Atchison

Q1 2025

Tactical Asset Allocation Outlook

Illuminating
the way forward

Tactical asset allocation

Tactical asset allocation (TAA) is an investment style where the three primary asset classes of shares, bonds, and cash are actively balanced and adjusted based on market performance to meet stated risk tolerance and investment objectives.

The focus is on asset classes rather than specific assets themselves, as the strategy blends and augments passive buy-and-hold methods with medium term views on market dislocations and valuation opportunities.

This report is developed in conjunction with our recent **Investment Outlook,** incorporating capital market assumptions (CMA), that project the returns of asset classes over a ten-year horizon.

These assumptions serve as key inputs into our strategic asset allocation (SAA) model, and can be termed as ***neutral*** asset allocation positions.

Introduction

The primary lessons from 2024 was that being selective and diversified is the key to riding the economic cycle. Had investors avoided risk assets on that premise, we would experience a mild recession, and investors would have missed the maginficant7, and artificial intelligence boom. A boom that sent the S&P 500 and the MSCI World ex Australia Index up more than 20%.

Even one of the riskiest asset classes, private equity is represented by LPX 50 Index (global performance of the 50 most highly capitalised and liquid Listed Private Equity companies) returned more than 35% for the year.

Looking ahead in 2025, we have a new US president, but he looks familiar. Markets have rallied on the back of the new administration, and its proposed economic policies, much as they did after the 2016 election.

The US economy remains robust, leading the world at a time when other developed nations are stumbling. Instead of falling into a recession, as many had predicted a year ago, we could be heading even higher.

If we look at what could trip the markets up in 2025, we face the similar troubles to 2024. Much like the Cold War era which lasted from 1947 to 1991, and focussed on the geopolitical rivalry between Soviet Union and the US, US leadership is once again being challenged.

Conflicts in the Ukraine and the Middle East, tensions with China threaten to disrupt the world. Populist movements are gaining momentum, fuelling a potential reversal of free trade policies, andmacro uncertainty brings with it market volatility.

These risks are not expected to go away in the short-term, therefore we prefer to take a prudent stance, and tactically seek to achieve a balance between growth of capital and capital preservation.

Atchison acknowledges that good corporate earnings, a robust global economy, interest rate cuts and strong momentum will continue to support equities. In addition, bonds are expected to play an important role again as the normalisation of interest rates will result in fixed income providing a measure of income, diversification and a ballast against stock market volatility.

However, according to Bank of America, the global equity market seems euphoric. The cash allocation of global fund managers has never been lower, and the allocation to US equities has never been higher.

The valuation of the US equity market (which makes up around 75% of the MSCI World ex Australia Index) also remains high.

Key take-outs

- Global growth is projected at 3.3% both in 2025 and 2026, below the historical (2000–19) average of 3.7%. The forecast for 2025 is broadly unchanged from that in the October 2024 World Economic Outlook (WEO), primarily on account of an upward revision in the US offsetting downward revisions in other major economies.
- Global headline inflation is expected to decline to 4.2% in 2025 and to 3.5% in 2026, converging back to target earlier in advanced economies than in emerging market and developing economies.
- The Australian market continues to trade at record levels pushed decisively higher by the big ASX bank stocks on the back off better-than-expected first half earnings, and consensus view that the Reserve Bank of Australia (RBA) will start cutting rates in Q1 2025. We are of that view that the Australian market is overvalued and there is an opportunity to take profits.
- The US market is still attractive despite the uncertainty around US policy and tariffs. The economy continues to remain resilient and show signs of momentum. Consumption remains healthy, supported by positive real wages, and corporate earnings growth remains on track for double-digit returns this year.
- Emerging market shares have undergone a massive de-rating since 2008. They trade at around a 35% discount to their developed market peers. However, with easier monetary policy by the US Fed may prove to be a catalyst for change.
- China continues to account for a sizeable proportion of the emerging market index, even after its recent weakness. And it has been a dead weight around the investment class for years. The reasons are well known and largely focused on a prolonged slump in the country's property market. Add the risk of a US-China tariff war leads us to avoid China in Q1 2025.
- European stocks valuations are creeping up as the economic gap between Europe and the US is closing. The International Monetary Fund expects economic growth of 2.2% in the US and 1.6% in Europe this year. With further interest rate cuts in Europe that gap should continue to narrow.
- Bonds to shine in 2025, on the back of expected interest rate cuts and hedge against economic headwinds.
- Credit spreads even though tight can still provide returns excess of cash yielding above 5% while maintaining robust AAA or AA credit rating.
- Gold even though at record highs is still deemed a hedge against inflation, and given the potential uncertain economic environment we may experience.

