Australia: Opportunities amid global chaos

> "Equity market falls of more than 5% are not unusual. The recent pullback in the Australian equity market has presented some interesting opportunities worth exploiting in sectors outside banks and resources."
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> MARK SKOCIC, MUTUAL TRUST, AUSTRALIAN EQUITIES PORTFOLIO MANAGER

We are currently experiencing market disruption and challenges to the global status quo. Uncertainty around trade policies and international relations will likely continue for some time. Predicting the next move by the Trump administration is impossible, let alone the international response. Meanwhile, monetary and fiscal policies globally are also in flux.

Risk aversion has risen on the back of rising economic policy uncertainty, although we are yet to see any material change to underlying fundamentals. Equity markets are stumbling from their lofty valuations – particularly those companies priced-for-perfection, such as U.S. technology.

The Australian equity market is being buffeted by these global squalls. The S&P/ASX 200 Index has broadly followed the U.S. markets lower, with expensive bank and technology sectors being key areas of weakness.

In this Quarterly Outlook we focus on the implications for Australia and where we are finding investment opportunities, despite current market uncertainty. Major considerations include:

1. Australia's economy appears to have turned a corner and modestly improved.
2. Fiscal dominance continues, with public sector spending supporting the Australian economy, investment and labour demand – reinforced by this week's Federal Budget.
3. Global trade policy upheaval has various implications for Australia and will weigh on investor confidence near-term; Over the medium-term, China's economic response could also be a major swing factor for Australia's outlook.

We expect volatility in global markets to continue while investors digest ongoing policy developments. However, amid global chaos investment opportunities arise. The recent pull back in equity markets provides more attractive entry points in select quality companies for long-term investors. Therefore, we are increasing our portfolio weighting to Australian equities to neutral (previously moderately underweight).

In looking for opportunities, Mutual Trust's Australian equity team focuses on those businesses operating in our 'portfolio sweet spot' – offering structural growth or defensive growth attributes. Select companies outside the banks and resources sectors are particularly attractive, such as industrials and real estate investment trusts, offering superior expected earnings growth.

Furthermore, we continue to encourage allocation to alternative asset classes where we source opportunities in Australian private credit, direct property and private markets equity.

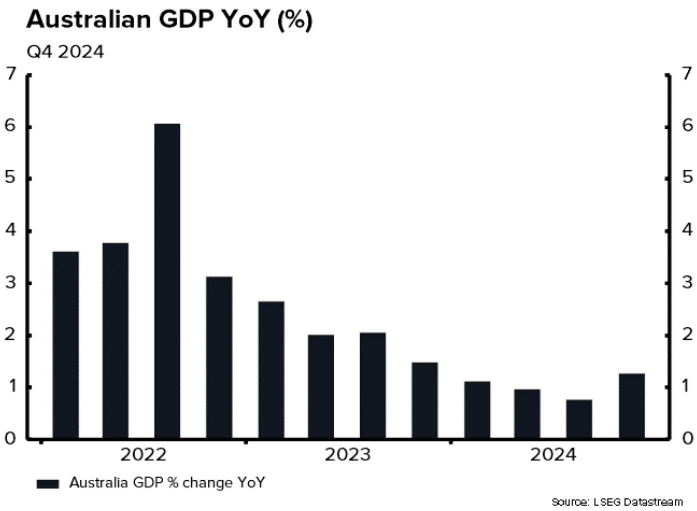
Australia's economy appears to have turned a corner

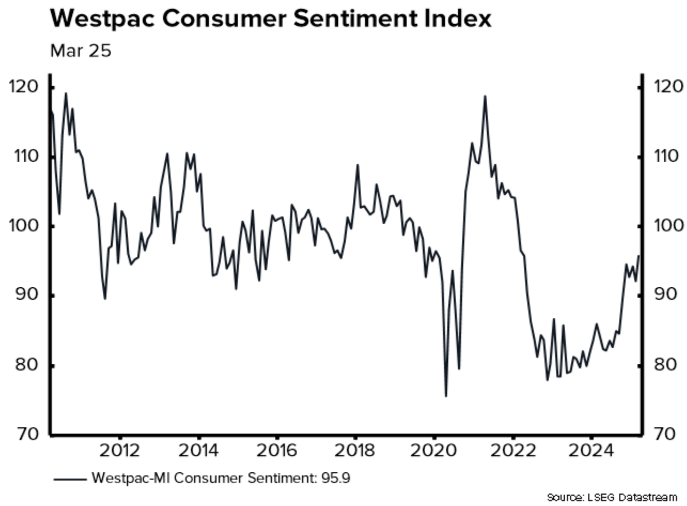
Although global uncertainty remains, Australia's economic data has modestly improved. Government spending continues to play a dominant role supporting the Australian economy, together with elevated net migration. We are seeing early signs of a more positive consumer.

