds is clear: passive funds have lower fees, as they do not need to cover the cost of expensive research teams. This leads to a critical inference – net of their higher fees, the average active fund does worse than passive. While that's not to say that individual funds cannot produce strong alpha, the aggregate active industry is a zero sum game with the winners subsidised by the losers. Institutional investors are also embracing a higher passive allocation given its advantages with respect to implementing tactical calls and for improving liquidity.

The rise in passive leads to implications for the investment landscape.

Firstly, passive funds 'buy and hold' securities and hence an increase of passive money in the market inevitably leads to reduced liquidity.

37.5%

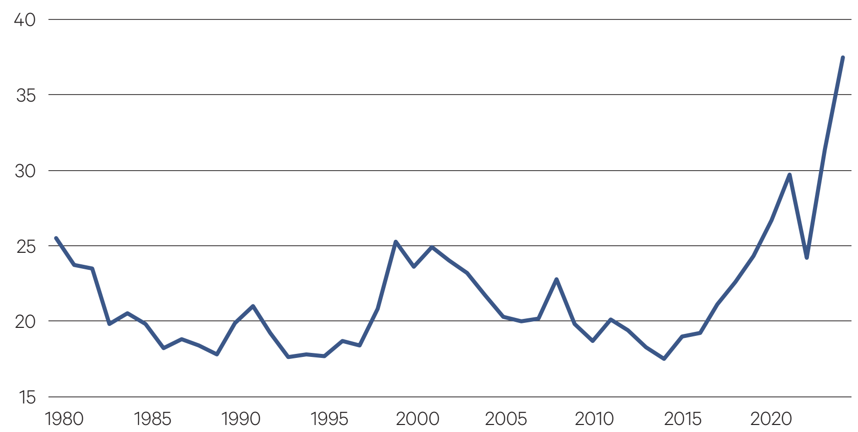
The concentration of the top 10 stocks in the S&P 500, higher than any year since 1980.

S&P

Passive funds are price takers and don't trade on changing fundamentals. Many passive index funds and ETFs (Exchange-Traded Funds) are capitalisation-weighted. This means, the higher a stock price moves, the higher its weight in a passive fund. This creates a feedback loop where rising prices lead to a higher weight in the index, which can further attract investment due to the perceived strength of these stocks. In a passive world, the market trades on momentum, not fundamentals.

As large caps are typically the core allocation of a passive investor, this can disproportionately support the prices of larger companies at the expense of the smaller end of the market. The rise of the 'Magnificent 7' is a case in point. While superior earnings growth has undeniably been the primary driver of their outperformance of the residual S&P 493, valuation-conscious active funds have been underweight the group as they have soared to new highs. With money flowing out of weaker active funds into passive, this has pushed the Magnificent 7 higher, creating further headwinds for active funds.

S&P 500: Concentration of top 10 members



Source: S&P

If everybody indexed, the only word you could use is chaos, catastrophe.

Jack Bogle, founder of Vanguard

A more unstable, uncertain macro environment, such as the one we are likely to be in for the next few years, is one in which active funds should prosper. Individual stocks will be driven by idiosyncratic factors that only active investors can position for. This is the active investor advantage.

Related to this is an end to the structural decline in bond yields. We expect to move into a higher for longer yield environment. As a starting point on which different risk premiums are added, higher bond yields are associated with higher returns. A higher for longer environment will relieve the pressure on after-fee returns that initially drove the market toward passive investing.

While we are clearly not there yet, there is a natural limit to the proportion of the market that passive can attain. As Bogle himself noted, if everyone indexed then 'markets would fail'. This notion of 'peak passive' has been generating increasing attention and at some future point an equilibrium will be realised.

Theme 3: The Age of Robotics

Darragh Kennelly
Investment Analyst

After many false dawns, robotics is about to have its moment in the sun. Nvidia's Jensen Huang has called it the next wave of A.I.. Jeff Bezos thinks we are at the beginning of a golden age for automation and robotics. Elon Musk believes we will eventually have more humanoid robots than humans.

Estimates suggest the robotics industry represents a global revenue opportunity worth $24 trillion by 2030. The use of robots is expanding rapidly – from an estimated 354 million in use today to an estimated 1.3 billion by 2035 and 4.1 billion by 2050.

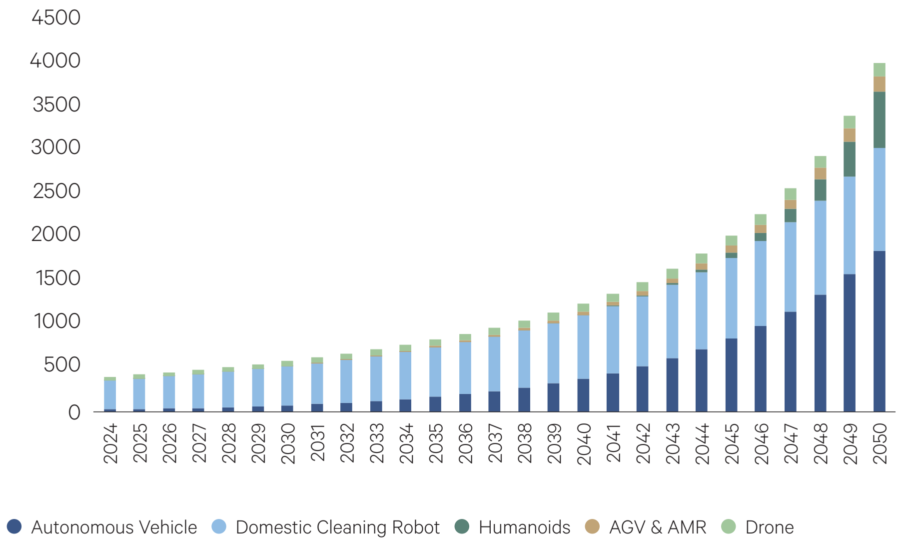
The growth is being driven by innovation coming from new technology such as AI, a reduction in costs and payback periods, and a broadening out in industrial applications.