Summary of our Q1 2025 TAA

1. Marginally increase overweight position to international equity – on the back of Trump euphoria and potential improvements in geo-political situation.
2. Maintain overweight position to the US equity market and underweight the position to European equities.
3. Increase allocation US mid-caps and maintain current exposure to US large cap. Earnings resilience, AI-driven structural growth, a deregulatory government agenda, and pockets of reasonable valuations support US markets.
4. Increase allocation to Japanese equities – Japanese banks and mid-cap stocks attractively priced, whilst China stimulus should kick-start their economy, consumer confidence remains subdued.
5. Underweight broad-based growth in favour of quality growth (companies with resilient earnings and strong balance sheets) and growth at a reasonable price (growth potential without excessive valuation risk). While interest rate cuts are anticipated in Q4 2025, a selective approach remains key to extracting value in an environment where earnings sustainability and pricing power matter.
6. Maintain overweight position to emerging market equities ex China – to diversify away from growth bias exhibited in most international equity portfolios, emerging economies have been more successful in reigning in inflation.
7. Increase underweight to Australian equities – due to weaker economic growth, limited interest rate cuts in 2025, less demand for commodities, profit taking from major Australian banks and technology.
8. Neutral on alternatives – provides diversification, increase allocation should economic conditions deteriorate.
9. Marginally underweight duration – remain long short-term bonds and short long-term bonds.
10. Remain overweight credit – with tilt to investment grade credit and high yield.
11. Underweight cash.
12. Currency - maintain a bias towards unhedged currency exposure, as the RBA is expected to begin cutting interest rates earlier relative to the US, potentially leading to a weaker AUD relative to the USD.

Australian Shares

Australian equities remain a challenging landscape, prompting a modest underweight stance in our allocation. The financial sector, particularly major banks like Commonwealth Bank of Australia (CBA), has experienced significant price appreciation, with the ASX 200 Financials Index up 35.2% over the past 12 months.

This strong performance is driven by resilient loan growth, strong net interest margins, and robust dividends, but valuations now appear stretched.

The materials sector faces headwinds due to softer demand from China, Australia's largest export partner, particularly for iron ore, which has seen price volatility amid concerns over Chinese steel production curbs. BHP, Rio Tinto, and Fortescue Metals Group have experienced selling pressure as reduced construction activity in China weighs on commodity demand.

However, gold prices have surged 37.6% over the past year, propping up the broader materials sector, with Newcrest Mining and Northern Star Resources benefiting from investor demand for safe-haven assets. Lithium stocks, in contrast, have struggled, as declining electric vehicle (EV) demand and oversupply have dragged down producers like Pilbara Minerals and Allkem.

The Australian information technology sector has been a standout performer, up 54.3% over the past year, led by names like WiseTech Global, Xero, and NextDC. However, this segment represents a small portion of the overall ASX 200, and valuations now appear stretched compared to global peers, increasing the risk of pullbacks if earnings fail to meet high expectations.

Given these factors—overextended financials, weakness in materials, and stretched IT valuations—a selective, cautious stance is warranted on Australian equities, maintaining a modest underweight position while monitoring sectoral dynamics closely.

International Shares

Our portfolios maintain a pro-growth stance, with preference for US assets. We anticipate a continuation of US equity performance into 2025, supported by pro-growth policies, resilient private sector balance sheets, and broadening earnings growth. However, rate implementation, tariff risks, and geopolitical uncertainties may introduce further volatility.

