INTERNATIONAL EQUITIES

Asset Allocation Outlook

December 2024

Executive summary

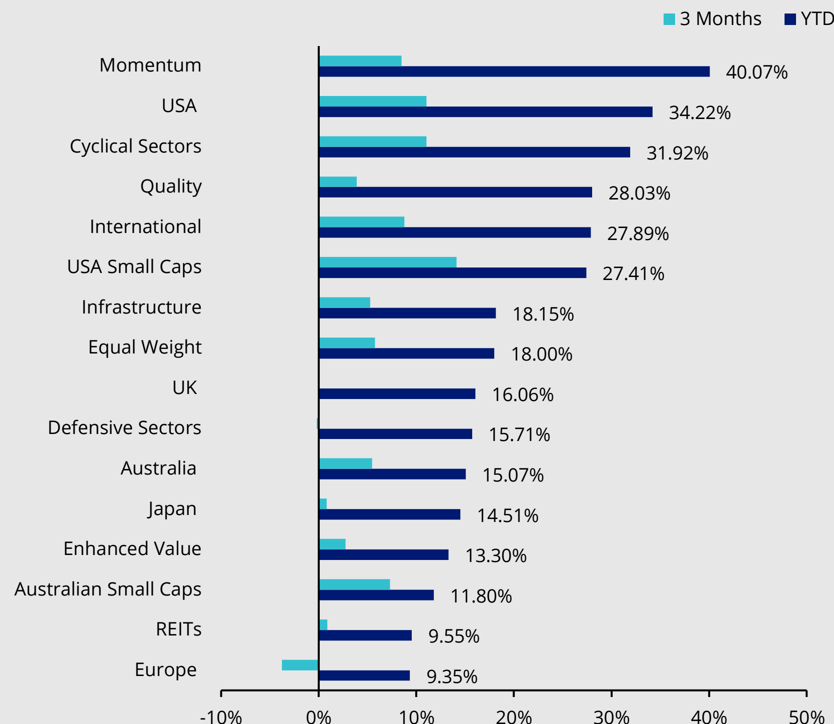
2024 extended on the impressive returns of 2023 and then some. At the end of last year, markets were predicting six to seven Fed rate cuts with much contention around a soft landing, hard landing or no landing. Had investors been overly cautious and avoided risk assets they would have missed the stellar equity markets.

US equities have led the charge, driven by renewed optimism about the US economy's resilience. More recently there is a renewed optimism, particularly in small companies, following Trump's sweeping victory and his administration's pro-business agenda which benefits US mid and small-cap companies.

Looking ahead, VanEck's latest portfolio compass dissects our observations on inflation, policy rates, economic growth and exogenous risks.

While the US appears fully priced, we think there are opportunities in equities at the sector, regional, market capitalisation and stock levels. The stars are potentially aligning for global small caps to outperform large caps due to attractive valuations and the prospect of the global economy avoiding a recession. Global REITs and infrastructure could also do well due to their relative valuations, coupled with the potential for long-term interest rates to decline through 2025.

International equities performance as at 30 November 2024



Source: Bloomberg. Momentum is the MSCI World Momentum Index; USA is the S&P 500; Cyclical Sectors is the MSCI World Cyclical Sectors Index; Quality is the MSCI World Quality Index; International is the MSCI World ex Australia Index; USA Small Caps is the Russell 2000 Index; Infrastructure is the FTSE Developed Core Infrastructure 50/50 100% Hedged to AUD; Equal Weight is the MSCI World Equal Weighted Index; UK is the FTSE 100 Index; Defensive Sectors is the MSCI World Defensive Sectors Index; Australia is the S&P/ASX 200; Japan is the Nikkei 225 Index; Enhanced Value is the MSCI World Enhanced Value Index; Australian Small Caps is the S&P/ASX Small Cap Ordinaries Index; REITs is the FTSE EPRA Nareit Developed ex Australia Hedged in AUD; Europe is MSCI Europe Index. You cannot invest in an index. Past performance is not indicative of future performance.

Global macro observations

The pace of US disinflation may stall

- Tight labour market and government policy shift may sustain inflationary pressures.

Neutral rate higher than may be expected

- Sustained economic growth may limit the scale of monetary easing.

Deeper European easing cycle

- Weaker manufacturing activity and headline inflation supports the need for a deeper easing cycle.

Exogenous risks

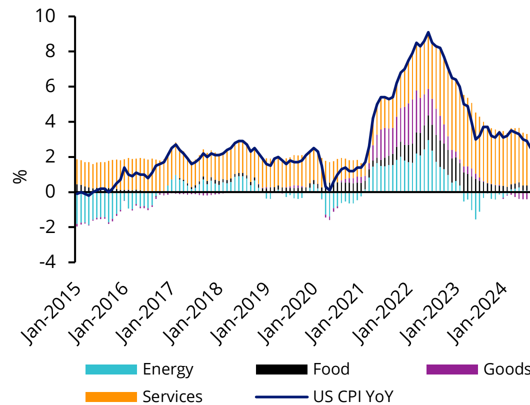
- Be vigilant for inflation and market shocks due to the heightened geopolitical environment.