$24 trillion

robotics industry potential opportunity by 2030.

ARK Investments

Robot unit numbers forecast to reach 4.1 billion by 2050



Source: Citi

4.1 billion

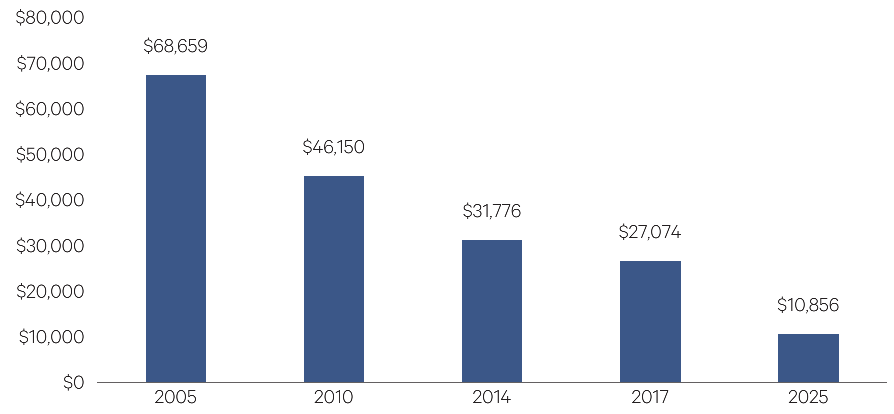
Forecast for the number of robots in circulation by 2050.

Citi

Robotics historically faced many headwinds - high R&D costs, expensive prototyping and manufacturing, and safety issues. Recent enhancements in AI have helped change that. Tasks such as seeing, learning, moving, and taking instruction, all standalone tasks, can now be performed simultaneously. Improved reasoning and dexterity and edge computing means robots can navigate complex environments and make real-time autonomous decisions.

The payback period for humanoids varies widely and depend on initial cost, productivity and hours of operation. Goldman Sachs estimate a two-year payback period by 2025-26 for a humanoid robot working 20 hours a day, assuming a base case unit cost of US$250,000.

Falling average cost curves of industrial robots (US$)



Source: Statista

1.9 billion

Projected number of fully autonomous vehicles by 2050.

Citi

Improved dexterity in robotics has significantly impacted the healthcare sector. The DaVinci surgical robot has performed over 10 million procedures globally and reports 40% fewer complications, shorter patient recovery times and over $22,000 in savings per case because of fewer complications.

Industrial cleaning robots are in their early stages of development, unlike home cleaning robots. Skyline Robotics' Ozmo, an autonomous skyscraper cleaning robot, makes 250 decisions per second regarding pressure, movement, efficiency, and safety and can operate 24/7. All without risking human lives. It's three times faster than traditional methods with a three-year payback period. With only 9% of the industry's workforce under 30, robotics offers a solution to labour shortages in this dangerous occupation, improving efficiency and productivity.

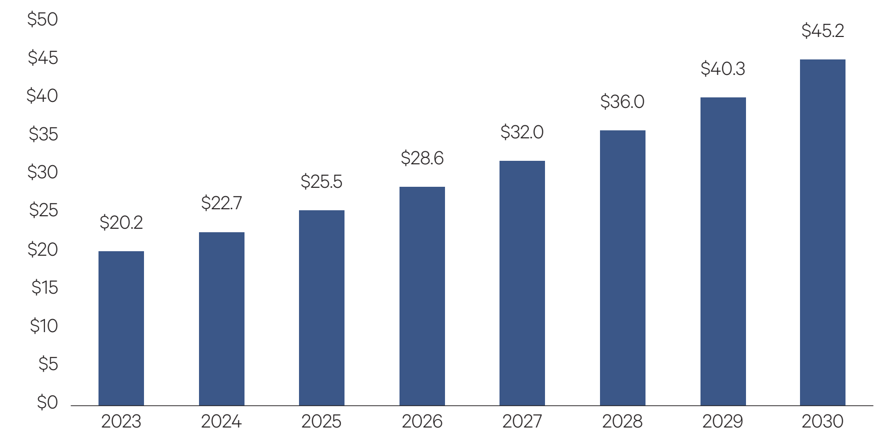
Autonomous vehicles (AVs) are expected to scale rapidly due to AI improvements enhancing safety and decision-making. Fully autonomous vehicles are projected to increase from 27 million currently to 1.9 billion by 2050, with consumer cost per mile dropping from $0.70 to $0.25 within a decade. The growth in robotaxis has the potential to significantly change urban transport with the most recent vehicles from Waymo having a 500 metre detection range.