United States Shares

In 2025, we recommend a modest increase in exposure to US mid-cap equities while maintaining current allocations in large-cap stocks.

The resilience of corporate earnings, driven by advancements in artificial intelligence (AI) across sectors such as healthcare and financial services, underpins this strategy. Notably, the AI boom is expected to broaden, benefiting companies beyond the major tech firms.

Additionally, the current US administration's deregulatory agenda and potential corporate tax reductions are anticipated to bolster both revenue and earnings, particularly in the latter half of 2025 and into 2026. Despite the postponement of interest rate cuts, now anticipated to occur in Q4 2025, pockets of reasonable valuations are still evident in the US market. While consumer sentiment has dipped and productivity growth has slowed, positive business sentiment and strong consumer spending continue to support US economic growth.

Japanese Shares

Japan’s corporate governance reforms have driven structural changes, including the unwinding of cross-shareholdings by major insurers, improved board independence through revisions to the Corporate Governance Code, and a stronger focus on capital efficiency by leading firms.

These shifts have also encouraged increased shareholder activism, greater transparency, and a rise in mergers and acquisitions, enhancing competitiveness and driving Japanese stock indices to multi-decade highs.

Japan’s corporate governance reforms have significantly enhanced market performance, attracting global investors. The unwinding of cross-shareholdings by major insurers like MS&AD Insurance, Sompo Japan, and Tokio Marine has improved capital efficiency, enabling greater share buybacks and dividends, leading to stronger return on equity (ROE).

Revisions to the Corporate Governance Code have strengthened board independence, enhancing management oversight and strategic decision-making. Companies such as Toyota, SoftBank, and Fast Retailing have focused on capital efficiency, boosting earnings growth and valuations, while heightened shareholder activism has spurred mergers and acquisitions, notably with Astellas Pharma and activist investor Farallon Capital. Additionally, firms like Tokyo Electron and Keyence have improved transparency and capital allocation, reinforcing competitiveness.

These structural changes have elevated investor confidence, pushing Japanese stock indices to multi-decade highs.

European Shares

Europe continues to face structural challenges, including sluggish economic growth, an ageing population, and persistent energy dependence, leading Atchison to reduce exposure to European equities over the next 12 months.

The European Central Bank's delayed rate-cut cycle and weaker corporate earnings growth—especially in sectors like manufacturing and financials—have weighed on market sentiment. Companies such as Siemens and Volkswagen are struggling with slower industrial demand, while banks like Deutsche Bank and BNP Paribas face compressed margins due to high funding costs.

Additionally, declining foreign direct investment and regulatory constraints have hindered capital market competitiveness. Despite policy efforts like the Capital Markets Union (CMU) and the EU's Green Industrial Plan, execution risks remain high. These structural headwinds are expected to limit near-term upside, justifying a cautious stance on European equities.

Emerging Markets

Emerging markets are poised for selective growth, prompting a modest increase in allocations to key regions such as Brazil, India, and Vietnam, while concerns over Mexico's trade outlook temper its investment appeal. Given escalating trade tensions between the U.S. and Mexico, a more cautious approach is warranted in Mexican equities, while Brazil, India, and Vietnam present stronger structural tailwinds for long-term investment.

Vietnam continues to benefit from global tariff shifts, with companies like Samsung and Apple expanding manufacturing operations to reduce reliance on China, reinforcing its role in global supply chains.

Mexico's nearshoring advantages are now under threat due to the proposed 25% U.S. tariffs on Mexican imports, which could disrupt key industries such as automotive manufacturing, impacting firms like GM and Ford, which have significant production facilities in Mexico under the USMCA framework.

Brazil's vast natural resource base, particularly in iron ore (Vale) and agriculture (JBS), is set to gain from rising global commodity demand, with iron ore exports to the U.S. accounting for 25% of total trade between the two nations. This solidifies Brazil's role as a key supplier of industrial materials critical to the U.S. economy.

India's recent tariff reductions on key imports, coupled with government incentives for semiconductor production (Tata Electronics) and technology investments, further support its trajectory as a global manufacturing and innovation hub.