The pace of US disinflation may stall

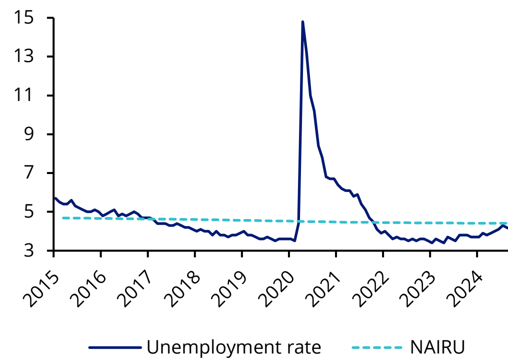
USA: Tight labour market and government policy shift may sustain inflationary pressures.

- US headline inflation has been trending down over the past few years, primarily due to deflationary pressures from energy and goods prices.
- Services inflation, which is closely linked to the strength of the labour market, has begun to moderate but the pace may slow.
- Government spending has played a significant role in boosting public service job growth, while the private sector has been restrained by the need to manage higher borrowing costs.
- The Trump administration's 'pro-business' initiatives, such as reducing corporate and personal tax rates, aim to strengthen the labour market and boost aggregate demand.
- These measures could keep the unemployment rate below the NAIRU rate, potentially maintaining elevated services inflation.
- Additionally, proposed tariffs, including a 10% tariff on all imports and a 60% tariff on products sourced from China, could lead to a resurgence in goods inflation.

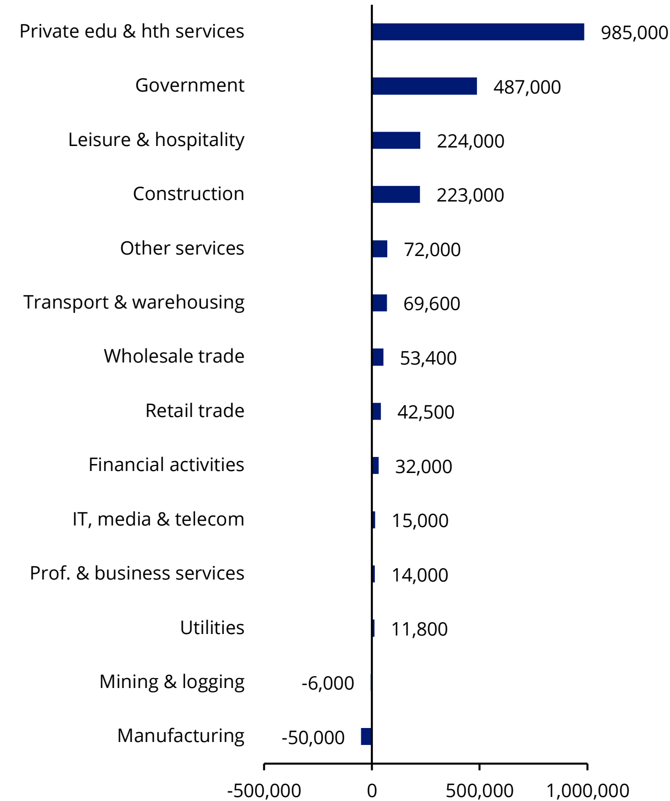
US CPI year on year contribution



US unemployment rate



US unemployment rate change: 12 months



Non-Accelerating Inflation Rate of Unemployment (NAIRU) : Theoretical measure that indicates the lowest unemployment rate that can be sustained without causing wages growth and inflation (notably services) to rise unsustainably.

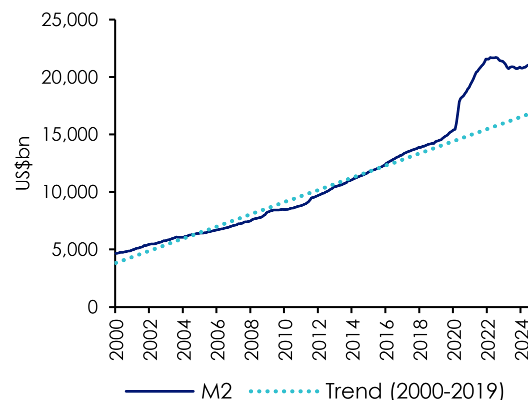
Source: Bureau of Labour Statistics. Federal Reserve Bank of St Louis. As at 30 November 2024.

Neutral rate higher than may be expected

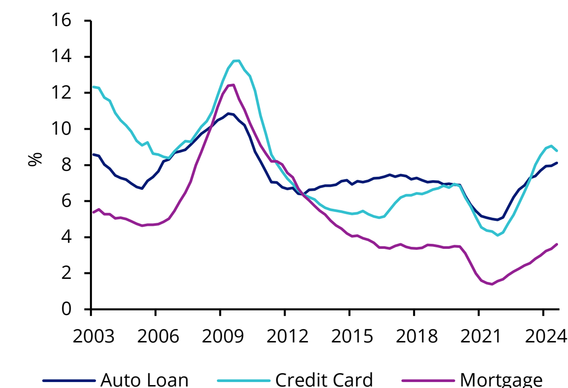
USA: Sustained economic growth may limit the scale of monetary easing.

