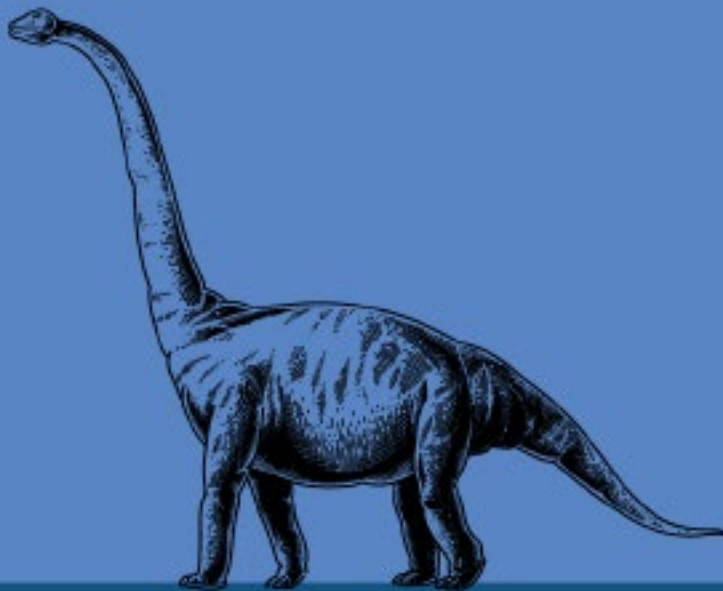


RETURNS LOOM LARGE IN 2025



By Marcus Ryan, Deputy Portfolio Manager, Broadcap Australian Equities

2024: A good year for Australian equities

Approaching the end of 2024, the ASX 200 total return sits handsomely at +13.2%.¹ This is a strong result compared to the market's average historical 12-month return (+9.1%) and a relatively lacklustre economic backdrop characterised by:

- Anemic and uneven economic growth in Australia (GDP 1-1.5% y/y, but negative in per capita terms)
- Various cross currents at play: higher interest rates are now biting, inflation is easing but so too is pricing power, fiscal stimulus is modest, policy uncertainty is an overhang (energy, education, the consumer)
- Confidence remains very fragile: business confidence plunged to -3 in Nov-24 (vs. +6 LT average), with consumer confidence below 85 for much of 2024 (vs. 101 LT average)

However, not all "Sector Boats" have been "Buoyed Evenly." Substantial sector divergence has been a feature of 2024 (refer chart), specifically:

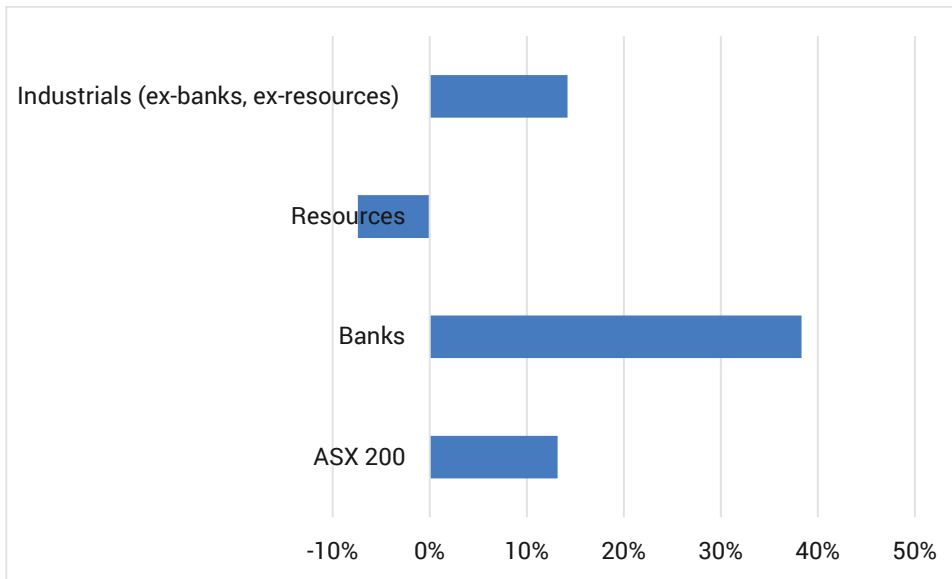
- Big-4 banks (23.4% of ASX) rallied hard (+38.3%), driven predominantly by a P/E "re-rate" rather than earnings and being a key beneficiary of a range of non-fundamental drivers
- Resources (21.4% of ASX) substantially lagged (-7.4%), driven by weakening commodity outlooks and lack of certainty around China stimulus
- Industrials (ex-banks, ex-resources) (+14.2%) reflected a "mixed bag of results" from strength in Technology (+48.4%) driven by increasing focus on data centre and AI themes, to negative returns from the non-discretionary retail sector (-4.3%), i.e. supermarkets, as the sector battles with rising costs, affordability-constrained consumers and increased regulatory focus.