Drones have seen wide adoption across a number of industries including construction, agriculture, real estate, oil and gas, utilities, manufacturing and logistics. The enterprise drone market is forecast to grow from $16 billion today to $29 billion by 2030.

Global defence spending is rising, with the US allocating over US$900 billion in 2023 and EU spending growing by 10%. Anduril Industries, a private company which develops autonomous defence systems for the US government, recently raised $1.5 billion at a $14 billion valuation. Their products include unmanned aerial systems that operate autonomously, process real-time data, and provide actionable intelligence for defence applications.

Much of the development in robotics is taking place in private markets. Companies such as Sanctuary AI, Figure, Mantis, Agility Robotics and 1X are all forging partnerships with public companies like Nvidia, Amazon and Microsoft to help develop robots faster and with more capabilities.

Military drone spending is expected to top $45 billion by 2030



Source: GlobalX

Fixed Income

Holly Brenchley
Investment Analyst

2024 was the year to be invested in actively managed floating rate credit. Fixed rate bonds (which appreciate in value as long term yields fall) looked to be the obvious choice, however fewer rate cuts than expected meant long term yields rose faster than shorter dated bond yields. Higher starting yields, strong issuance and tightening credit spreads made for a ripe environment for active credit managers.

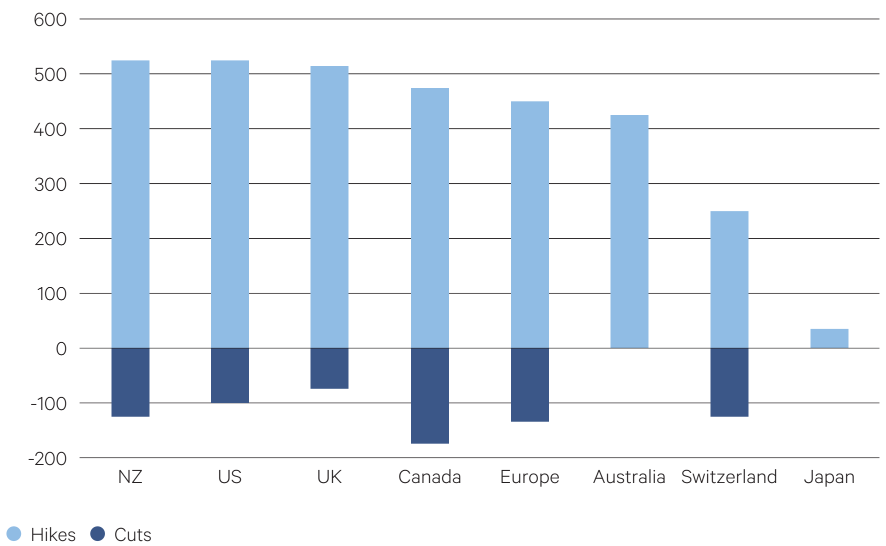
Over the 12 months, G10 central banks cut a total of 825 basis points, the highest yearly total since the GFC. Persistent inflation meant that the cuts came later and were shallower than expected. With the lid barely on inflation and a Trump presidency on the horizon, rates won't come back to the Covid era lows in the US or Australia. The last soft landing in the US in 1995 saw rates cut only 125 basis points from a peak of 6% over the next four years, compared to an average of 440 basis points over the last forty years.

825 bps

of interest rate cuts in the G10 in 2024.

Reuters

Rate changes since 2022 (bps)