- The US economy is in a robust state, sustaining inflationary pressures and limiting the scope for the US Federal Reserve to ease policy further.
- There is an abundance of liquidity in the market, which will continue to support business activity. The money supply has been trending upward and is significantly above pre-COVID trend levels. Financial conditions remain loose, with US lending conditions, such as credit spreads, at a record post Global Financial Crisis (GFC) low.
- The Trump administration has also committed to expanding government spending, which is expected to provide additional support to the economy in the near term. However, in the medium term, this increased spending may raise concerns about debt serviceability.
- Importantly, the US consumer is in a strong position. Although there has been an increase in delinquency rates on auto loans, credit cards, and mortgages, these rates have now stabilised at 'normal' levels. This stability in consumer credit health is a positive indicator of continued economic resilience.

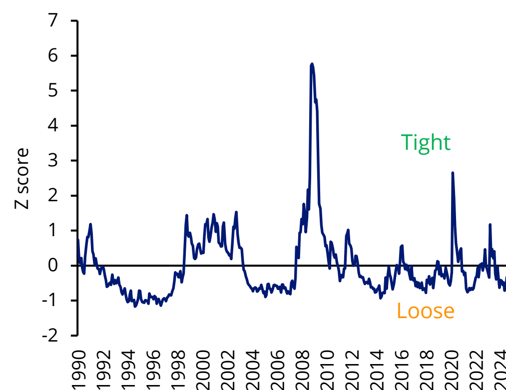
M2 money supply



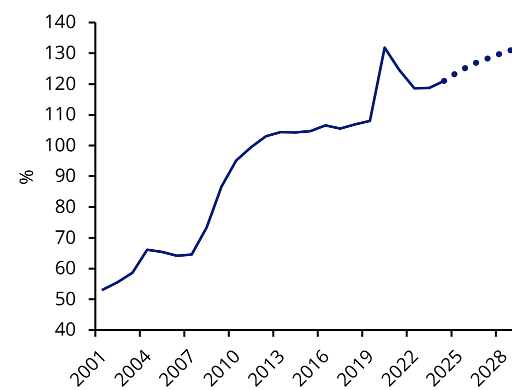
Delinquency rates (30 days plus arrears)



Financial conditions



US Government debt (% of GDP)



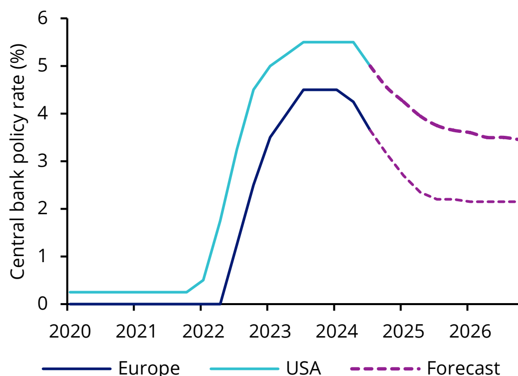
Source: Bloomberg, Federal Reserve. IMF, Equifax, Financial conditions as Chicago Fed Adjusted National Financial Conditions Index. As at 30 November 2024.

Deeper European easing cycle

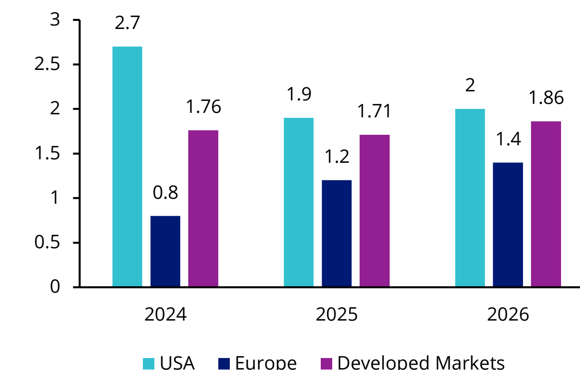
Europe: Weaker manufacturing activity and headline inflation supports the need for a deeper easing cycle.

- Lighter fiscal support and structural issues, such as higher taxation, burdensome regulations, and lower labour productivity growth, have contributed to weaker economic growth in Europe (0.9% year on year for 2024) compared to the US (2.7% year on year for 2024).
- European manufacturing activity has been in a deeper contractionary cycle, and inflation is now below 2% in many countries. German companies listed in the Fortune 500 Europe have announced over 60,000 layoffs this year, impacting major firms such as Bosch, Deutsche Bahn, and Siemens. In a historic move, Volkswagen is threatening to shut down its German plants for the first time in its 87-year history.
- This necessitates a more aggressive monetary easing cycle to revive economic growth, but there will be a lagged effect in terms of how this impacts the economy.