We are encouraged by recent economic data. Australian inflation is moderating closer to target levels and recent economic data shows signs of improvement from late last year. Economic growth picked up notably at the end of 2024, with December quarter GDP expanding 1.3% year-over-year. Importantly, per capita growth turned marginally positive after seven negative quarters. Forward looking forecasts are also positive – the Treasury is forecasting GDP to increase from 1.5% in 2024-25 to 2.75% in 2027-28 (per this week's Federal Budget). Meanwhile, the recent improvement in the Purchasing Managers' Index suggests Australian business activity remains relatively resilient, despite global uncertainty.

Household disposable income has improved, bolstered by rising real (after inflation) income growth and the labour market remains resilient, supporting wage growth. Household consumption has also turned a corner. Consumer sentiment regained momentum in March, with the Westpac Consumer Sentiment Index rising to a three-year high (albeit still in pessimistic territory), supported by slowing inflation and the RBA's decision to cut rates in February (with expectations of more easing to come).

Bond markets are expecting the RBA to make at least two more rate cuts in 2025, with the next one fully priced in by July. While a shallower rate cut cycle might eventuate if inflationary concerns reignite, the current trajectory points towards easing of monetary conditions and is supportive for consumer and business confidence and economic activity.





Fiscal dominance continues, with public sector spending supporting the economy

Robust public spending is currently supporting the Australian economy and continues to outpace GDP growth. Election promises are expected to see this trend continue into 2026, regardless of which political party is in power. At the same time, we are encouraged by the recent lift in household consumption. However, growth in Australia's private sector faces ongoing structural challenges, such as labour shortages, over regulation and languishing productivity.

Public spending across local, state and federal governments has increasingly supported the Australian economy, investment and labour demand and helped stave off any recession. Public sector demand accounted for a record 29% of GDP at the end of December 2024 (versus 21% a decade ago).

This week's Federal Budget underscores ongoing fiscal dominance, with greater spending commitments financed through strong revenues (achieved through a stronger than expected labour market and a lower Australian dollar supporting commodity tax revenues). Cost of living announcements (such as extension of electricity rebates, modest tax cuts and increased access to bulk billing) will help reinforce consumer confidence and household spending and be supportive for consumer-related industries.

We acknowledge however, that the current public spending dynamic is unsustainable over the long-term. The rate of growth is expected to slow and the private sector will need to step-up.

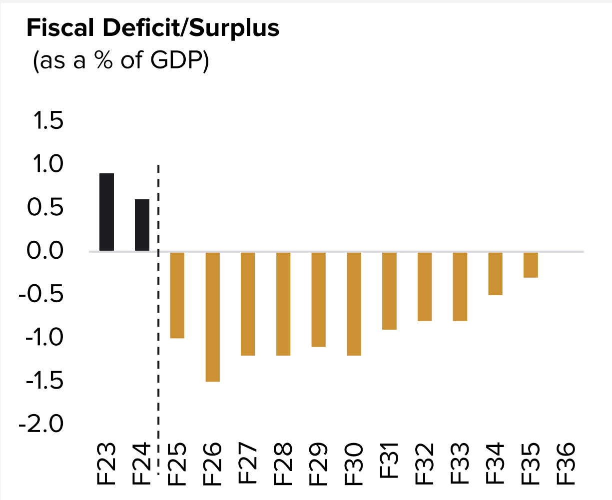
Growth in private sector investment has been stagnant for years. In the recent Australian reporting season, companies continued to reference ongoing structural challenges, such as labour shortages, over regulation, languishing productivity and energy price uncertainty. Ultimately, this pressures margins and deters domestic investment by the private sector.