Source: Bloomberg, as at 31/12/2024

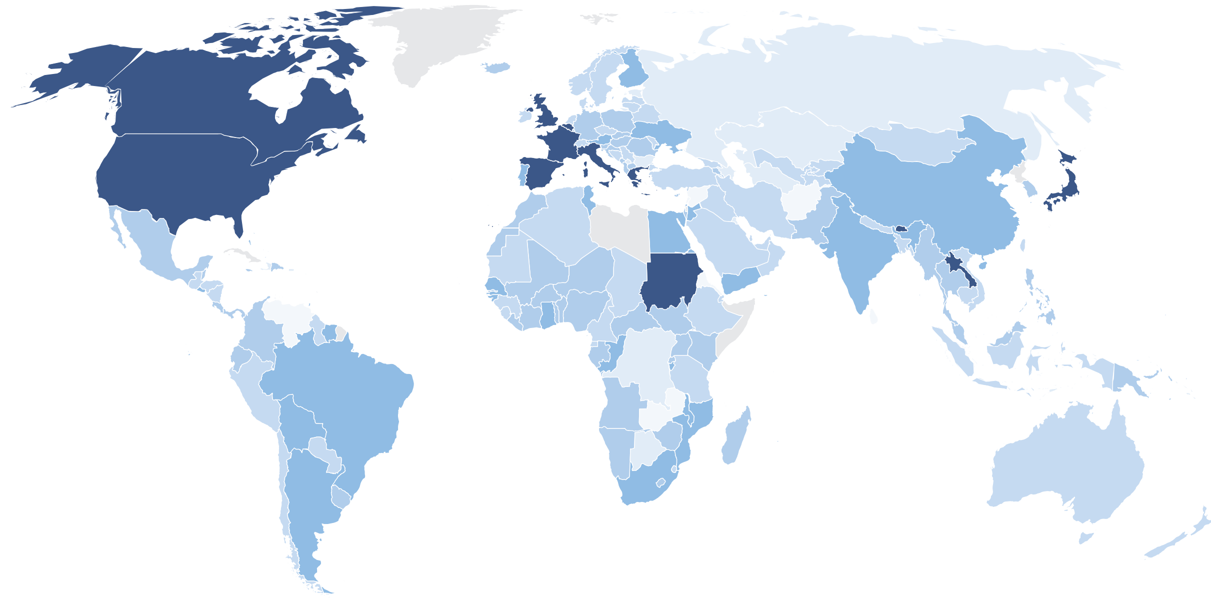
US$100 trillion

Estimated outstanding government debt at the end of 2024.

IMF

Mortgage holders and corporates aren't alone in welcoming the easing of rates. Indebted governments are seeing a reduction in the cost of borrowing, but with deficits continuing to grow, sovereign debt is at its highest peacetime level in nearly 200 years. With sluggish global growth expected over the coming years, sovereigns will have a challenge meeting repayments without increasing their deficits.

Government debt to GDP (%)



Over 100% 75–100% 50–75% 25–50% Less than 25% No data

Source: IMF, 2024

When you look at the data, you can forgive sceptics of the US 'soft landing' story. For 783 consecutive days, the US yield curve was inverted, surpassing the previous record of 624 days set in 1978-1979. Yield curve inversion occurs when short term bonds are paying more than long-term bonds and has signalled recession on all but two occasions – once in 1998, when the curve inverted for only a matter of weeks, and again this year.

So perhaps it's not so surprising that, despite the fastest hiking cycle on record, borrowers have fared rather well. Defaults have increased from cycle lows but remain below the long-term average. Despite higher borrowing costs across the board, fewer borrowers defaulted in 2024 than 2023 in all regions except Europe, and more issuers were upgraded by the ratings agencies than downgraded.

In 2025, we expect demand for floating rate products to ease slightly as rates come down. A steepening of the yield curve will also pose a challenge for longer duration fixed rate bonds. Credit spreads should widen from near historic lows, undermining their total return potential.

783

consecutive days the yield curve inverted from 2022–2024.

Bloomberg

3.5%

of speculative-grade bonds expected to default in 2025.

S&P Global

The impact of higher interest rates should be felt by borrowers in the coming year as excess cash reserves dwindle. US tariffs will impact the Chinese economy and its APAC trading partners, including Australia. However, global defaults are expected to remain below long-term averages as private credit investors offer an alternative for speculative grade borrowers.

In this environment, our preference is for short-dated, highly liquid floating rate bonds where all-in yields are still offering 6-8%. Both credit and interest rate risks are high, and investors aren't getting paid for taking on either. Given the increased volatility in the fixed income market, investors are best rewarded by staying active and staying diversified.

Australian Equities

David Bruty
Investment Analyst

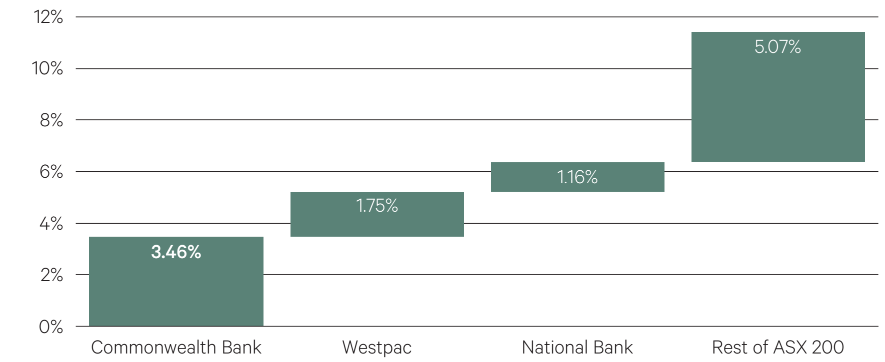
The Australian equity market's double-digit return was similar to that of international equity markets in 2024, though overshadowed by the mega-cap technology-driven performance of the US. It marked a second successive year of rising valuations more than offsetting softer earnings, primarily driven by a further normalisation in commodity prices from their post-pandemic peak.

56%

The three largest banks account for 18% of the ASX 200 but together accounted for more than half (56%) of the market's returns in 2024.

Bloomberg

ASX 200 2024 attribution



Source: Bloomberg

Many valuation measures now paint the market as expensive. The market's forward P/E ratio of 18x is more than 2 points above the average of the last decade – high, but not excessively so. The forward dividend yield is now just 3.6%; the only time yields have been lower in the last 15 years was amidst the pandemic when companies had suspended dividends. Lastly, the earnings premium on equities over long term bonds has contracted from a level of 4% for most of the last decade to around 1% today.