the **2025**
outlook
large caps

¹ ASX200 total returns, as at 13 December 2024, historical is last 10-years average

Chart 1 – 2024 CYTD returns



Source: Macquarie, FactSet, Dec 2024.

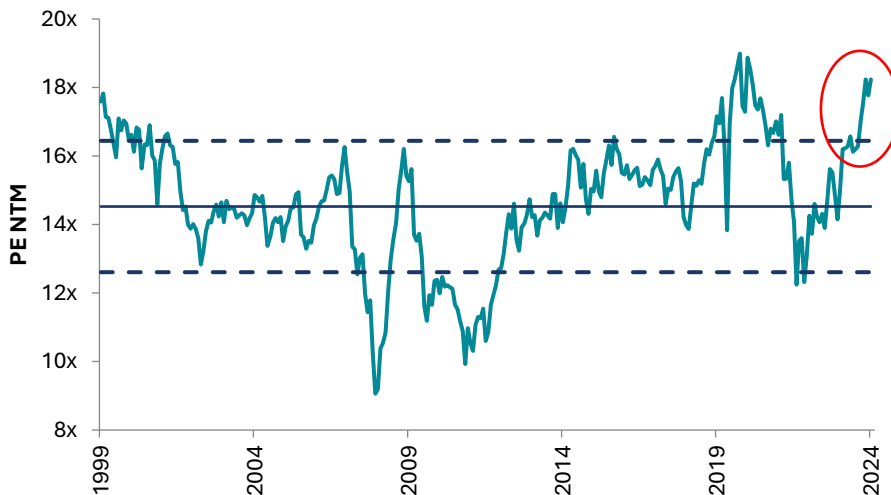
FY25: the third successive year of earnings declines

Many of the drivers of the 2024 resilience appear to be fragile heading into 2025. In particular:

- Immigration and university caps are set to create significant headwinds (in 4Q23, half of GDP growth was international students);
- Housing starts have slumped (-39% from the mid-2021 peak) and affordability is challenged.
- The reprieve for the consumer from tax cuts and energy rebates is extremely modest (~1.3% of disposable income); and
- Productivity gains – which are key to unlocking growth – remain elusive. Despite some improvement in early 2024, it is abundantly clear that Australia lacks competitiveness in key sectors.

Against this backdrop, ASX 200 firms trade at an average forward P/E of 18.2-times, or 26% above the 20-year average (refer chart 2). Multiple expansion will be difficult given the outlook for half the market, specifically Banks (24% of ASX200) and Resources (22%). Referencing historical multiples for these sectors is also likely flattering given lower ROE's (banks), with China through peak demand growth (resources).

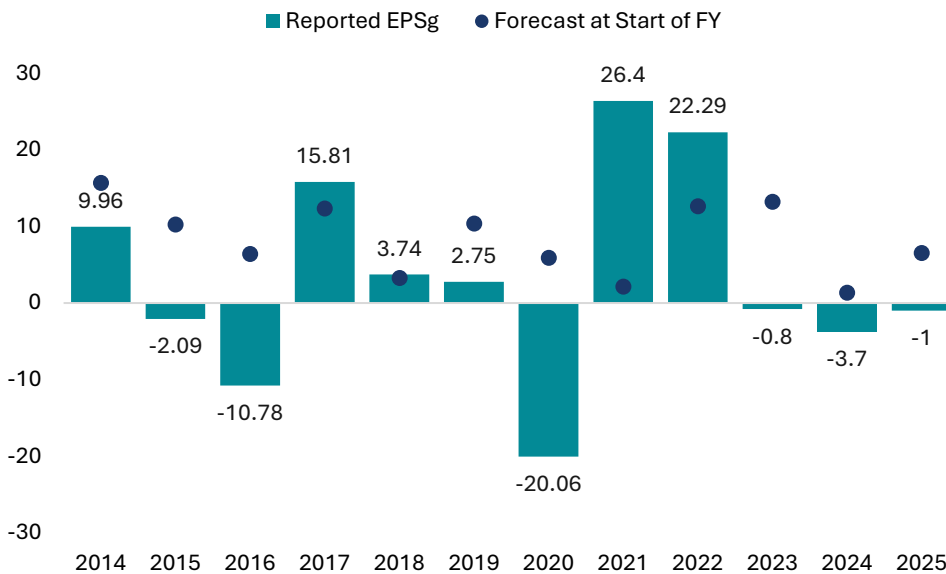
Chart 2 – ASX 200 firms trade at 26% above the 20-yr average



