MARTIN CURRIE AUSTRALIA

2024 Outlook

MARTIN CURRIE
A Franklin Templeton Company

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Is 2024 the year of a hard, soft or no landing?

Fundamental perspectives on the outlook for Australian equities

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In the following paper, we look at what has shaped the Australian market in 2023 and provide our investment team's fundamental perspective on what lies ahead for Australian equities and our Martin Currie Australia (MCA) portfolios in 2024.

We outline our thoughts on the key issues driving our outlook and expectations for earnings and dividend growth, dive deeper into the implications of higher bond yields for Real Assets and discuss the Sustainability themes that we will be focussing on in our engagements with companies in 2024.

As the world continues to settle into more 'normal' long-term interest rates, long-term inflation expectations, and a probable contraction in household budgets, our outlook highlights how carefully selected Australian equities can provide investors with attractively valued income and growth opportunities. We also reiterate the importance of a balanced approach to portfolio management to navigate what may be a choppy macro-economic ocean over the coming year.

Contents

[1]Our Fama Macbeth (FM) multivariate model allows us to consider additional returns linked to a one standard deviation increase in one factor.

Key economic and market themes driving our 2024 outlook

Michael Slack
Head of Research

Services resilience provides global growth uplift

Most growth indicators have pointed to a slowing global economy since late 2022 because of higher rates, less fiscal stimulus and the drag from high inflation readings.

The Global Manufacturing Purchasing Managers Index (PMI) has historically been highly correlated to the global EPS cycle and is pointing to recession.

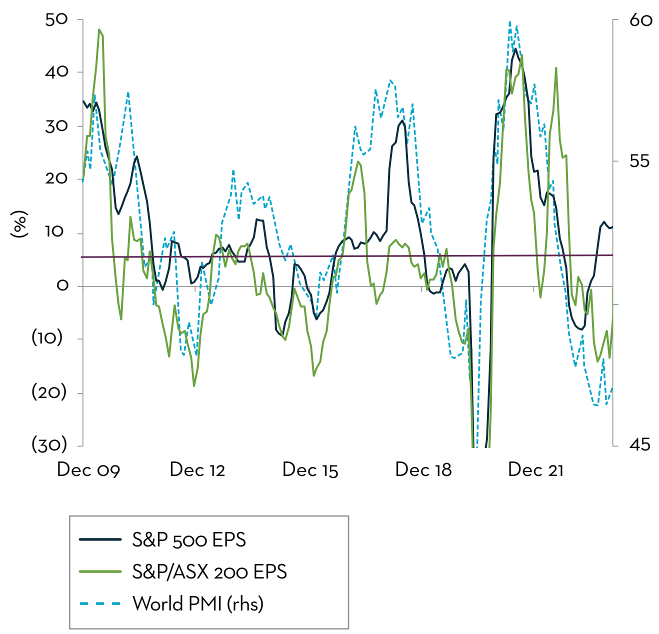
A consistent theme of late has been sequentially lower core US CPI increases. This has allowed bond markets to rally and the Fed to shift to a more dovish stance. However, despite the apparent contradiction of peak rates and inflation in the US, consensus forecasts still have US EPS improving in 2024 – driven by the "Magnificent Seven" tech stocks. Notably, we have seen that the PMI for services (rather than goods) has been surprisingly resilient and has contributed to the bounce in these expectations since March 2023.

Australian slowdown despite high savings buffer

The rise in domestic short rates has worked to slow local GDP growth, particularly on a per-capita basis. This had manifested into weaker household consumption, the worst since Covid, however it is holding up relatively well given the ability of Australian households to continue running down savings.

Data published by the CBA's chief economist shows there is still a way to go to fully work through this Covid-fuelled excess savings pool[2]. The saving ratio is still mildly positive, which means that the stock of savings is still actually rising, albeit at a slower pace in recent quarters.

Expected NTM EPS growth and World PMI



Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 December 2023.

Expected next 12 Months (NTM) data is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed and may differ materially from the figures mentioned. The figures may also be affected by inaccurate assumptions or by known or unknown risks and uncertainties. In respect of the broker consensus data the number of brokers included for each individual stock will vary depending on active coverage of that stock by a broker at any point in time. A median of brokers is typically utilised. All estimates avoid stale forecasts which are removed after a certain number of days.