ASX 200 forward dividend yield

Source: Bloomberg

3.6%

The forward yield on the ASX 200 is 3.6% and has rarely been this low in the last 20 years.

Bloomberg

After two years of P/E expansion, a resumption of earnings growth is a prerequisite to drive domestic equities higher in 2025 – the market needs to grow into its full valuation. On this measure, the outlook is better than in prior years, though inferior to key global markets.

What will be the source of earnings growth?

Among financials, the banks have a very modest low-single digit growth rate in the medium term, though there are better prospects among the insurers and diversified financials who are benefiting from strong investment markets. The downside among the miners now appears limited, though a rebound is dependent upon Chinese stimulus, while gold remains a bright spot within the sector. Despite representing less than half of the benchmark, the outlook for industrials is robust, with health care, communications and IT all projecting healthy growth.

37%

Commonwealth Bank's share price gain in 2024.

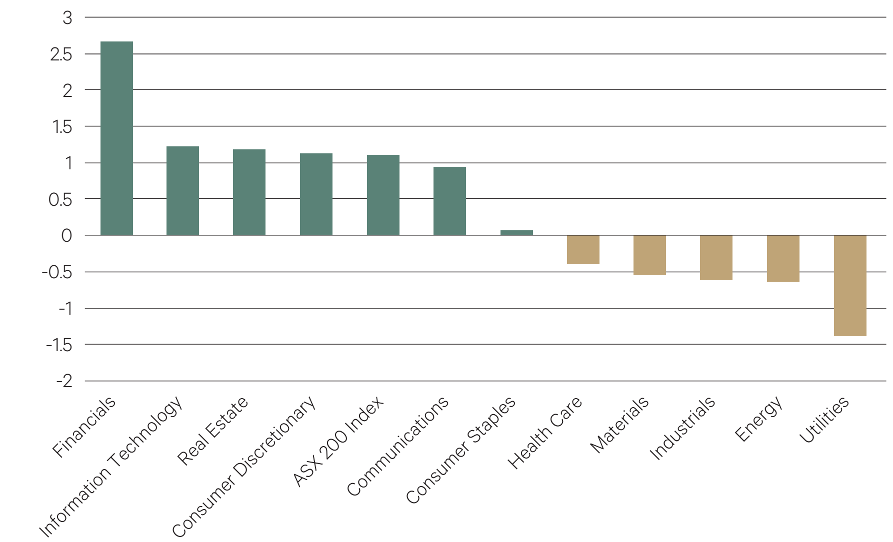
Bloomberg

4 years

Small caps underperformed large caps for a fourth successive year, though stand to benefit from an RBA easing cycle.

Bloomberg

ASX 200 sector P/Es: Current vs 10 year average (standard deviations)



Source: Bloomberg

Two other factors point to some optimism for the year ahead. There is hope for the domestic economic backdrop to improve as the year progresses after several quarters of negative per capita growth. After lagging other economies, we are on the cusp of a cash rate easing cycle with inflation slowly moving back to the RBA target. Though the easing cycle may prove to be quite shallow in nature, it nonetheless will be welcomed by households and corporates alike and will help spur additional M&A and IPO activity. Economic-linked industrials should benefit in this environment. Additionally, the likelihood of stimulatory fiscal largesse is enhanced by the imminent federal election.

Secondly, the transition to Trump 2.0, in our view, provides opportunities as well as risks. Australia's trade deficit with the US leaves sees us far less likely than our regional peers to be hit with tariffs. Further, many of our larger industrial and technology companies have significant operations within the US that stand to benefit from US expansion. It is true that the imposition of tariffs from the US on China would have a second-order impact for Australia from a weaker Chinese economy. However, it is also equally likely that this would be cushioned by additional Chinese stimulus measures.

With valuations most stretched in the major banks and the base case assumption for resources benign amidst China's structural issues, a tilt towards mid and small caps (who are greater beneficiaries of the factors noted above) is recommended for 2025.

International Equities

Tracey McNaughton
Chief Investment Officer

2024 was a year for cyclical sectors and technology stocks. Returns were once again narrowly concentrated in a handful of stocks. The rate hiking cycle that began in 2022 transitioned to a rate cutting cycle in 2024 beginning with the Bank of England in August. By year-end, seven out of the twelve major developed market central banks had cut interest rates. Over the year, monetary policy was eased by at least 825 basis points making it the largest annual easing cycle since 2009.

