

JBWere

CIO Office

Private View update

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The shock and awe of US President Trump's pronouncements may be diminishing as markets adjust to his unpredictable style, but at this stage that does not materially change the global economic outlook. For investors there is significant change underway, in our view.

The gains made in May and June, despite volatile global conditions, are an indicator that markets are trying to look through events that have been causing turmoil in the first four months of the year, such as tariffs, taxes on foreign capital and potential impacts on the technology sector.

Though it is worth remembering that even if we assume temporary tariff reprieves announced by Trump are made permanent, we are still staring down the barrel of the largest tax impost to global trade in nearly 100 years.

Can tariffs have legitimacy?

Trump has for decades championed tariffs as part of the solution to fixing the US trade (and fiscal) deficits. They deserve some attention, as they may become a significant driver of changed investor behaviour, along with more recent muted potential changes to taxes on foreign capital (so called 'Section 899').

We have kept a watching brief on the unsustainability of growing financial imbalances in the US. The two key imbalances are:

- Growing fiscal deficits culminating in an unsustainable public debt profile; and
- Persistent trade deficits culminating in an ever-larger negative net international investment position.

In the simplest terms, the US government is spending more than it can sustainably raise through taxes, even when the economy is operating at its full potential.

To help redress this issue the US must become more competitive, but according to Trump many countries enact

policies that inhibit US trade, and some of the points have substance.

China, for example, now runs a surplus trade balance with the world of nearly \$US1 trillion annually, of which about half is with the US. China pegs its currency to the US dollar, and the fixed rate is ultimately set by the Chinese government.

Ever larger Chinese surpluses and accumulation of foreign assets are prima facie evidence the fixed rate is working in China's favour at the expense of its trading partners. In other words, there is nothing wrong with US trade competitiveness, it just isn't competitive at artificial FX levels set by China.

Trump aims to ensure the US operates on a level playing field in global trade, even if it means the American public may have to bear some of that policy cost near term through higher domestic prices.

Despite the recovery in market sentiment and equity valuations, we likely remain early in the evolving global trade war. In our view, not much more has been learned about the end game over the past couple of months.

Other parts of the US equation involve the need for reform to internally increase government revenue or cut spending, or to find other ways to support ever growing Federal debt issuance.

There are several measures a compliant US Federal Reserve could undertake. It could change bank regulation to encourage more ownership of government debt. Or it could return to quantitative easing (printing money and buying government debt) or taking more explicit measures to control the yield curve, as the Bank of Japan did. Such measures have potentially severe side-effects, though, such as rising inflation or potential significant devaluation of the US dollar.

Tax and spending reforms are essentially austerity.

Will US citizens ever accept austerity?

In the 1980's, President Reagan managed to bring both the electorate and the government together on a bi-partisan basis to engage in a program of shared sacrifice. This included reforming social security and benefits and extending retirement ages and otherwise clipping the real value of entitlements. In our view, the US today, and for the foreseeable future, is far too politically divided, with wealth and income too unequal to come together to enact this sort of structural reform.

Far more likely on the austerity route, in our view, would be a material increase in different forms of wealth taxation. The policies required will be difficult to introduce but may be plausible in the right circumstances.

Currency and other implications

Clearly the above global economic challenges and their implications for Australian investors are complex. Amongst many, one of the key risks for local investors is the changing nature of important asset correlations.

For more than two decades, many local investors have taken advantage of 'American exceptionalism' and benefited from investing in the S&P500 and its constituents, typically on an unhedged basis.

Not only has performance been superior, but importantly the currency effect of owning US dollars was historically risk-reducing for portfolios in the aggregate. It was a form of portfolio insurance where, curiously, premiums had a negative cost. Particularly in crises when it really mattered—think the global financial crisis and GFC, where the US dollar sharply appreciated to cushion the downturn for local investors.

Not only is underlying growth exceptionalism (and the valuation premiums today attached to it) in question, but perhaps even more importantly, the role of the US dollar in portfolios is shifting. The US dollar has recently tended to fall as interest rates rise; but also fall as equity markets fall. Historically, this is a trading pattern found in emerging market currencies.

These are big changes for investors. Chart 1 shows the picture from a US Dollar-Euro perspective.

Chart 1: Few benefited more from the 'WTO Consensus' than large multinationals, and especially global Tech



Source: JBWere, Bloomberg. Past performance is not a reliable predictor of future performance.

Even without debating the underlying growth merits of US-centric investment, this is a potential game changer for local investors. It implies US Dollar exposures are now risk increasing and deserve lower portfolio allocations. Passive investments in increasingly concentrated broad market benchmarks, especially unhedged US indices, look increasingly problematic, in our view.