Source: Goldman Sachs, FactSet, Dec 2024

In addition, the market is now expecting FY25 to be the third successive year of earnings decline (-1% y/y) for the ASX200 following the over-earning periods of FY21-FY22 (the 'COVID bump'). Thus far, FY25 is proving to be a typical year where consensus earnings expectations started the year (+3.7%) higher than where actual earnings are likely to be delivered (refer chart 3).

Chart 3 – Australian companies – Reported EPSg vs. Initial Forecast (%yoy)



Source: YCM, Factset, December 2024

Focusing on attractive opportunities within the market, rather than the market itself

With parts of the market trading at record multiples, we remain highly selective:

- Resources: we expect continued divergence, and remain focused on stock rather than sector opportunities
- Energy: the sector looks encouraging, with a decade of underinvestment difficult to reverse
- Industrials: margin pressure is likely to remain a dominant theme, with almost half of the 'COVID EBITDA margin boost' to ASX200 Industrials remaining today

- Banks: the sector simply isn't compelling given the backdrop of intense competition, falling returns and record valuations
- REITs: valuations appear to be bottoming, but discounts to NTA remain elusive. Fundamentals in some sub-sectors (i.e. office) are expected to weaken further before we see a recovery

We believe that Business Quality remains key to the outlook, in particular:

- Quality businesses operating below mid cycle: our approach to 'fundamental quality' assesses a company's market position, industry structure, pricing power and management. Plumbing supply company Reliance (RWC) and metal scrap participant Sims (SGM) are two companies trading at discounts today and which we believe will benefit as end markets normalise
- Commodities are approaching 'choke' points, reflecting supply driven tightness: investor focus on 'demand drivers' arguably made sense when China was growing rapidly and urbanising. Supply for many commodities has been heavily constrained in recent years and with no quick fixes. Certain commodities are approaching choke points that should boost prices. Portfolio examples include:
 1. Copper: we hold positions in Sandfire (SFR) and Evolution mining (EVN); and
 2. LNG: we hold positions in oil & gas leader Woodside (WPL) and energy engineering services company Worley Parsons (WOR)
- Businesses and industries with structural growth: we are particularly focused on data centres, software, and marketplaces where we often observe low levels of industry penetration, pricing power, offshore growth channels, high recurring revenue and high incremental returns. Portfolio examples include:
 1. Accounting software provider Xero (XRO) which offers demonstrable pricing power in Australia and New Zealand and good growth optionality in the UK and US;
 2. Global sleep apnea leader ResMed (RMD). The industry is growing with significantly under-penetrated markets (<25% penetrated in USA); and
 3. Leading domestic data centre provider NextDC (NXT). The industry is facing surging demand, with NXT additionally seeking proactive growth into Asia
- Turnarounds with significant potential and catalysts to re-rate: we typically need to see durable franchises, with strong brands and industry structures. Additionally, short-term issues that have driven the dislocation are now offering substantial valuation upside. Portfolio examples include:
 1. Online residential real estate registry business PEXA (PXA), a high-quality core business being overlooked due to missteps with UK expansion and data commercialisation; and
 2. Vehicle part retailer, Burson (BAP), has strong brands (Burson, autobahn) and resilient product demand, has seen temporary disruption through business reset program and management change

2025: focusing on identifiable catalysts

Conviction positions away from the benchmark and with identifiable catalysts give us confidence in our ability to outperform over 2025.

Importantly, risk management is at the forefront our investment approach ensuring that stock ideas are weighted appropriately based on risk/reward, ensuring a balanced portfolios with capable of outperforming through varied market cycles.

Stemming from our proactive research approach, our 15-person equities team conducts more than 2,500 meetings annually which underpins a strong pipeline of new ideas for the year ahead.



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As we close the year, the ASX200 total return sits handsomely at
+13.2%.

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