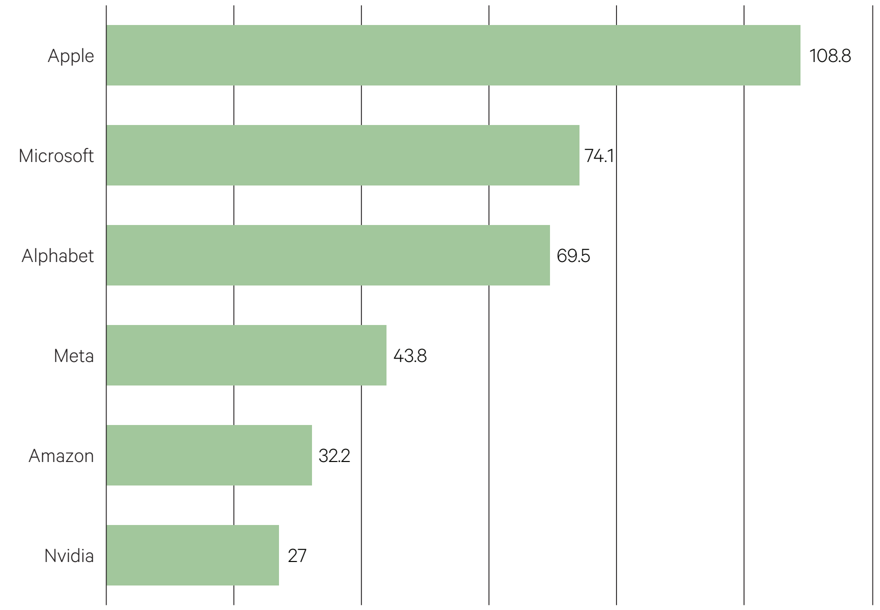
The rate cutting cycle will continue in 2025 but at a slower pace. This will be particularly beneficial for small to medium-sized companies, less so for large companies, where net interest payments are already at near record-low levels.

We remain positive on equities, particularly in the US where earnings are expected to grow by 15% compared to 10% last year.

Big technology companies remain lucrative cash machines. Apple is still on top, creating over $100 billion of free cash flow in the past year. A major use of Apple's cash is returning value to shareholders through share buybacks and dividends. Microsoft is also an established dividend payer. Alphabet, Nvidia and Meta all paid dividends for the first time in 2024.

Some of this cash will also be used to invest. Microsoft has announced plans to spend $80 billion in capex in 2025, more than half of which will be in the US.

The big tech cash generators (Trailing 12 month free cash flow US$ bn)



Source: Bloomberg, data as at 5/12/24

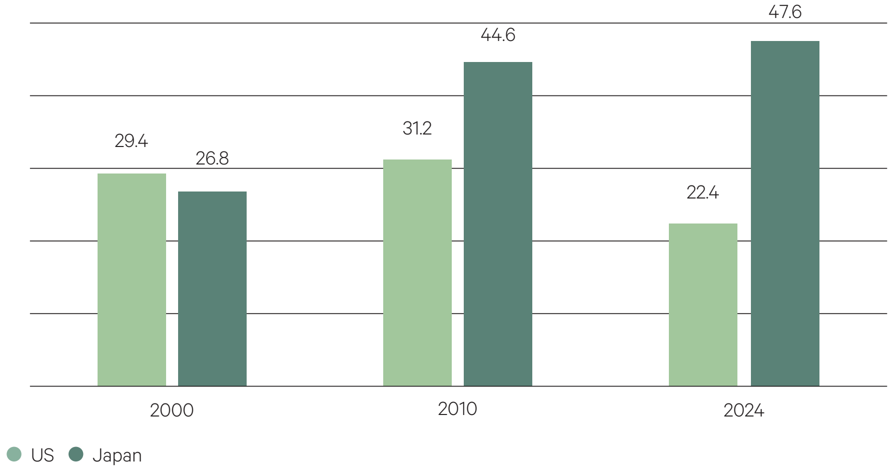
8.25%

The amount monetary policy was eased in 2024 making it the largest annual easing cycle since 2009.

Reuters

Japan will be in focus for investors in 2025. Two things have changed recently. Inflation has finally come back after decades of deflation. And investor activism and encouragement from the Japan Stock Exchange has increased pressure on listed companies to be better allocators of capital. Nearly half of Japanese companies have net cash on their balance sheet compared with a fifth of companies in the US.
High cash and low debt positions means interest expense is low. More than a third trade below their book value as a result, compared to around 5% for US companies.

% of companies with net cash



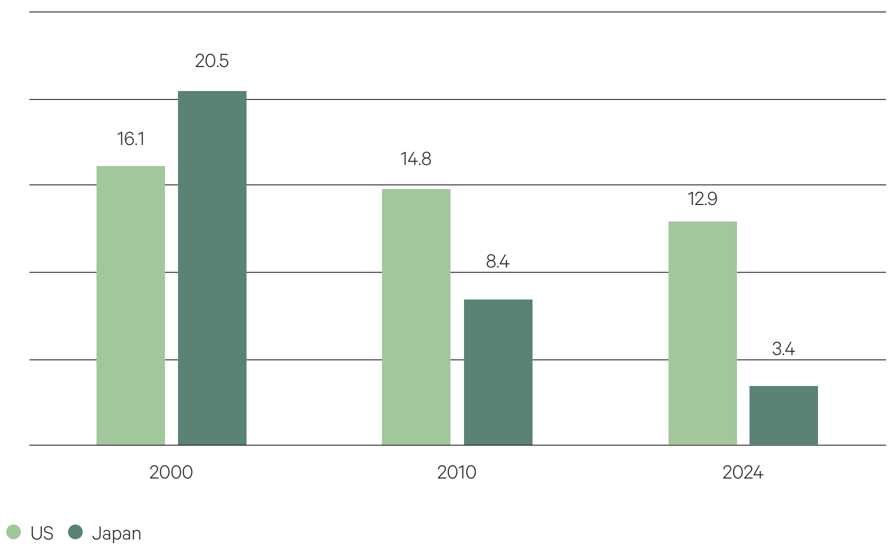
Source: Compustat, data as at April 2024

US$655bn

The amount of stock Apple has bought back over the past 10 years.