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[2]Source: Commonwealth Bank of Australia (CBA), 18 December 2023; Vantage Point: 2024 Global and Australian Economic and Market Outlook (page 7).

Domestic economic stats continue to deteriorate

Whilst the Government's budget and export surplus does remain strong, many other aspects of the national accounts have continued to deteriorate.

In the latest data release, nominal household disposable income slowed to near the weakest in decades, dragged by higher tax, and RBA rate hikes lifting household interest payments to a record high quarterly level.

While inflation has finally begun to show signs of slowing after 13 rate rises, it's still high vs. history, and expected to stay higher for longer. Wage growth hit decade highs, while productivity recovered slightly but remains around the lowest level since 2016. The terms of trade have also fallen to the lowest level since 2021.

Australia profits expectations continue to hurt

Australian profit growth expectations have trended down with Global PMI, with consensus profit forecasts for the year ahead showing a modest 3% growth. Resources and Financials are the main growth inhibitors, while growth pockets do reside in the Real Assets, Industrials, and Insurers within Financials.

How the Australian economy lands is critical

In 2024, we see that macroeconomic data will remain subdued, and rate cuts and easing inflation will likely be required to offset the continuing weakening state of household finances.

The shape of the landing, be it soft/hard/none, and the degree of further compression in demand indicators relative to persistent cost pressures such as wages, will be critically important for company profits.

Further resilience in employment may support the soft-landing thesis established in recent market action.

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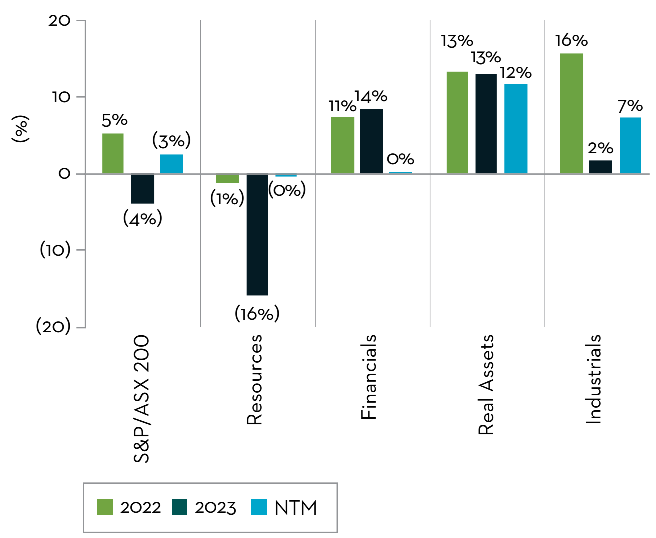
S&P/ASX 200: Profit growth forecasts vs. prior year results



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Expectations for earnings and dividend growth

Reece Birtles
CIO and Portfolio Manager,
Martin Currie Equity Income Fund

Robust balance sheets and pricing power

Unfortunately, the outlook for dividend growth is dominated by this poor earnings growth outlook, even though Australian company balance sheets are generally strong and payout ratios are modest versus history. As a result, being selective in stock picking for income and growth is as important as ever.

We expect that higher-quality, more defensive businesses that have pricing power to pass through inflationary impacts into their revenue stream will be better placed to grow dividends in the current environment. We note that inflation-linked mechanisms can often take time to flow through to revenues, so we see that positive impacts of past inflation can benefit returns for some time after inflation does slow.

Rates to impact Financials in 2024

Financials generally weathered the steep hiking cycle relatively well in 2023, but 2024 may be harder.

Banks impacts are nuanced. Initially in 2023, poor economic growth and falling house prices – which in turn can affect bad debts – were being balanced against positive rate impacts on net interest margins. Banks did enjoy strong deposit margins initially, however much of this was squandered on mortgage discounting, which is now causing declining pre-provision earnings. Macro relief has ensued, but looking forward we believe banks still face further deposit margin adjustment, and whilst bad debts have proven to be resilient so far, face downside skew.

Insurance stocks outperformed in 2023 as they benefit from rising rates via their investment earnings, and the rates cycle accompanied a hardening premium cycle. We see them as well placed in 2024 to grow dividends.