Federal Budget F25-26: Fiscal dominance continues

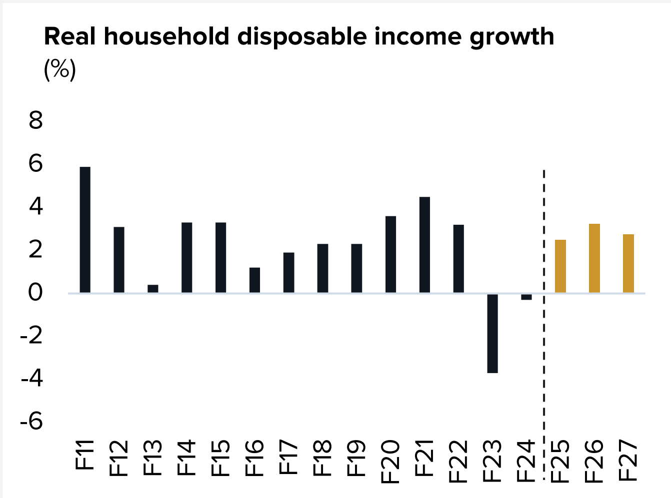
> "Our economy is turning the corner. Inflation is down, incomes are rising, unemployment is low, interest rates are coming down, debt is down, and growth is picking up momentum."
>
> THE HON DR JIM CHALMERS, TREASURER OF AUSTRALIA, MARCH 2025

Treasurer Jim Chalmers delivered his fourth Federal Budget on Tuesday, 25 March, 2025 (the Budget). The Budget reiterates the trend of fiscal dominance, with the federal government budgeting to spend the most in 40 years as a percentage of GDP (excluding pandemic). The Budget deficit is expected to rise from $27.6 billion in F25, to $42.1 billion in F26, and then see modest declines over the next few years, with a balanced budget only expected a decade later.

Net debt is expected to rise to 25% of GDP in F30 (up from 19.9% in F25). While not as large as other nations, such as the U.S. or Germany, it leaves a fiscal burden for our future generations. To fund the growing public expenditure, there will need to be a deluge of government debt issuance by the Australian Office of Financial Management (AOFM) from F26.



Source: F26 Budget Papers and Treasury



Source: ABS Australia National Accounts

We expect the cost-of-living measures announced in the Budget (e.g. extension to energy price relief until 31 December 2025, student debt reduction, cheaper medicines, improved access to bulk billing) to be somewhat encouraging for the continued recovery in consumer sentiment and household disposable income. However, the personal income tax reductions are very modest, saving Australian taxpayers up to $286 in F26 (or just $5 per week), and increasing to $536 in F27. This comes at an overall cost to the government of $17 billion over five years. Similarly, the extension to energy price relief ($150 energy bill rebate) is a welcome measure for households and small businesses, yet it doesn't offset the significant increases to energy costs experienced, nor does it address the structural issues of insufficient energy supply domestically.

Budget forecasts point towards improving GDP growth and ongoing resilience in the labour market. Treasury have revised down forecasts for peak unemployment, from 4.5% to 4.25%. Public sector spending initiatives are supporting jobs growth (post pandemic, the public sector accounted for approximately 80% of all new hiring), including the Budget's $17.1 billion additional pipeline of infrastructure spending projects. Although a tight labour market is positive for the consumer (through higher wages), higher labour costs for businesses may pressure margins where it is increasingly challenging for companies to continue to pass these on through repricing. This reinforces our focus on investing in companies with sufficient pricing power.

With the Federal Election due by May 17, 2025, initiatives announced in this Budget remain uncertain.

Global trade policy upheaval – implications for Australia

President Trump has flagged further tariff announcements – reciprocal and sectoral – expected to be announced on Wednesday, 2 April (U.S. time). The threat, retaliation and implementation of tariffs impacts Australia in various ways, with certain sectors more at risk. Near-term, it will weigh on investor confidence and market stability. However, the eventual economic impact on Australia may prove less than feared by equity markets.

The U.S. is Australia's fourth largest export market, making up only 5.7% ($37.5 billion in F24) of our direct global trade in 2023-24, according to the ABS. This is small in comparison to China, our largest export market, at 32.3% ($212.7 billion) and Japan, our second largest market, at 12.2% ($80.5 billion).

