Outlook 2025

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Key points

- **Over the longer-term, prospects for Australian equities remain promising. Structural growth drivers such as strong corporate governance, a high dividend yield and a large and low-cost natural resource base prevail in Australia.**
- **As we move ahead, inflation is still lingering, and the possibility of interest rates being cut in the short-term has taken a back seat. The government has introduced tax cuts to safeguard lower income earners and introduced subsidies on electricity bills in response to sticky inflation.**
- **Markets have priced in some risk factors of high inflation, higher for longer interest rates, regulation and taxation. As a result, there are ample investment opportunities with attractive risk-adjusted returns which can deliver strong investment returns over the long term.**

What is your outlook for Australian equities?

2024 was dominated by macroeconomic factors such as inflation, interest rates, geopolitical concerns, conflict, and fiscal policies. As we move ahead, inflation is still lingering. Consequently, the possibility of interest rates being cut in the short-term has taken a back seat. The government has introduced tax cuts to safeguard lower income earners and introduced subsidies on electricity bills in response to sticky inflation. Geopolitical tensions and conflict are still prevalent, but the recent stimulus measures by China are a positive. While we believe that economic growth will continue to be muted and, we do not think that Australia will move into a recession. Sectors such as insurance, communications, healthcare, diversified financials, and some consumer staples should remain strong, or improve through the year.

Over the longer-term, structural growth drivers such as strong corporate governance, a high dividend yield and a large and low-cost natural resource base prevail in Australia. On a positive note, markets seem to have priced in some risk factors of high inflation, higher for longer interest rates, regulation, and taxation. As a result, there are ample investment opportunities with attractive risk-adjusted returns which can deliver strong investment returns over the long-term.

The outlook for the market pivots around interest rates. We have recently seen some interesting moves with the US starting its interest rate cutting cycle with a 50 basis points (bps) cut and cuts in Europe, the UK, New Zealand, China and a host of other small countries. Yet Australia held firm on interest rates. This divergence is in line with our long-held view that Australian rates will be higher for longer due to a number of factors. Firstly, Australian interest rates have not risen as much as peers, having peaked at 4.35 per cent compared to the 5.00-5.50 per cent levels seen in other countries, and as a result are much less restrictive. Secondly, inflation in Australia is proving sticky, especially for services inflation, courtesy of the larger output gap and less labour mobility in Australia. And finally, Australia's productivity growth is at the lowest level in 60 years, whereas in the US we saw productivity growth in 2023 outpace the annual average since 2004.

How are you looking to position your portfolio against this backdrop?

The Fund is comprised of our highest conviction, best ideas across the full spectrum of market cap in the Australian market. We remain focused on company fundamentals as well as experienced and competent management teams, which is crucial to their ability to manage through the current uncertainty. Australia remains home to many innovative companies that are well positioned to deliver long-term growth. We favour high-quality companies with a sustainable competitive edge, strong free cash flow generation and robust earnings growth.

The portfolio is positioned to benefit from Australia's long-term structural growth drivers but is also attracted to companies that offer more resilient business models. An example is CSL which was formed back in 1916 and been able to grow their earnings strong over many decades through a business model focused on innovation and Research & Development (R&D). We expect them to continue to be able to compound earnings at mid-teens growth rates over the medium-term. Over the next few years, the company will be driven by its core blood plasma business which will be driven by a combination of recovering volumes, increasing yields, and optimising donor payments. A strong pipeline of innovative drugs will also support growth over the medium term. On top of this, we have confidence in the quality of the CSL management, in particular their ability to derive value out of acquisitions over the long-term.

While the Fund's largest holdings are large cap stocks, this concentrated broad-cap strategy allows for a variety of stocks, including small-caps. Indeed, it is the combination of investing in small and mid-cap companies with good growth prospects as well as a concentrated core of large cap holdings, is what we see as the "sweet spot" for portfolio construction. It enables the portfolio to be sufficiently diversified and differentiated from the index, whilst also managing risk and liquidity. Typically, small- and mid-cap companies, those with a market cap of less than

$5bn, comprise almost half of the portfolio.

One mid-cap company we hold, with a market cap at just under $1.8 billion*, is Polynovo. This biotech company focusses on the treatment of severe burns. Its patented product, NovoSorb, effectively turns a large wound into a series of micro wounds, giving the body a scaffold to heal itself. Thanks to its myriad of benefits, this product is fast becoming the standard of care in the treatment of burns. The burns industry is a large market which generates about $1.2 billion globally per year, and we believe Polynovo are only at the very early stages of penetrating this market.

Furthermore, Polynovo can leverage their technology to treat other indications such as trauma, hernia surgery, breast reconstruction and diabetic foot ulcers, to name a few. To support this growth, Polynovo is expanding their production facilities in Melbourne, from where they export to the world. So, whilst many believe that the Index is comprised only of big banks and big miners, it should be evident that a myriad of opportunity for growth exists in the Australian market.