Unfortunately, it may be a hard lesson to learn, as old habits die hard—especially when these are exactly the investments that have worked so well for so long.

Policy choices to determine path for assets

Under an austerity path, bonds should perform well, and the adjustment would most likely be borne predominantly by growth assets, largely in the form of softer equity and house price outcomes. The US Dollar would perform better in this scenario, but in our view may still not be particularly strong. It would depend on the actions of other major foreign central banks.

The alternative scenario of an interventionist Fed would involve a large part of the adjustment falling on the value of the US Dollar. Nominal bonds would probably suffer, although inflation-linked bonds should perform. Stocks should ultimately preserve the real value of wealth for investors, but perhaps only after an initial adjustment in valuation. This was the case in the 1970's under partially related, but different circumstances. Gold, commodities and other 'real' assets would be used by investors to try to preserve value, but their efficacy in doing so depends on whether starting valuations are reasonable.

Market update - the year so far

Despite the May-June recovery, Europe continues to materially outperform year-to-date. Australian equities have risen ~7% as we head towards the halfway mark. The US Dollar remains weak.

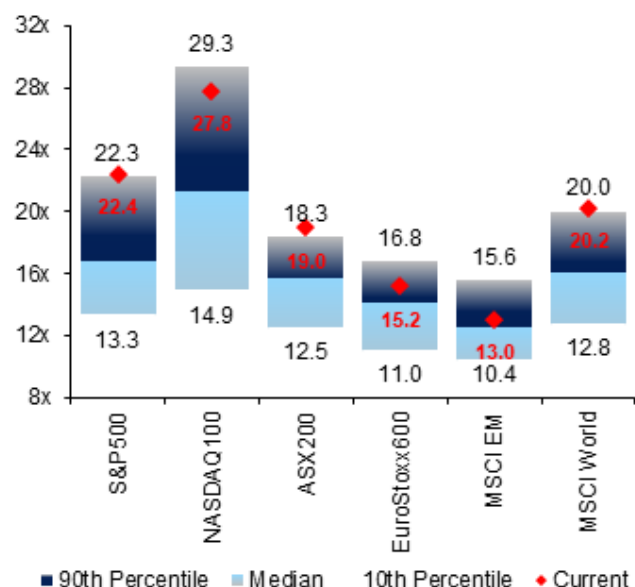
Sector-wise, Telstra and the banks have led the local market so far this year. Defensive sectors such as staples and utilities have outperformed. Healthcare and energy stocks remain laggards across most major markets and may provide opportunities, in our view.

Earnings forecasts for 2025 are still being downgraded across major indices. The ASX200 and S&P500 are down 3–4% YTD. European forecasts are now down 6–7%. Despite declining earnings, equity markets have advanced due to valuation expansion. US markets are trading in the top decile of historical forward price/earnings (P/E) valuations, raising long-term return concerns.

Valuations

How do markets go up when earnings are revised lower? Valuations expand. As Chart 2 shows, based on 1-year forward earnings multiples, a number of major markets are currently trading well into the top decile of valuations recorded over the past 20 years. The US is trading in the top decile of valuations recorded in the post-War period

Chart 2: Current P/E range, today vs last 20 years

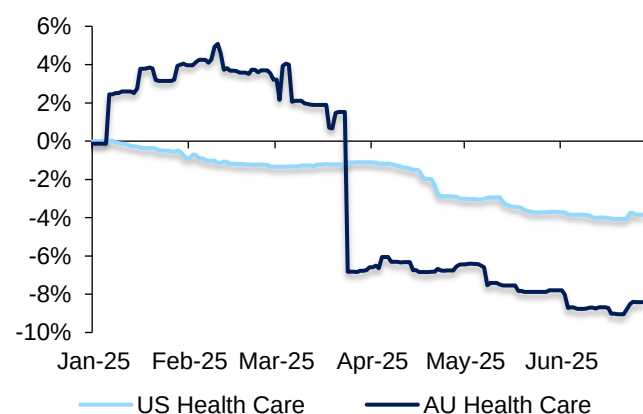


Source: JBWere, Bloomberg. Past performance is not a reliable predictor of future performance.

Sector opportunities

Outside select individual opportunities, at a sector level fertile ground looks likely to be found in Energy and Healthcare. Healthcare, unusually, has seen negative earnings revisions. Particularly on the ASX, where sector index weight is dominated by CSL. We believe that the extent of sector underperformance and derating, which has far exceeded the earnings revisions, is broadly overdone. Particularly on a market relative basis.

Chart 3: 2025 EPS healthcare sector YTD cumulative revisions



Source: JBWere, Bloomberg. Past performance is not a reliable predictor of future performance.

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