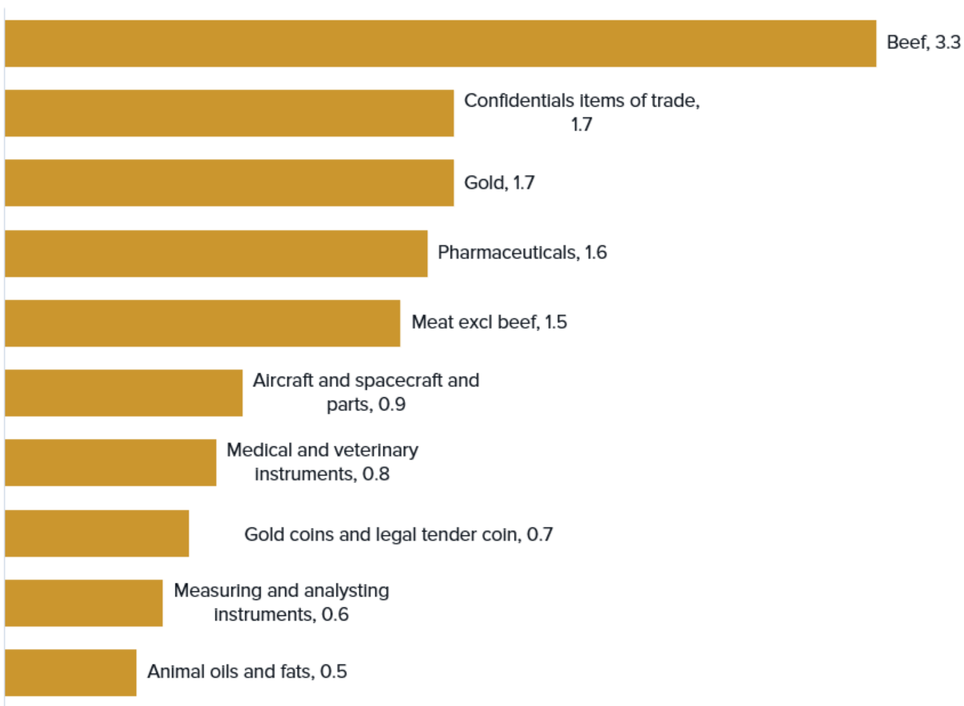
The anticipation of tariffs creates significant uncertainty, weighing on investor, consumer and business confidence and potentially delays capex and hiring intentions. There has been a notable reversal in Australian business confidence, falling back into negative territory in February. However, the impact to confidence may prove overdone versus the actual Australian economic impact realised.

Swings to investor confidence and risk appetite will also be driven by many other factors, including the upcoming U.S. quarterly reporting season (commencing April 11, led by the major banks), fiscal developments (e.g. potential approval of U.S. tax cuts by Congress) and central bank rate moves.

Tariff implications for Australia:

- Direct impacts: Some Australian sectors will be directly impacted by U.S. tariffs. While the implementation of tariffs on steel and aluminium exports will unfortunately affect some companies negatively, the overall economic impact to the Australian economy is not significant (estimated 0.02% reduction in GDP by 2030). However, President Trump's threat of sectoral tariffs may include Australia's largest export markets to the U.S. (Meat $4.8 billion and Pharmaceuticals $1.6 billion in F24). This will have greater potential to impact U.S. relations, industry profitability and Australia's economic prosperity unless negotiation or eventual trade diversion can be sought.

Australia's top 10 exported goods to the U.S
FY24 ($b)