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Overly optimistic China growth expectations

2023 saw disappointing Chinese growth. Chinese government advisers have recommended 2024 growth targets to range from 4.5%-5.5%[3], but reaching such targets will require Beijing to step up fiscal and monetary policy to stimulate aggregate demand beyond what has been announced and overcoming significant current housing headwinds.

Compared to weak growth, surprisingly high steel production has continued to feed into optimistic expectations for iron ore, whereas prices of the broader commodity complex are acting more consistently with recession expectations.

Lithium supply and demand out of kilter

The lithium outlook has deteriorated, with supply now ahead of demand, particularly as electric vehicle (EV) take-up has fallen short. EV penetration rates have flat lined, particularly in China, but also Europe and the US. Reports out of China suggest Chinese lithium producers are not seeing production cuts and new mines continue to ramp up/expand. This could see the market oversupplied in 2024, creating extra pressure to see reduced supply growth, otherwise excess supply gets worse in 2025 with downstream industry destocking broadly playing out.

As a result, we have lowered our outlook for an improved supply/demand balance and underlying spodumene prices and related Australian equities.

Travel recovery

Travel stocks have continued to see improving earnings expectations as the travel recovery has played out. International holiday travel continues to grow, with an average 95% vs pre-Covid levels over the last three months. This means the recovery tailwind has broadly passed but we still see some opportunity from here in further margin normalisation.

[3]Source: Reuters, 22 November 2023; China government advisers call for steady growth target in 2024, more stimulus.

Martin Currie Equity Income Fund

The diversification of the MCA Equity Income Fund means that we are structurally underweight the Top-20 ASX stocks, and higher dividend risk sectors such as Resources and the Banks.

The diversified portfolio includes high-quality and high-yielding names such as Telstra Group, Medibank Private, ANZ Group Holdings, Aurizon Holdings and Suncorp Group to provide a stable and growing franked dividend income stream.

With the Government sounding out new MySuper type default retirement products in its latest discussion paper on Super in Retirement, the next 12 months also looks interesting for solutions that focus on providing a 'sufficient income for life' through dividends, such as MCA's Equity Income strategy.

Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were or will prove to be profitable.

Source: MCA, FactSet; as of 31 December 2023. Data presented for a Martin Currie Australia Equity Income representative account.

Australian market remains attractively valued

Reece Birtles

CIO and Portfolio Manager,
Martin Currie Equity Income Fund

Valuation advantage for Australian equities

Compared to the rest of the world, our view is that consensus EPS forecasts for Australian stocks have already digested more of the economic slowing, while global (especially US) EPS forecasts remain at cycle highs. Given the economic outlook of slowing inflation and growth, and the prospect of rate cuts, we expect EPS to be under pressure everywhere in 2024. At the same time, the forward Price-to-Earnings (P/E) ratio for Australia is much lower than that for global markets. Therefore, we see better value in the more discounted Australian market. There appears to be a contradiction between the economic growth pessimism of falling bond yields and the optimism of rising equity market P/E ratios.

MSCI World

S&P/ASX 200

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Source: Martin Currie Australia, FactSet; as of 31 December 2023.

*Long term average forward P/E ratio for the market.

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Value-style stocks offer attractive opportunities

Within the attractively valued Australian market, we continue to see a wide dispersion between Growth-and Value-style stocks. This valuation dispersion narrowed in 2021-2022 on higher rates, but since the peak rate narrative and excitement around AI kicked off in March 2023, the valuation dispersion has again widened.

Our view is that the greater the valuation dispersion between typical value stocks and growth stocks, the greater the excess return opportunity for a disciplined valuation investment approach.

MSCI Australia: Forward P/E ratios by style

Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 December 2023.

Martin Currie Select Opportunities Fund

Given the wide value dispersion in the market, and our expectation for a difficult growth environment in Australia, our Martin Currie Select Opportunites Fund is seeking undervalued names that have defensive business characteristics or profit drivers less related to the broader economic cycle.