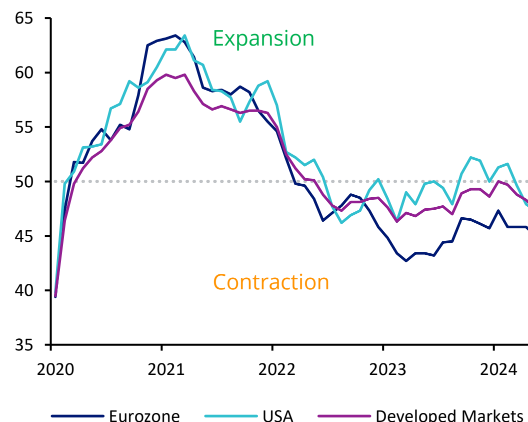
Central bank policy rate



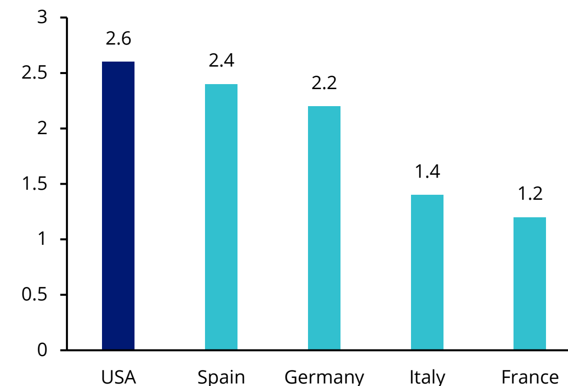
Real GDP growth consensus forecasts



Manufacturing activity



Inflation year on year



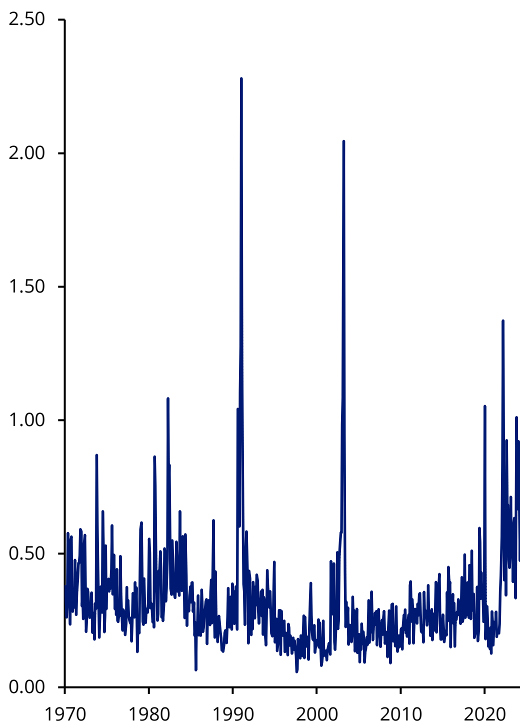
Source: Bloomberg consensus forecasts, S&P Manufacturing country and region PMIs.

Exogenous risks

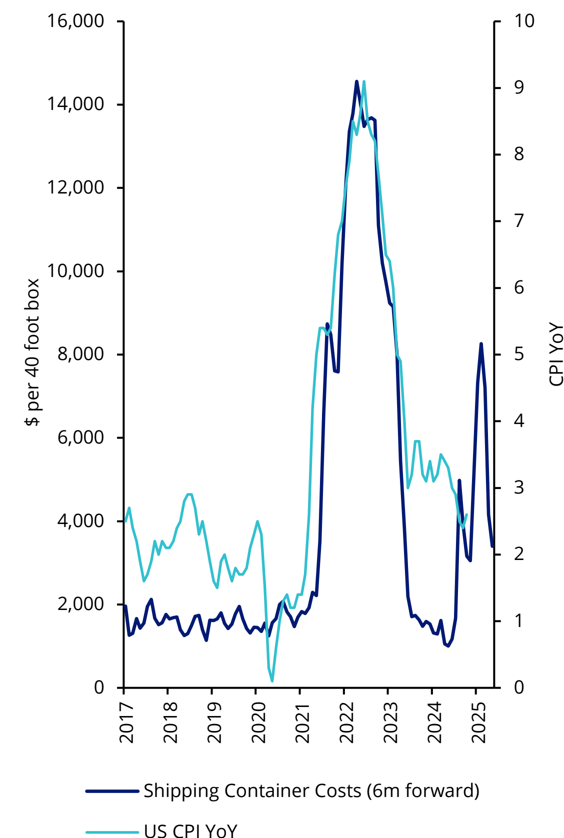
Be vigilant for inflation and market shocks due to the heightened geopolitical environment.

- The risk of inflation and market shocks has increased in a more fractured geopolitical environment.
- Since COVID-19, the threat of war has risen, exemplified by the spike in natural gas prices following Russia's invasion of Ukraine.
- Another concern is the potential broader fallout of the Red Sea Crisis, which has forced ships to reroute around Africa instead of passing between Saudi Arabia and Egypt. This detour has caused shipping prices to soar up to eight times higher. Historically, such spikes in shipping costs, like those seen after COVID-19, took 6-12 months to affect consumer goods prices. We might see a similar impact in early 2025.