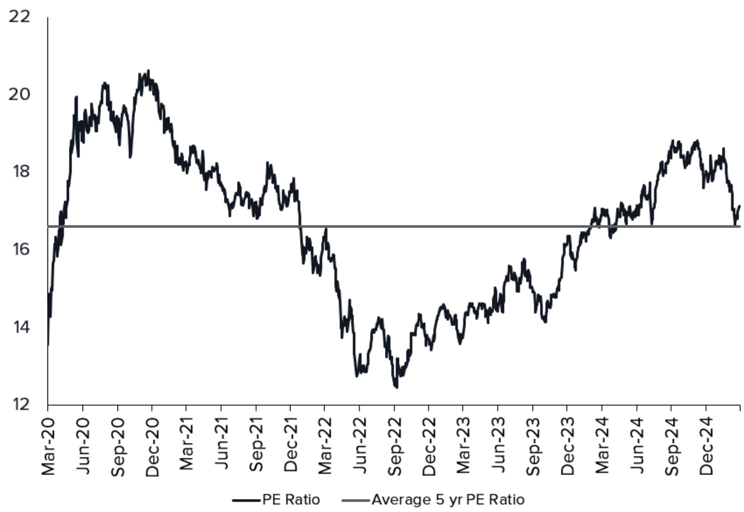
- Indirect impacts: The Australian Treasury estimates the indirect GDP impact of a trade war could be up to four times larger than the direct effects of tariffs on the Australia economy. As our largest trading partner, China is a key swing factor for Australia's outlook. A trade war with the U.S. could slow an already subdued Chinese economy. In the absence of Chinese stimulus measures, this would have negative economic impacts domestically – predominantly through a reduction in demand for our exports of iron ore and other minerals to China.

Investment opportunities in Australia – equities and unlisted assets

We are increasing our portfolio weighting to Australian equities to neutral (previously moderately underweight). The recent pullback in Australian equities provides more attractive entry points into select quality companies for long-term investors. However, global uncertainty and volatility will likely persist for some time. We also encourage allocation to alternative asset classes, sourcing attractive opportunities in Australian private credit, direct property and private markets equity.

Australian equities have followed the direction of U.S. equity markets lower, with the S&P/ASX 200 Accumulation Index falling almost 9% from its 14 February peak to its trough on 13 March. The sectors with the largest drawdowns included those which significantly outperformed during 2024 and were trading at expensive valuations – technology, financial services and banks. Meanwhile, the more defensive sectors, such as utilities and telecoms, outperformed.

S&P/ASX 200 PE Ratio close to 5 year average

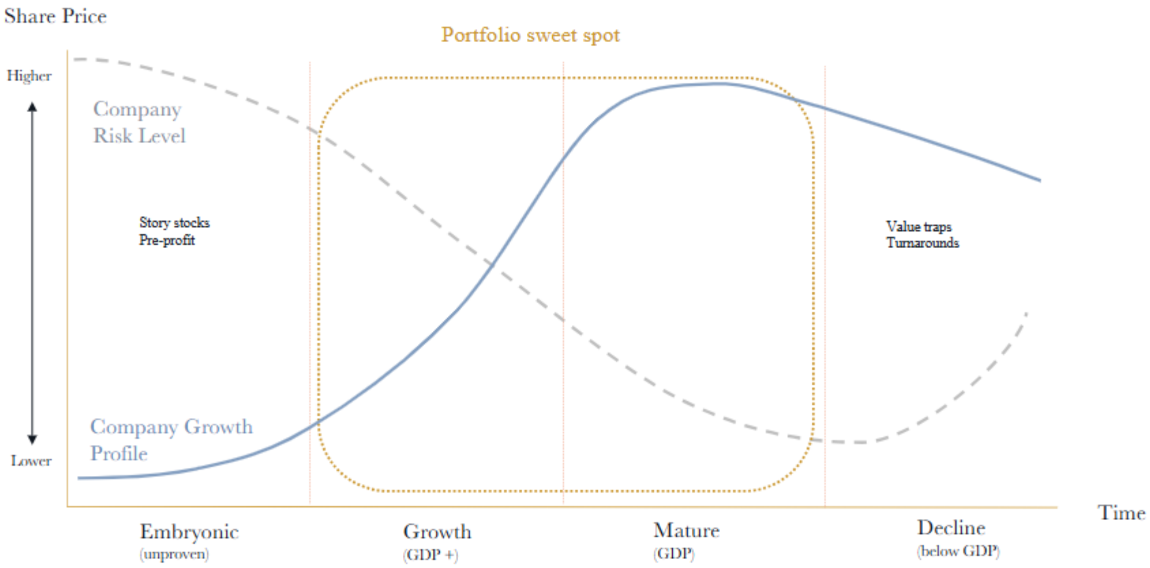


Source: Bloomberg, 26 March 2025

The S&P/ASX 200 Index PE ratio is now close to its five-year average, offering a more attractive risk-reward proposition than a month ago. Therefore, we have moved to a neutral portfolio weighting for Australian equities (previously moderately underweight) but remain highly selective when sourcing opportunities.