Chinese Shares

China's economy presents a complex landscape marked by both resilience and underlying vulnerabilities. In 2024, the nation achieved a 5% GDP growth, aligning with official targets, primarily driven by robust exports, which surged by 7.1% to a record $3.47 trillion.

This export strength was partly due to businesses expediting shipments ahead of anticipated US tariffs. However, the housing market remains a significant concern, with prolonged downturns affecting consumer wealth and spending. Major companies like Alibaba and Apple continue to play pivotal roles in the tech sector, while BYD leads in electric vehicle production.

Despite these successes, many Chinese firms are grappling with financial challenges, including overcapacity and weak domestic demand, leading to substantial losses in key industries such as steel and battery manufacturing.

Inflation rates have remained low, with consumer prices barely rising in 2024, indicating persistently weak domestic demand. Employment figures are stable, yet concerns persist regarding job security, especially in sectors affected by global trade tensions.

Consumer and business sentiment are cautious, influenced by uncertainties surrounding potential US tariffs and internal economic challenges. While recent data shows signs of economic recovery, structural issues such as high debt levels, an aging population, and reliance on exports contribute to ongoing volatility.

Given these factors, we maintain a cautious outlook on China's economic trajectory, acknowledging the recent positive indicators but remaining vigilant to the inherent risks.

Duration

Yields in fixed income are high versus historical levels – the Bloomberg Global Aggregate index yield level is in the 78th percentile of yields over the past 20 years, and the 88th over the past 10 years.

Starting yields have a strong correlation to positive total returns over the long-term, thanks to the compounded income attributes of the asset class.

Inflation has reduced dramatically since the post-COVID highs across developed markets and economic growth remains steady, albeit muted. This supports our argument for lower central bank rates, which are expected to materialise over 2025, and should provide an additional boost for fixed income investors over the income component.

This will come from both capital appreciation and by lessening the impact of the higher interest burden issuers are facing, bolstering their fundamental strength.

While over time the result of interest rates falling will reduce the income received from those bonds, it is not expected to fall to levels investors saw a decade ago.

Yield curves have been steadily steepening since the remarkably deep inversion territory seen in 2023 and into 2024. Yields on 10-year governments bonds in the US, the EU and the UK are now broadly 30bps higher than their 2-year equivalent. This is a small additional yield versus historical averages (80-100bps differential).

For investors looking to maximise risk-adjusted returns, short duration bonds appear attractive thanks to:

- The natural liquidity that short duration provides
- The lower interest rate duration naturally bringing lower volatility
- A potential continued steepening of the yield curve - as short end policy rates should continue to ease but long-end yields could remain sticky thanks to expanding fiscal deficits and inflation headwinds.

Credit

A typical metric to assess credit market attractiveness is the credit spread over the equivalent government bond. For US investment grade credit, spreads are close to the lowest they have been since before the Global Financial Crisis. US high yield is similarly valued. European IG and HY spreads are less stretched, but still tighter than long term averages.

This should flag as a warning signal to credit investors about potential excess returns over government bonds.

The pricing is broadly justified, and do not expect a strong reversal without a meaningful market event.

Falling central banks rates, strong corporate balance sheets and near-term fiscal stimulus across markets should maintain strong fundamentals, providing strong support for investment grade and high yield bonds.

Within high yield specifically the trend is more rising stars than fallen angels and for default rates to remain relatively low.

For the US market, the average credit quality of high yield issuers has increased in recent years while the overall duration of the market has declined. This helps support structurally lower credit spreads.

In addition, the increased issuance in debt over 2024 and early 2025 has been met with healthy demand from investors looking to allocate to fixed income.

On balance, we are more positive on the credit-sensitive investment grade and high yield broad sectors, although will carefully monitor the impact of macroeconomic themes on corporate fundamentals.

Alternatives

Expected returns from alternatives seem to be getting compressed, especially for total return type strategies when near-term cash hurdles are a tough bar to beat. However, a diversified portfolio of alternative strategies that can still meet liquidity needs of investors have an important role in multi-asset portfolios.