We are finding opportunities in insurance names exposed to strong premium rate increases, contractors exposed to energy transition and infrastructure work, and industrial & consumer businesses with strong pricing power. Other themes that continue to provide opportunities include the post-Covid travel recovery, and energy, food & labour shortages. Examples of our attractively valued holdings include ANZ Group Holdings, Medibank Private, QBE Insurance Group, Aurizon Holdings, Santos and Telstra Group.

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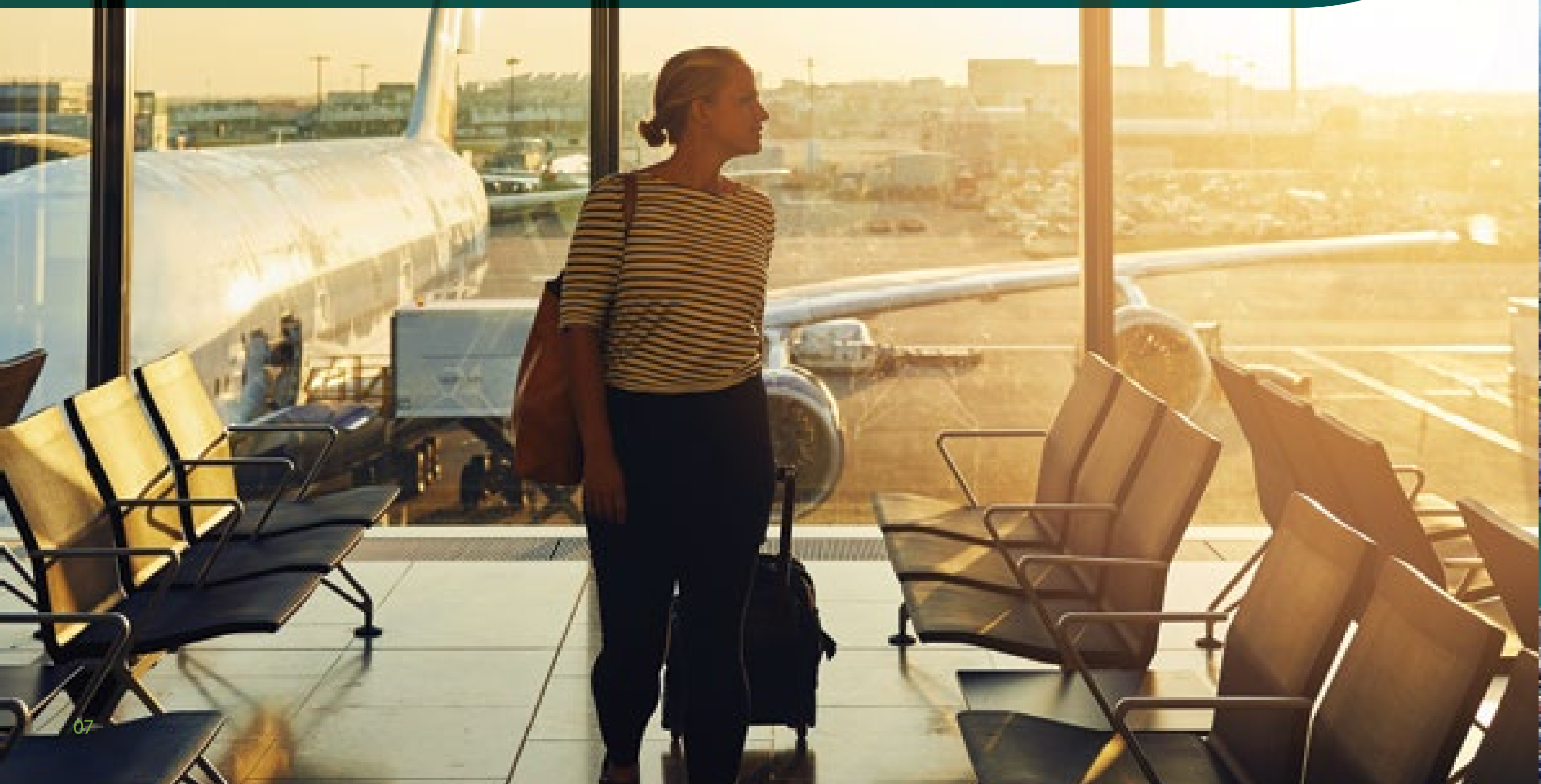
Source: MCA, FactSet; as of 31 December 2023. Data presented for a Martin Currie Australia Value Equity representative account.