Geopolitical risks Index



Shipping costs versus US CPI YoY



Source: Bloomberg; LHS chart data to 30 September 2024; RHS chart data to 30 November 2024.

International equity observations

Equity Markets

- The market has been ‘front running’ the expectation that the US can achieve a soft landing.

Valuations

- Certain market segments stretched reinforcing the need for selectivity.

USA

- US market is poised to outperform international counterparts, bolstered a higher proportion of ‘quality’ companies and innovative sectors like tech.

Small Caps

- Small caps could lead the next stage of the market rally due to attractive valuations and Trump’s incoming presidency but consider company fundamentals.

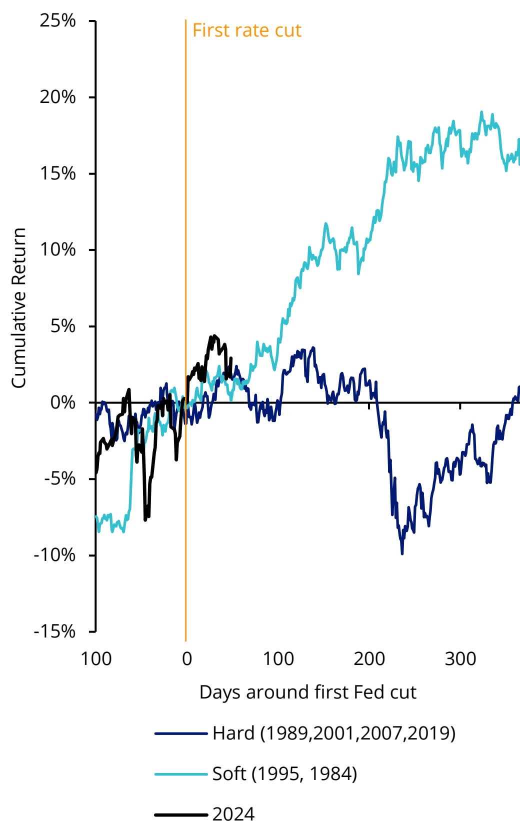
Listed REITs and Infrastructure

- Monetary easing cycle together with compelling valuations bode well for rate sensitive asset classes.

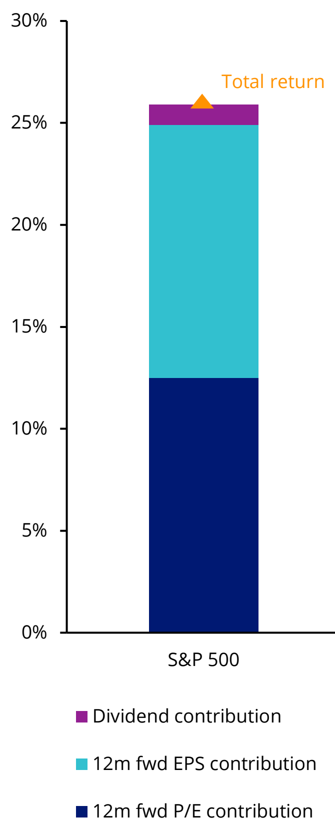
Equity markets

The market has been 'front running' the global soft-landing narrative

S&P 500 Performance around first rate cut



S&P 500 price performance contribution



Key observations

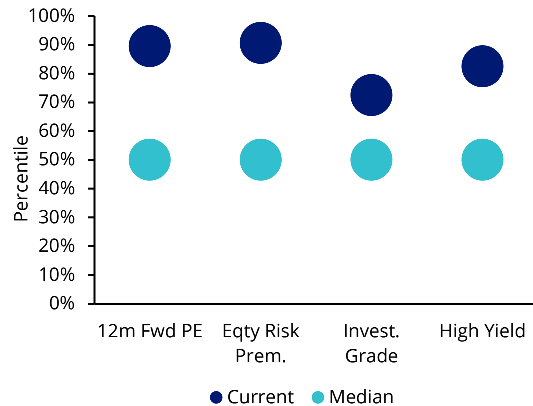
- The S&P 500 has achieved top quartile year-to-date performance relative to previous years, driven by renewed optimism about the US economy's potential for a soft landing post-hiking cycle.
- This optimism, coupled with a broadening of earnings growth beyond the 'Magnificent Seven,' has contributed to price-to-earnings multiple expansion.
- This expansion has contributed 50% to the total return, pushing valuations to one standard deviation above the historical average.
- The move suggests that the market appears to be 'front running' expectations that the US can successfully navigate a soft landing, similar to the rallies seen during the last two soft landings.

Source: Bloomberg, Goldman Sachs. Data to 30 November 2024. You cannot invest in an index. Past performance is not indicative of future performance.