Especially with public equity markets richly valued and concentrated, interest rates volatile and stock-bond correlations still marginally positive. Alternatives can provide alpha, income, inflation protection, and diversification.

Stronger balance sheets and an uptick in economic activity could fuel more corporate direct lending, the largest strategy within private credit. In addition, an aggressive US deregulatory agenda should also support public and private lending.

Post-financial crisis regulation has made lending and due diligence expensive for banks, driving lending activity into private credit over recent years.

Atchison acknowledges there is a very wide spectrum of potential policy outcomes, higher terminal interest rates (real interest rate that supports an economy at full employment whilst keeping inflation steady) appear likely to remain in many regions, with Europe and China being notable exceptions.

Higher interest rates have increased the cost of leveraged buyouts, favouring private equity firms focused on operational efficiencies and organic growth. However, high levels of dry powder and private credit financing continue to support deal activity.

Growth equity strategies and venture capital rely less on debt financing, allowing these funds to be more active in a high-rate environment and capitalize on structural trends like health care innovation and cybersecurity. However, at the portfolio company level, it is noted that high interest costs can weigh on cash flow and valuations. Valuations on investments made at the lowest point of interest rates post-pandemic may capitulate to a high-for longer interest rate environment.

Hedge funds are well positioned to navigate fiscal and monetary policy shifts, and volatility fomented in this environment may benefit select hedge fund strategies.

These changes are likely to create diverse impacts across companies and sectors, offering fertile ground for hedge funds employing long/short strategies to exploit market inefficiencies. Varying interest rate regimes across the globe combined with trade uncertainty also increases the potential for higher currency and rate volatility and may provide macro hedge funds with opportunities for alpha generation.

Real Assets

Trade tensions during the first Trump administration, along with supply chain issues during the pandemic, reversed the decades-long trend toward greater globalization. A second Trump administration could result in greater protectionism and new trade dynamics across the globe.

Should trade tensions and tariffs prove to be inflationary, real assets can also provide critical inflation protection. Although new-build infrastructure could suffer higher costs, operating regulated utilities have the contractual ability to raise end-user prices in response to input cost increases.

Similarly, in real estate, operating costs are typically passed through to renters via rent increases. In addition, the same economic growth that pushes up interest rates also increases property revenue, offsetting the negative effects. Lastly, transport lease rates and asset values have historically followed higher rates and inflation.

Based on the scenario above, real assets that are in demand and can benefit from either high or low interest rates is the

residential real estate sector. Housing supply remains constrained, bolstering valuations. In addition, in the rental market, elevated mortgage rates continue to divert would-be homebuyers into rentals, sustaining demand for existing multifamily and single-family rental assets.

Currency

At the start of 2024, markets were pricing in over six US Fed rate cuts for the year. However, persistent inflation pressures and stronger-than-expected US economic data have led to a significant reassessment of monetary policy expectations. As a result, markets now anticipate just one to two Fed rate cuts in 2025, a sharp contrast to the aggressive easing cycle that was initially forecast.

As we move through Q1 2025, the USD has been on a steady climb, showing notable strength since late September. A combination of a solid US economy and diminishing expectations of significant Federal Reserve interest rate cuts has bolstered the dollar's position in global markets.

While the USD flexes its muscles, several currencies face headwinds:

- EUR, GBP, and CNY: - These currencies are particularly vulnerable to US tariff hikes due to their reliance on exports to the US. The Eurozone could face a double hit as the European Central Bank (ECB) considers deeper rate cuts, exacerbating the Euro's weakness.
- AUD and NZD: - With global economic activity expected to slow in the first half of 2025, these currencies could see downward pressure. Both economies are sensitive to shifts in global trade and commodity demand.
- CAD: - The Canadian dollar has slipped to a five-year low, driven by a weaker domestic economy and its export dependence on the US. However, there's a silver lining: as Canada's economy slowly recovers, the CAD may have already absorbed the worst of its depreciation.