Active management is essential, given the ASX200 Index is highly concentrated in low growth sectors (banks and resources make up circa 50% of the Index) versus the S&P500 Index which is concentrated in high growth technology companies. Mutual Trust's Australian equity team adopts a bottom-up approach with low turnover, focusing on high-quality businesses operating in our 'portfolio sweet spot' – those offering structural growth or defensive growth attributes (refer chart):

- Structural growth - Proven business models with structural tailwinds and a long growth runway. Companies such as Seven Group Holdings, Goodman Group or CSL fall into this category.
- Defensive growth - Mature companies with defensive growth characteristics including being high cash generators. Companies such as Telstra, Wesfarmers or Mirvac fall into this category.



Source: Mutual Trust

(Note, resources companies, such as BHP and RIO, typically straddle between growth and mature given their cyclical nature).

In contrast, we aim to avoid those companies outside our 'portfolio sweet spot' such as mature businesses facing structural decline, where valuations may look attractive yet growth is unappealing. For early-stage growth companies which typically carry higher risk, we gain exposure predominantly through our private market equity investments or specialist diversified small-cap equity funds.

We believe companies outside the financials and resources sectors currently offer the most appealing attributes, with superior earnings growth versus the S&P/ASX 200 Index over the next two years (particularly those with international earnings exposure). Select quality industrial companies and real estate investment trusts are particularly attractive, in our view. We remain underweight the major banks which offer low single-digit earnings growth, negative consensus earnings momentum and elevated valuations. Meanwhile, the major resource companies offer attractive valuations, however China's growth outlook remains an important swing factor with the potential for stimulatory measures to help offset negative China-U.S. tariff escalation impacts.

Through our stock selection, Mutual Trust can deliver an Australian equity portfolio offering superior forecast earnings growth (circa 9% in F26) versus the S&P/ASX 200 Index (less than 6% in F26).

Example industrials exposure held within Mutual Trust's Australian Equity portfolio: SGH Limited (SGH)

SGH is a second-generation founder-led business with strong shareholder alignment, a track record of executing on growth initiatives and a history of strong earnings growth – despite having exposure to cyclical industries such as mining and infrastructure.

SGH owns a portfolio of Australian-based businesses which all have dominant market positions in their respective industries. The main wholly owned portfolio companies include WesTrac (#1 Caterpillar dealer); Boral (#1 construction materials company) and Coates (#1 equipment hire business). These brands are market leaders and essential service providers to their customers, giving them some pricing power. Meanwhile, ongoing public sector infrastructure spending supports demand. SGH also owns 30% of ASX listed Beach Energy and 40% of Seven West Media

SHG offers low double-digit forecast EPS growth over the next 2 years, circa double the growth profile of the S&P/ASX 200 Index. Furthermore, we see upside to consensus earnings forecasts, which tends to fade growth for companies in cyclical industries.

We also look beyond traditional asset classes to alternative assets to enhance potential portfolio returns and reduce portfolio volatility. Our allocation to alternative assets includes a blend of investments offering defensive qualities and/or consistent, stable income (such as private credit) and those higher-risk higher-returning opportunities (such as venture capital):

- **Australian Private Credit:** We recommend combining more defensive, performing Australian private credit and property debt exposures with selective distressed debt opportunities.
- **Direct Australian Property:** Population growth, infrastructure spending and higher costs are limiting new construction and will underpin demand for well-located space over the long-term. We recommend blending more defensive property exposures (such as healthcare assets), with higher returning opportunities across office, retail and industrial sectors. (see: Wealth matters: Brick by Brick)
- **Australian Private Markets Equity:** We are encouraged by the science and technology innovation coming through the CSIRO and Australian universities and flowing through to commercialisation investment opportunities. We favour early-stage venture capital opportunities focused on addressing global challenges (i.e. resource efficiency & circular economy, decarbonising the planet and innovation & technology) and secondary strategies providing liquidity solutions to investors.

The period ahead is characterised by significant uncertainty and change. We encourage long-term investors to diversify their portfolios across both public and private market investments. Market volatility provides opportunities to selectively capture attractive Australian opportunities.

Please reach out to your Mutual Trust Advisor with any questions.

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what matters most.

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