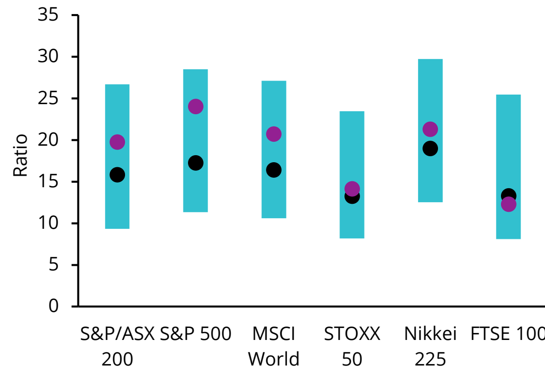
Valuations

Certain market segments stretched reinforcing the need for selectivity

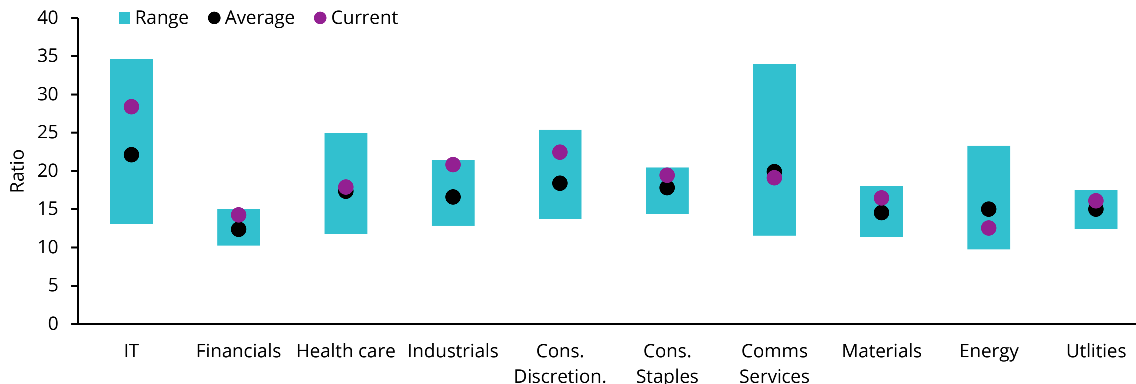
Valuation percentile: Global



12 month forward PE: Region



12 month forward PE: Global sectors



Key observations

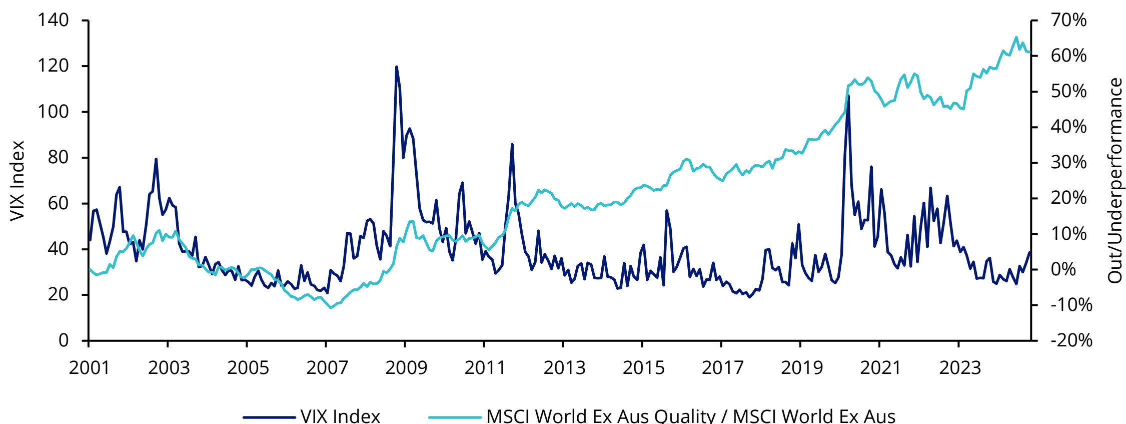
- The impressive equity market rally has contributed to stretched valuations in certain sectors and regions, suggesting that further upside may be constrained.
- Therefore, it is prudent to be selective and identify 'cheaper' segments with attractive characteristics to navigate the next potential phase of the equity market rally.
- These include global small caps, quality companies, listed infrastructure and REITs.

Source: Bloomberg. Data to 30 November 2024. Top LHS chart indices are Bloomberg Global High Yield Credit Spread, Bloomberg Global Investment Grade Spread, MSCI World 12 month forward PE, and the S&P 500 equity risk premium as earnings yield less US 10 year government bond yield. Bottom chart indices are the MSCI World Sector Indices. Data to 30 November 2024.

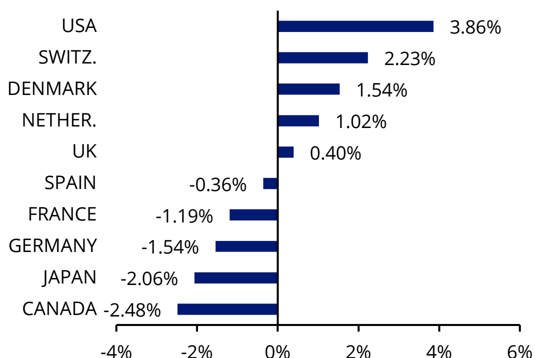
USA

Stay with the US but selectivity prudent

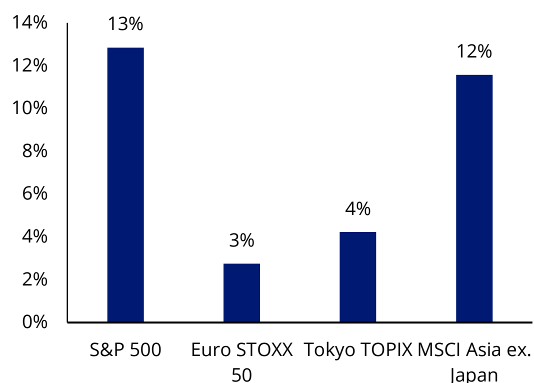
Global international equities versus equity market volatility