Bloomberg

Interest expense / EBIT



Source: Compustat, data as at April 2024

Elsewhere, we are selective on emerging markets. China continues to suffer under the weight of high debt levels, a housing overhang where consumers are 70% levered to the property market, and softening domestic demand. Our preference remains India given its relatively healthy consumer sector, a business-friendly government and the benefits flowing to it from the re-design of global supply chains.

Europe bears watching for significant policy shifts that could present opportunities. Germany's stagnating economy is burdened by poor productivity, high energy costs, and weak export demand, particularly from its major trading partner China. France is grappling with rising bond yields due to fiscal pushback.
Both also face political challenges from the right that could see the union as a whole come under the kind of pressure it faced during the 2011 sovereign debt crisis.

Valuations will be the biggest challenge in 2025. The long-term decline in bond yields, which has been a key source of support, has come to an end. Investors should be prepared for bouts of volatility as the market transitions to a new, higher yield environment.

70%

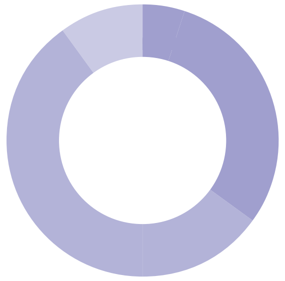
The amount of household wealth in China invested in property.

Reuters

Alternatives

Darragh Kennelly
Investment Analyst

Stephen Dickinson
Investment Analyst



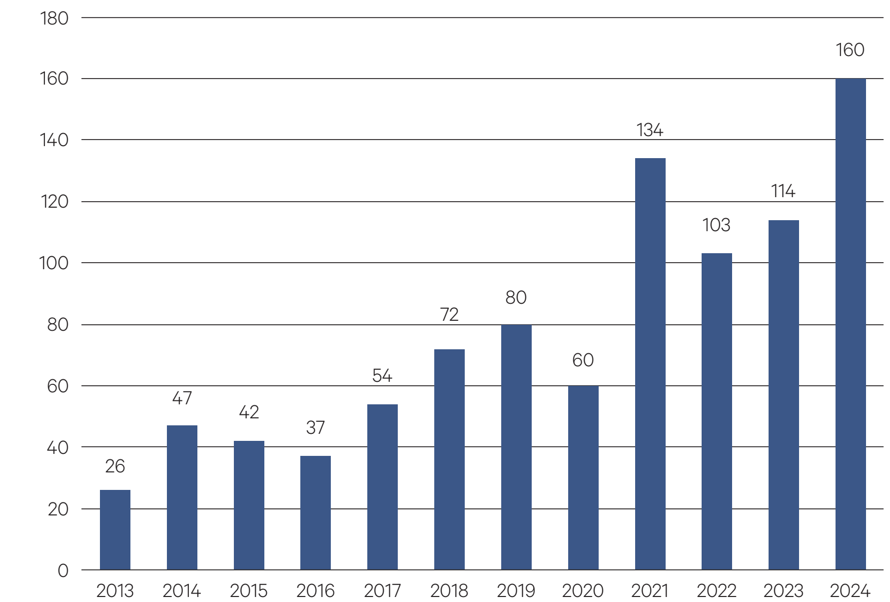
Alternative assets continued the momentum of recent years and estimates show it has now reached a total assets value of $16.3 trillion. Demand remains strong for private equity and private credit, whilst uncorrelated strategies will gain popularity as investors look to increase portfolio diversification in a more challenging environment in 2025.

$16.3 trillion

Total asset value of Global Alternatives

Preqin

Secondary market transaction volume (US$ billions)



Source: Evercore

New origination deal flow more than doubled in 2024.

Pitchbook

Private equity

With more certainty on interest rates, private equity (PE) buyer and seller expectations are likely to converge meaning the well-anticipated pick up in PE deal activity is likely to materialise in 2025. Elevated cash levels and over a quarter of undeployed capital now four or more years old means managers are eager to deploy capital in 2025. Secondary transactions have become a go-to solution for liquidity and deal flow. Deal volume in secondaries rose 73% in H1'2024 on the prior year and total year estimates likely surpassed previous records. The incoming US administration will likely create a more conducive environment for mergers and acquisition (M&A) activity. Valuations have normalised in Venture and Growth Equity markets, and both are well placed to offer access to innovative companies in their highest-growth phase.

Private credit

Private credit continues to see significant growth in activity and fundraising. Whilst refinancing and repricing accounted for the vast majority of activity last year, new origination deal flow was more than double the prior year. In 2024, credit spreads tightened significantly across the curve from public right through to private credit markets. Sourcing high quality deal flow at attractive spreads will be key this year. Our preference remains for globally diversified opportunities. A more challenging economic environment will pose a headwind for Australian-based funds.

