INNOVA
ASSET MANAGEMENT

QUARTER ONE 2025
CFS FIRSTCHOICE

— MARKET OUTLOOK REPORT

Key Takeaways

- **Australian Market Outlook:** In 2024, Australian banks thrived while cyclical sectors struggled, and the ASX200 remains at high valuations driven by the big banks. With higher interest rates benefitting savers but burdening borrowers, and the economy relying on immigration and government spending, the outlook remains uncertain due to persistent inflation pressures.
- **Global Positioning:** Globally, maintaining a long-term, valuation-driven strategy has historically outperformed. While strong earnings growth now seems more achievable due to improved retail performance and cheaper production costs.
- **Monetary Policy and Economic Conditions:** While our base case is a soft landing, we believe the risks lean towards persistently high inflation and prolonged higher rates rather than a deflationary shock. Strong growth, resilient labour markets, rising real wages, and supportive fiscal spending should generally lead to positive outcomes for risk assets.
- **China's Market Surge:** China's stock market rally, driven by government support, depends on further fiscal stimulus to sustain momentum, particularly in addressing the property market downturn.
- **Portfolio Adjustments:** We have adjusted our portfolio to maintain a neutral equity weight, with a more balanced position in fixed income. We emphasise value equities and defensive positioning in Australia.

What's happened in markets

The fourth quarter was driven by U.S economic strength, the dominance of AI investments, and Trump's return to the presidency with a "Red Sweep." While fixed income and currency markets faced heightened volatility from macroeconomic surprises, equities emerged as a more attractive investment option. Selective fixed-income strategies, such as focusing on domestic floating rate notes, performed well, providing stability amid market uncertainty.

US mega-cap companies remained the primary earnings driver globally, though a shift toward cyclicals and small caps has begun. This aligns with expectations of a soft landing, supported by easing monetary policy and strong labour markets. Optimism around Trump's pro-growth policies, such as tax cuts and deregulation has boosted sectors such as small caps, regional banks, and industrials. However, concerns over tariffs and inflation risks persist, even as the US economy demonstrates resilience with high labour productivity and efficient resource allocation.

In 2024, Australian banks performed strongly, while cyclicals like materials and miners struggled. With the RBA in a challenging position and heavily indebted households facing mortgage stress, we remain cautious about discretionary sectors. As the ASX200 hits record-high valuations, driven by the big four banks, the economy's reliance on high immigration and government spending for growth appears unsustainable, especially with persistent inflation in healthcare and construction.

Innova House view

- The Australian market continues to rally despite declining earnings and weak economic growth, largely due to faith in potential monetary policy loosening. However, Australian banks remain expensive relative to global peers, despite weaker returns.
- It is currently a widely held consensus that risk assets should enjoy another strong year in 2025, with the rally broadening out from the AI winners and mega caps in the US, towards more cyclical areas.
- We prefer enhanced value stocks with attractive pricing and strong growth potential, while remaining neutral on expensive areas like quality and momentum.
- The U.S. is experiencing a mild slowing in labour markets, but ongoing government spending and rate-cutting cycle suggest a soft landing with a cyclical recovery in small-cap and undervalued stocks.
- The Chinese government has tried to stabilize certain assets, but there has been no significant fiscal support to fully reverse the negative momentum. As a result, we remain cautious on Chinese equities until we see a clear recovery in the real economy, addressing issues like deflation, the property crisis, and deleveraging.