Top and bottom 5 quality active country weights



1-year earnings per share growth forecasts



Key observations

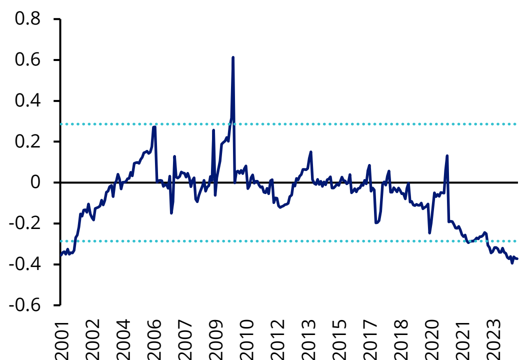
- While valuations on aggregate in the US may seem elevated, we believe the market is poised to outperform international counterparts, but selectivity is crucial. There are pockets of relative value and stocks with attractive characteristics. US equities have a higher proportion of 'quality' companies, demonstrating resilience and outperformance during heightened market volatility. This is particularly important given the market's vulnerability to disappointments and the heightened geopolitical environment.
- Moreover, the US market's focus on innovative sectors like technology continues to drive growth. The US market also boasts the highest forward earnings per share growth, further enhancing its appeal.

Source: Bloomberg, lower right - Bloomberg forward consensus. Data to 30 November 2024. You cannot invest in an index. Past performance is not indicative of future performance.

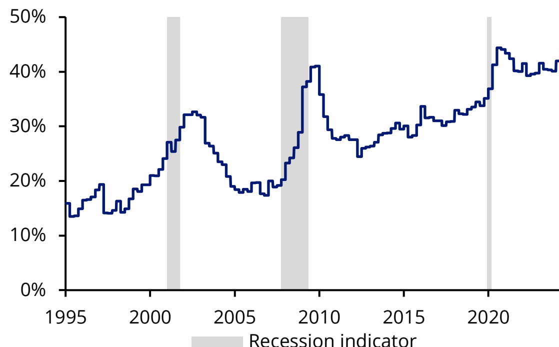
Small caps

Small caps could lead the next stage of the market rally but consider company fundamentals