Infrastructure

As interest rates fall, infrastructure deal activity is expected to rise in 2025. Longer term structural trends in themes such as decarbonisation, digitalisation, and demographics continue to provide an attractive backdrop in the asset class. Regulatory support for energy transition and energy security is expected to continue. In the EU, the electricity market reform adopted in 2024 should help accelerate investments by expanding the use of long-term contracts to support the green transition.

Within digital infrastructure, the rapid growth in cloud computing and data centres has been driven by the rise in generative AI – a theme forecast to expand over the next decade.

Hedge funds

Valuation distortions in specific stocks and sectors is providing an attractive landscape for hedge fund investing. A more normalised interest rate environment is conducive to fundamental security selection where higher costs of capital clarify the quality of business and strength of management. Given the large difference in earnings growth between market leaders and the median stock, this is providing a range of opportunities with the ability to invest both long and short.

Median short interest as a % of market capitalisation of S&P 500 constituents

Source: Bloomberg

The global market opportunity within the royalty finance space is significant.

Royalties

Compared to debt and equity, royalty finance offers a unique approach with a focus on revenue-linked returns and without diluting ownership or involving fixed repayment obligations. The global market opportunity within the royalty finance space is significant, encompassing various established sectors (i.e. pharmaceuticals, music, natural resources, environmental assets, media, sports, and brands) as well as emerging high-growth royalty sectors. Royalties have low correlation to traditional asset classes and provide stable, diversified cash flows.

Asset Class Quilt of Market Returns

High ↑ / Low ↓	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
High	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%	Gold 29.6%	AFI 11.4%	HY 19.6%	US Eq 29.6%	US Eq 11.4%
	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%	EM Eq 16.4%	IFI 10.5%	AE 18.8%	IE 24.1%	IFI 10.4%
	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%	HY 14.8%	Gold 10.1%	EM Eq 15.1%	AE 19.7%	AFI 9.8%
	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%	US Eq 12.8%	Cash 5.0%	US Eq 13.4%	HY 7.3%	AE 5.0%
	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%	IE 9.6%	IG 4.3%	IE 13.2%	Cash 2.9%	IG 3.1%
	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5	IFI 9.3%	HY 3.1%	IG 11.2%	IFI 2.3%	IE 2.9%
	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%	AFI 6.0%	US Eq 0.0%	IFI 9.7%	AFI 2.0%	Cash 2.7%
	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%	IG 5.8%	IE -7.6%	AFI 7.7%	IG 0.3%	HY 0.0%
	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%	Cash 4.7%	AE -11.4%	Gold 7.1%	EM Eq -5.0%	Gold -1.4%
Low	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%	AE 3.3%	EM Eq -20.4%	Cash 4.0%	Gold -28.3%	EM Eq -4.6%

- **AE:** Australian Equities
- **HY:** High Yield Credit
- **Gold**
- **IFI:** International Fixed Income
- **EM Eq:** Emerging Market Equities
- **Cash**
- **AFI:** Australian Fixed Income
- **US Eq:** US Equities
- **IG:** Investment Grade Credit
- **IE:** International Equities

Source: Bloomberg, 2024 data as at 31/12/2024

2024 saw a remarkable performance across various asset classes, with all generating positive returns for the second consecutive year. Gold emerged as the standout performer, reflecting heightened geopolitical risk and uncertainty. Ongoing conflicts in Ukraine and the Middle East, coupled with political instability, pushed investors towards this safe-haven asset.

US equities also had a stellar year, with the AI boom propelling stocks to new highs. The end of the hiking cycle provided additional support to equities both domestically and internationally. Emerging market equities, led by India and Taiwan, posted gains despite concerns over slower economic growth in China.

US equities have topped performance charts a record five times in the last two decades. However, emerging market equities, though out of favour recently, have also been top performers five times in the same period.

Diversification matters – every asset class has taken its place in the top performers for a given year over the last two decades. Conversely, every asset class has taken a turn at the bottom. A diverse, actively managed portfolio drives returns when times are good, and offers protection when times are more challenging.

2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%	Gold 25.1%	US Eq 26.9%	Cash 1.3%	US Eq 24.2%	Gold 27.2%
IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%	US Eq 16.3%	IE 20.1%	Gold -0.3%	IE 21.8%	US Eq 23.3%
AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%	EM Eq 15.8%	AE 17.7%	AE -3%	HY 14.0%	IE 17%
Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%	IE 14.1%	HY 0.9%	AFI -9.7%	Gold 13.1%	AE 11.4%
US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%	IG 10.4%	Cash 0.0%	IFI -12.3%	AE 13.0%	HY 9.2%
IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%	HY 7.0%	IFI -1.6%	HY -12.7%	IG 9.6%	EM eq 5.1%
HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%	IFI 5.1%	AFI -2.9%	IG -16.7%	EM eq 7.0%	Cash 4.5%
IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%	AFI 4.5%	IG -3.2%	US Eq -19.4%	IFI 5.3%	AFI 2.9%
Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%	AE 3.6%	Gold -3.6%	IE -19.5%	AFI 5.1%	IFI 2.2%
EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%	Cash 0.4%	EM Eq -4.6%	EM eq -22.4%	Cash 3.9%	IG 1.1%

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