Opportunities for Real Assets from higher bond yields

Ashton Reid
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Martin Currie Real Income Fund

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Portfolio Manager,
Martin Currie Real Income Fund

Higher yields in bond markets certainly have found the attention of income-focused investors. We believe that it is also an opportune time to turn attention towards listed Real Assets.

Prices and yields already reflect higher rates

Listed Real Assets prices have swiftly adjusted to the global shift toward higher interest rates and bond yields, thanks to their deep liquidity and transparent pricing. We believe that any subsequent fall in interest rates is likely to have a positive impact on listed Real Asset valuations.

Real Asset yields have also historically been positively correlated with interest rates. Among other things, rising rates can lead to higher costs for Real Assets, affecting their dividends. In turn, as longer duration assets, higher interest rates can also see the market apply a higher discount rate to listed Real Asset markets. As a result, yields for listed Real Assets may rise.

Yield growth driven by pricing power and accelerating cashflows

While high interest rates can present challenges, they may also signal a stronger growth outlook that could lead to increased cashflows for listed Real Assets.

Unlike nominal fixed-cashflow assets whose values may erode with inflation, Real Assets often possess cashflows that are contractually linked to inflation rates.

For example, property leases often reference the Consumer Price Index (CPI), regulated monopolies typically include an inflation measure in their allowed returns, while Energy Utilities can benefit from a rising inflation environment as they often have the pricing power to pass through higher prices to end users.

Megatrend-driven demand to navigate uncertainty

In the face of economic and geopolitical uncertainties, listed Real Assets can provide attributes of an equity like defensive 'anchor', diversifying portfolios from the volatility that often accompanies stocks with more uncertain earnings streams.

This is because Real Asset companies are typically less exposed to the economic cycle given their 'everyday needs' nature, and have demand growth drivers that are more removed from short-term economic and market levers.

We see three key megatrends providing tailwinds for Real Asset demand growth:

- Population growth is driving greater demand for Real Assets and their services. Quite simply, the more a population grows, the higher the volume of demand for Real Assets to serve everyday needs.
- This is further bolstered by the energy transition theme, where there is a demand to build out our networks and grids to facilitate greater electrification.
- Explosive data growth is further driving demand for Real Asset services, such as telco towers, data centres and distribution sheds.

A strong setup for long-term total return

The current environment of higher than usual real interest rates and inflation sets a favourable stage for the total return of Real Assets in 2024, especially considering that even a minor downward adjustment in long-term inflation expectations can enhance their valuation outlook.

Combined with their defensive quality, and key megatrends driving consistent demand, the outlook is promising and robust for listed Real Assets.

Martin Currie Real Income Fund

The Real Income strategy focusses solely on the listed Real Assets (REITs, Infrastructure and Utilities) that we believe are the true essential building blocks of the economy. These include diverse assets such as supermarket-anchored shopping centres, data centres, telecom towers, healthcare facilities, ports & toll roads, gas & water pipelines, and renewable electricity generators.

The diversified portfolio includes opportunities such as Aurizon Holdings, Scentre Group, Digital Realty Trust, Chorus and Charter Hall Retail REIT.

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Source: MCA, FactSet; as of 31 December 2023. Data presented for a Martin Currie Australia Real Income representative account.

Next twelve month (NTM) expected data is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed and may differ materially from the figures mentioned. The figures may also be affected by inaccurate assumptions or by known or unknown risks and uncertainties. For broker consensus data, the number of brokers included for each individual stock will vary depending on active coverage of that stock by a broker at any point in time. A median of brokers is typically utilised. All estimates avoid stale forecasts which are removed after a certain number of days.

Sustainability themes for 2024

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Portfolio Manager,
Martin Currie Sustainable Equity Fund

Naomi Bant
Portfolio Manager,
Martin Currie Sustainable Equity Fund

Sustainability will continue to be an important topic for Australian investors and companies in 2024. As part of our in-depth fundamental stock research, we will be continuing our focus on Net Zero outcomes, and our work to bring more awareness to our investee companies of social issues such as First Nations people, work safety, modern slavery and data privacy.