Potential scenarios and positioning:

CYCLICAL REBOUND (PRIMARY OR BASE CASE)	GROWTH SHOCK	INFLATION SHOCK	VALUATION DOWNGRADE
• The U.S. labour market is experiencing a mild slowdown, but ongoing government spending and an expected rate-cutting cycle point towards a soft landing. This environment supports a potential cyclical recovery, particularly in small-cap and undervalued stocks. • The portfolio remains neutral on equities, with increased exposure to quality small caps while maintaining allocations to equal-weight U.S. indices. • Allocations to Asia have been reduced due to ongoing concerns about China.	• We believe the asymmetric impact of higher interest rates will persist into 2025, benefiting savers while placing increasing pressure on borrowers. • The country is relying solely on higher-than-average immigration and government spending for its growth.	• Inflationary pressures from Trump's stimulatory policies are beginning to take hold, with markets now pricing in a 40% chance of a U.S. rate hike as inflation builds.	• Overall, the U.S. CAPE ratio sits in the 98th percentile historically, dating back to 1920, indicating stretched valuations. • Meanwhile, developed markets outside the U.S. are trading at historically low valuations relative to their benchmarks, presenting potential opportunities. • In this environment, long-term government bonds should perform well.

How we're positioning our portfolios

ASSET CLASS	VIEW	CHANGE	RATIONALE
EQUITIES			
Global Value Equity	Overweight	-	The relative valuation gap between value and growth should narrow if the reflation trade materialises. A rate-cutting cycle should also reduce growth uncertainty. Historically, periods of increased fiscal spending and nominal growth exceeding 4% have been more favourable for value equities.
Japanese Equity	Neutral Weight	-	Strong earnings growth but heightened volatility in August spooked investor sentiment. Valuations are slightly stretched on multiple metrics.
European Equity	Neutral Weight		Challenging macroeconomic conditions and significant valuation expansion in 2024, despite the absence of earnings growth. However, the Equity Capital Markets remains in an easing cycle.
Australian Equity	Neutral Weight	-	Weak economic outlook both domestically and within China. We're avoiding Australian cyclicals and prefer defensive sectors. Valuations also appear stretched at a headline level.
US Mega Caps	Underweight	-	Stretched valuations though carrying much of the quality and profitability within global equities. We prefer to take risk elsewhere despite the chance of the AI play continuing.
REAL ASSETS			
Global REITS	Neutral Weight	-	Should benefit from rate cutting cycle and trades on attractive valuations relative to net assets.
Global Infrastructure	Underweight	-	At fair value and no real catalyst in the shorter term.
Australian REITS	Underweight	-	Overvalued due to Goodman on a headline level. Global REITS more attractive due to certainty around global easing cycle and cheaper valuations.
FIXED-INCOME			
Australian Credit FRN	Overweight	-	Continues to provide a very decent yield with low volatility despite yields becoming tighter.
Australian Treasury	Neutral Weight	>	The recent yield sell-off has made Australian treasuries more attractive relative to US treasuries. With a 30% debt-to-GDP ratio, there is less need for a term premium, although the rate-cutting cycle remains delayed.
Global Credit	Underweight	-	Tight spreads.
Global Treasury	Underweight	-	Prefer domestic due to current premium though bond volatility has been quite high. Trump's election poses a risk to the long end and growth expectations have been repriced.
Global High Yield	Underweight	-	Tight spreads.
Cash	Underweight	-	

CURRENCY / COMMODITY			
AUDUSD	Underweight	>	Increasing hedged positioning in global equities due to repricing and an expensive USD. The AUD is expected to strengthen as the USD declines with rate cuts to a lower terminal rate, likely occurring faster than the RBA's adjustments.
Gold	Neutral Weight	-	Prefer gold miners to gold due to the gap in prices, with geopolitical tension and fiscal concerns prolonging the gold rally even when real rates have risen again.

- The portfolio remains neutral on equities, while maintaining a mild overweight to fixed income, balanced between long-duration government bonds and floating rate credit. And are currently researching whether we should increase this duration position and reduce credit further, given its excellent run.
- Value equities and relative value positions are key overweights, with a focus on cyclical sectors globally, but defensives in Australia due to concerns about its economy and earnings outlook.

Recent portfolio changes

TRADE	SUMMARY
14/08/2024 Global Quality (Sell) & Global Growth (Buy)	Our fundamental outlook for economic resilience and a stronger rebound in the US market remained unchanged, therefore we wanted to increase our growth equity exposure in these portfolios. This was executed through a manager switch, as our global quality manager had not delivered consistent outperformance relative to the quality factor. The global growth manager we selected provided an opportunity for more consistent outperformance while increasing our overall growth exposure.