Important information

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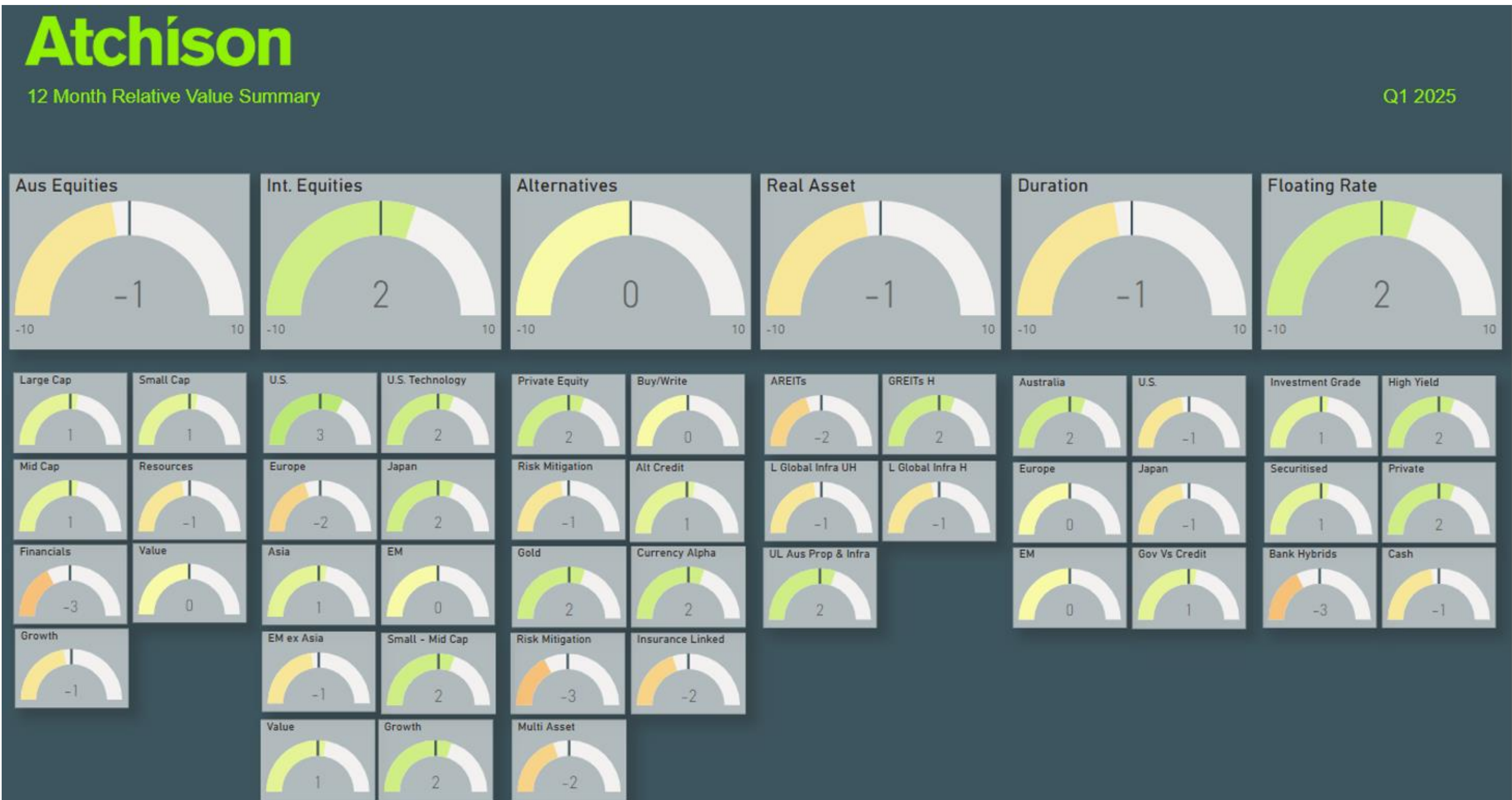
Table 1. Summay TAA Positions – Q1 2025



Refer to Table 1 for Summary TAA positions – Q1 2025. The recommendations shown in the summary are Atchison's conviction away from the SAA, therefore should not be interpreted as a recommended percentage change. a

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