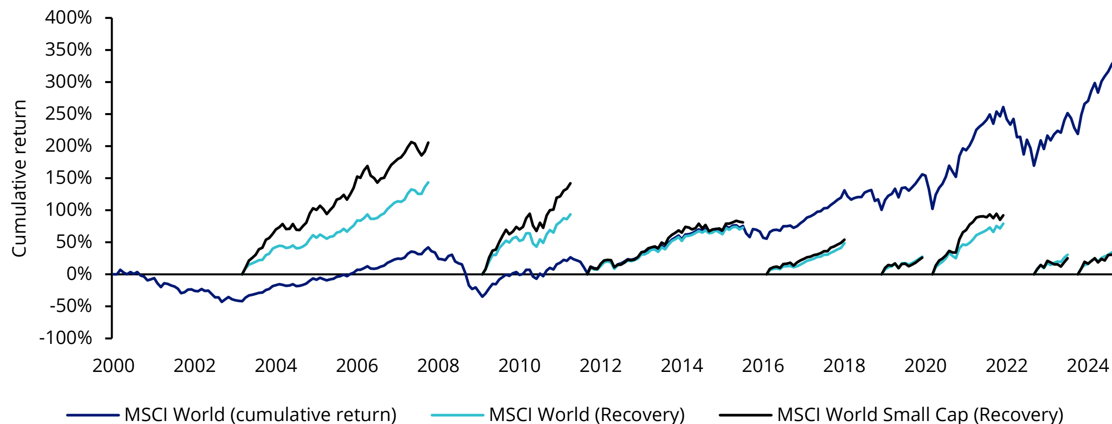
Small less large valuation z-score



Russell 2000: % of unprofitable companies



Performance comparison during market recoveries



Key observations

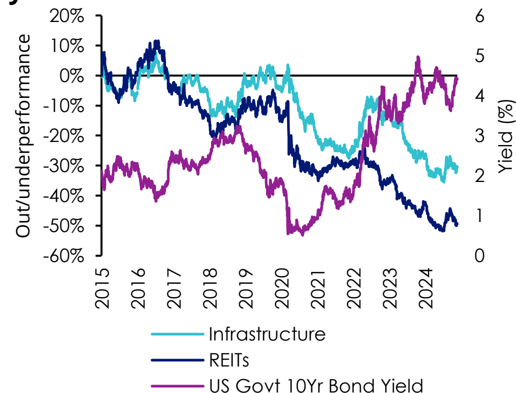
- The stars are potentially aligning for global small caps to outperform. While large caps, notably the 'Magnificent Seven,' have delivered the lion's share of performance over the past 12 months, this trend could shift for several reasons. Valuations are attractive, with global small-cap valuations relative to large caps near 25-year lows across various multiples. Additionally, if we see a prolonged market recovery, small caps typically outperform large caps, which seems likely given the increasing prospect of the global economy avoiding a recession over the next 12 months. Furthermore, the Trump’s pro-business agenda is expected to benefit US mid and small-cap companies.
- However, focusing on company fundamentals offers the potential to harness additional alpha. The percentage of unprofitable small caps has steadily increased, making them more susceptible to share price corrections. Research by Novy-Marx has shown that screening for quality companies were able to “generate higher returns in the small cap universe.”

Source: Bloomberg as at 30 November 2024, Z-score quantifies how many standard deviations valuations are different to the historical average. The graph above shows the average z-score by 12 month forward price to earnings, 12 month forward price to book, 12 month forward price to sales. Latest value is 2 standard deviations above the historical average. Global small caps represents MSCI World Small Cap Index, Large cap represents MSCI World Index. You cannot invest in an index. Past performance is not indicative of future performance.

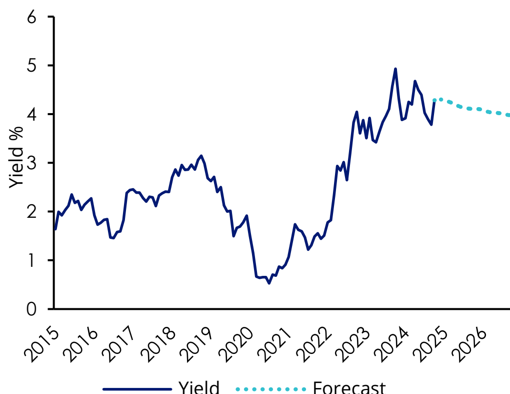
Listed REITs and infrastructure

Monetary easing cycle typically bodes well for rate sensitive asset classes

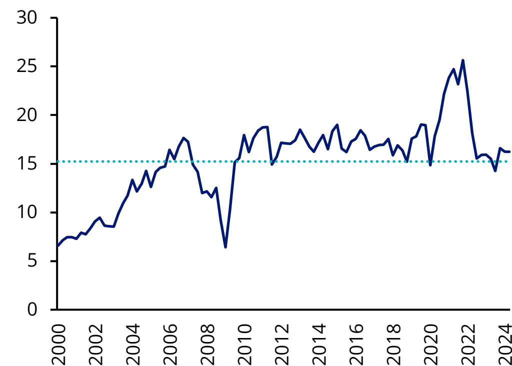
Relative performance to broad equities versus US 10 Year Government bond yield



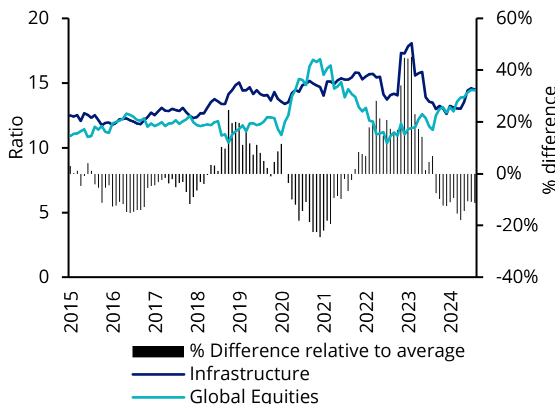
US 10 year Government bond yield consensus forecast



REIT Adjusted Funds from Operations Ratio (AFFO)



EV to EBITDA comparison



Key observations

- While we hold the view that the risk of a recession is low over the next 12 months as we tread further into the global monetary easing cycle, it is important to acknowledge that market volatility could resurface. Should economic conditions weaken, long-dated government yields would likely fall. To capitalise on this potential movement, investing in rate-sensitive asset classes such as REITs and infrastructure could be advantageous.
- REITs and infrastructure assets often outperform broad equities when long-dated government bond yields fall. This is because lower yields reduce borrowing costs, widen yield spreads, and increase the present value of future cash flows, making these assets more attractive to investors.
- Moreover, global REITs and infrastructure sectors are currently trading at compelling valuations. The Adjusted Funds From Operations (AFFO) for REITs is close to its historical average. Additionally, the Enterprise Value (EV) to EBITDA ratio for infrastructure is at a discount compared to global equities.

Source: Global infrastructure is FTSE Developed Core Infrastructure 50/50 Hedged into Australian Dollars Index, REITs is FTSE EPRA/NAREIT Developed ex Aus Rental in AUD Hedged Index. International equities is MSCI World ex Australia 100% Hedged to AUD Index. You cannot invest in an index. Past performance is not indicative of future performance.

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