Performance

	1 MTH	3 MTH	6 MTH	1 YR
CONSERVATIVE				
Innova Active Conservative Portfolio - FC Wholesale Pension	**-0.44%**	**0.59%**	**4.04%**	**6.59%**
Innova Active Conservative Portfolio - FC Wholesale Super	**-0.43%**	**0.58%**	**3.63%**	**5.84%**
Morningstar Benchmark	-0.02%	0.87%	3.56%	5.76%
MODERATELY CONSERVATIVE				
Innova Active Moderately Conservative Portfolio - FC Wholesale Pension	**-0.45%**	**1.21%**	**5.25%**	**8.69%**
Innova Active Moderately Conservative Portfolio - FC Wholesale Super	**-0.40%**	**1.20%**	**4.73%**	**7.92%**
Morningstar Benchmark	-0.43%	0.48%	4.04%	6.88%
BALANCED				
Innova Active Balanced Portfolio - FC Wholesale Pension	**-0.37%**	**1.70%**	**6.29%**	**10.48%**
Innova Active Balanced Portfolio - FC Wholesale Super	**-0.30%**	**1.73%**	**5.77%**	**9.75%**
Morningstar Benchmark	-0.64%	1.31%	5.55%	9.87%
GROWTH				
Innova Active Growth Portfolio - FC Wholesale Pension	**-0.52%**	**2.06%**	**7.27%**	**12.28%**
Innova Active Growth Portfolio - FC Wholesale Super	**-0.41%**	**2.11%**	**6.61%**	**11.51%**
Morningstar Benchmark	-0.97%	1.55%	6.39%	12.03%
HIGH GROWTH				
Innova Active High Growth Portfolio - FC Wholesale Pension	**-0.61%**	**2.46%**	**8.10%**	**13.46%**
Innova Active High Growth Portfolio - FC Wholesale Super	**-0.48%**	**2.50%**	**7.35%**	**12.66%**
Morningstar Benchmark	-0.99%	2.77%	8.20%	16.44%

Portfolio changes PREVIOUS 12 MONTHS

TRADE	SUMMARY
08/07/2024 Australian Index (buy) & Australian Alpha (sell)	We had observed several cyclical headwinds in relation to the domestic equity market (services inflation remained sticky, real GDP per capita was signalling a recession and forward earnings had declined while prices were still high). For these reasons we preferred quality and defensive exposures domestically. We executed a manager switch to reduce exposure to the discretionary spending sector, though we wanted to maintain a hedge against our base case for domestic equities (underweight cyclicals and overweight defensives) and therefore allocated to the Australian Equity Index to retain exposure to cyclical sectors while bringing down the overall cost of the portfolio.
15/02/2024 Quality small caps (buy) & Global Agriculture (sell)	Global small caps had not participated in the 23/24 equity market rally and were trading at a deep discount to their large cap counterparts. We opted to focus on the 'quality' end of the spectrum, which has historically shown to provide protection if a sell off were to occur, so allocated to global quality small caps. This was funded by selling our position in Global Agriculture as we did not believe we needed as much inflation protection in our portfolios going forward. We also reduced our cash exposure and increased our overall global equities exposure due to improving economic fundamentals. This reduced our underweight to global equities, but maintained our overall defensive positioning.
16/11/2023 Australian Equities (Buy) & Credit and Cash (Sell)	Australian Equities were looking more attractive with better forecast short- and long-term returns, given their poor performance this year. Our large allocation to domestic floating rate credit had performed extremely well and our model suggested selling this less attractively priced asset to buy the more attractively priced Australian Equities. Simply put, we were selling high (credit) and buying low (Australian Equities). This was to be funded with our overweight to cash, as we were waiting for an opportunity to deploy this into attractively priced growth assets