COP28

The 2023 United Nations Climate Change Conference, more commonly known as COP28, illustrated the continued commitment to reducing carbon emissions globally. A snapshot from Australia's emissions projections report suggests that Australia will likely cut its CO_2 pollution to 42% below 2005 levels by 2030[4]. These projections are based on an assessment of introduced and announced policies, including a revamped safeguard mechanism applied to industrial emissions, an expanded underwriting scheme to help reach 82% renewable energy and a pending electric vehicle strategy. It is becoming apparent that the Australian Government is now having to balance the inflationary impact of moving to a greener future with society's rising cost of living.

Energy transition beneficiaries

In 2022, Australia already accounted for 30% of total global lithium supply and approximately 5% of global rare earth supply[5]. With a growing global spend on fossil fuels transition, take up of EVs, and the prospect of additional funding from the USA Inflation Reduction Act into renewable energy investments, we see Australian suppliers of critical minerals – lithium, copper, nickel, cobalt, rare earths, and other minerals – as likely key beneficiaries.

First nations people

Supply Nation's Social Return on Investment Report suggests that $4.41 of economic and social value is generated for every $1 spent through Indigenous businesses[6]. The adoption of Reconciliation Action Plans (RAPs), and company action in communities, will be a focus for engagements with corporates in 2024. Currently 65% of companies have a RAP, with 21% at the Elevate stage[7]. As a business, we will also be adopting our own Reflect RAP in early 2024.

[4]Source: Department of Climate Change, Energy, the Environment and Water; 30 November 2023. Australia's emissions projections 2023.
[5]Source: MCA, Macquarie Capital, Goldmans Sachs, Geoscience Australia; as of 31 March 2023. Australia's share of global supply (2022).
[6]Source: Supply Nation; 2019. Connecting corporate and government buyers with Indigenous businesses.
[7]Source: MCA, Macquarie Research, Reconciliation Australia; as of 30 September 2023. Data calculated for the S&P/ASX 200.

Work safety and automation

For several Australian companies, workplace injury caused by automation in sophisticated warehouses and distribution centres was a regrettable theme in 2023. Through our engagements, we will be closely monitoring how companies improve staff training to better mitigate this risk in 2024 and beyond.

Modern Slavery

In this interconnected world, ethical sourcing is becoming much more important. A key concern of ours is how companies properly assess and monitor modern slavery incidents, and then mitigate and reduce the likelihood of reoccurrence. We introduced our Modern Slavery Risk framework in 2021, and in 2024 we will continue to engage with companies on understanding and reducing their risk.

Data privacy & cyber security

A recent report by Deloitte Australia states that one third of Australian consumers have been impacted by a data breach in the last 12 months[8]. The report also states that most breaches are avoidable. The updating of systems and adding a second form of user authentication will be key themes in 2024. Scams will also likely continue to be an issue for businesses, and will require significant capital to improve surveillance. An emerging theme is regulation around how customer data is stored, with growing pressure for much shorter time periods or deletion after use.

[8]Source: Deloitte Australia; August 2023. Privacy Index 2023.

Martin Currie Sustainable Equity Fund

We are finding opportunities based on our proprietary assessments of Net Sustainability Benefits, Sustainability Risk and Sustainability Pathways, alongside attractive expected returns, in stocks such as Macquarie Group, QBE Insurance Group, Medibank Private, Flight Centre Travel Group and Worley.

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Source: MCA, FactSet; as of 31 December 2023. Data presented for a representative Martin Currie Australia Sustainable Equity account.

Summary

As the world continues to normalise to peak rates and long-term inflation expectations, the environment plays towards Australian stocks with defensive earnings, robust cash flows, strong balance sheets and cost control amid the ongoing contraction in household budgets.

Right now, it is more important than ever for investors to be discerning in their stock picking, focussing on the right companies in this environment, avoiding stocks with valuation risk, or issues with poor pricing power, falling volumes, rising costs or sustainability concerns.

We believe that Growth-style stocks remain expensive, while Value stocks are still cheap relative to history. As the large spread between Value and Growth unwinds, and the market refocusses on valuations based on true earnings and dividend fundamentals, the conditions for MCA's strategies to outperform their total return and/or income objectives remain convincing.

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Important information