

Chris Burrell's Market View Blog

Asset Allocation amidst the noise

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Rate cuts: Inflation v unemployment

There is much geopolitical noise over the past period and particularly in this calendar year to date. The stock markets in both the USA and Australia have largely ignored the geopolitical noise of daily press reports, whether it be from Ukraine, the Middle East, or the latest announcement from Washington. The markets are instead focused on two key issues:

- The inflation rate, and in particular, the rate at which tariff increases will be reflected in US consumer prices
- The weakening labor market statistics in the US.

In respect of the first issue, the on again/off again tariffs together with deferral periods and the ability for US importers to build up stocks of pre-tariff priced goods means that for many wholesalers, the prices have not yet moved to the new tariff stocks and so prices have not increased to retailers and consumers. This deferral of tariff induced price increases is likely just that, i.e. a deferral pending the flow through of price increases. Businesses regard tariffs as a tax and their culture is to pass on tax increases as part of the cost of goods sold. To this extent tariffs and price increases resulting there from are a lagged indicator.

In respect to the second issue, being labor statistics, the expectation is that the policy mix in the US will result in a slower economy and an increase in unemployment. The debate is as to the rate at which this is occurring. Again, in a slowing economy, one of the last indicators to increase is unemployment. Unemployment is a late indicator that lags most other measures of economic activity. As such, if one waits until unemployment increases then the regulators have often left it too late to stimulate e.g. by way of lower interest rates.

The mix of these two factors will continue to play out over the balance of 2025 and into 2026. It is likely that central banks, including the Federal Reserve, will have decreased the US federal funds rate by

0.25%, but probably with the accompanying caveat that any future decreases will be data dependent. A 25 basis point rate cut with a reference to data dependency is not that exciting. Compared to the run up in stock markets both internationally and in Australia in anticipation of rate cuts, markets may well be disappointed. We could easily see a 'buy the rumor, sell the fact' reaction to rate cuts.

Asset allocation

In the June 25 FY international shares performed on average in the range 15-20% whilst domestic Australian shares performed on average 10-12%. Domestic listed property trusts (A-REIT's) recovered and had returns of 10%+ whilst domestic fixed interest on average returned 6%. Averaging these returns across a typical Burrell portfolio would result in an average return for the year of 10-12% on invested funds, which would be reduced overall to the extent that cash was held yielding around 4% in a cash management account.

How does this compare to the benchmark? There are few reliable benchmarks available for balanced and moderate growth portfolios. The Burrell PPS service uses a Morningstar benchmark which has a number of limitations. The key limitation to be aware of is that because Morningstar have their roots in America, their asset allocation for a moderate growth portfolio is 23% to Australian equities and 35% international equities. For a balanced portfolio the Morningstar allocation is 17% to Australian equities and 24% to international equities.

This is at variance with what might be regarded as more normal for Australian investors, whereby they traditionally carry a higher percentage weighting to Australian equities, which produce franked dividends and are not subject to currency fluctuation. Further dividend returns on overseas shares where there is the classic double tax system e.g. US, are often 2% gross whereas Australian dividends are 4.5%.

Whereas in this year a portfolio that has an Australian equity rating of say 40% for balanced and 50% for moderate growth and an international weighting of 12.5% and 15% respectively, then the portfolio will underperform in years such as 2025. Why is this so? Simply because the mathematics say that if the international portfolios were performing 5-7% above domestic shares and the portfolio weighting is the reverse of that in the US based indexes, then the portfolio will show a return less than the benchmark. The conclusion from this is that one should be slow to criticize what really have been excellent returns for most portfolios in the June 25 FY.

Increasing international weighting

The portfolios that performed best in the 2025 FY were those that increased their international weightings by 5% and certainly above 10% of the total portfolio. At the Burrell Investment and Research committee meeting (I&RC) held on the 9th of September the following were noted for portfolios with a balanced or moderate growth asset allocation. .

- International shares should have a weighting of 10% minimum
- Domestic property should have a weighting of 10% minimum
- Domestic fixed interest should be within the investment strategy bands ie 10-30% for moderate growth and 20-40% for balanced
- This means the domestic share weightings will likely drop from historical highs to 40-45% for balanced and 50-55% for moderate growth.
- Cash is the residual, usually 5-15% depending on market conditions and risk preferences

The above recommendations take into account current market conditions.

What about overvaluations, I hear some say? The Australian equities market on average shows lower earnings growth and above average valuation multiples (P/Es). The US has higher earnings growth which means if you calculate a PEG ratio i.e. Price earnings/earnings growth, US markets and most overseas markets are on average trading at a lower PEG ratio than Australia. Averages are interesting and we all know the old adage about statistics and damn statistics. There are some obvious areas of overvaluation in the Australian market which are well publicized including Commonwealth Bank on a valuation of over 20x when quality banks in the UK can be purchased on valuation multiples under 10x. There are also a number of tech stocks in both Australia and the USA trading on elevated multiples. As set out in the previous Bourse towards the end of July, to offset the tariffs the US stock markets needed good reporting from the technology companies. The reporting was not only good, it was exceptionally good and a number of companies associated with AI and the cloud reported stunning earnings results in the recent earnings period. These earnings have continued to fuel the US stock market and may continue to do so for some time to come. So how to play this?

In both markets we are looking for value and growth in reasonably priced stocks (GARP), rather than growth at any price stocks (GAAP) which includes those producing losses or trading on revenue net profit multiples. The latter are a recipe for disaster as we saw during the last tech bubble in 2000. But there are many companies in both Australia and overseas where reasonable earnings multiples are available and one can be comfortable with the current holding or buying prices. Some of our advisors think the current market in Australia is more akin to 2004 than the correction in 2007 and so see an ongoing runway for positive returns.

Themes

Gold

The gold theme was set out more fully in earlier blogs this year. Suffice to say the geopolitical factors have led to China and many others adding to gold holdings in material amounts. This has seen the gold price reach record levels. Some are predicting there may be a further \$1000USD to add to the current level and one should hold existing gold positions, notwithstanding the attractive prices for gold stocks.

Other themes

The Burrell World Equities Trust 28 portfolio (BWET28) is divided into themes. These are as follows:

- Software/AI
- Batteries/Lithium
- Financials
- Pharmaceuticals/Healthcare
- Defence
- Industrials
- Gold
- Consumer
- ETF's/Managed Funds

These themes have been useful in selecting stocks which last year produced a return of around 18%. These themes have also been useful in Australia although here we have fewer technology stocks and the consumer theme was lacking, at least until the recent reporting season.

Reporting season

As noted above, the reporting season was somewhat of a mixed bag in Australia. In terms of the Australian corporate results, one report shows 21% of stocks beating consensus, 45% in line and 34% misses.

Misses were dealt with harshly. It appears that the US merchants have now established deep trading desks in Australia with the backing of institutional funds including industry superannuation and that those trading desks now short sell any suggestion of earnings misses. This somewhat compounds the backdrop of trading algorithms and a large number of self-directed investors who may ask the first question "is it a good company?" but often lack the wherewithal ascertain whether it is good value. Often as not, the buying appears directed by sentiment, momentum and technical factors rather than fundamentals. This made the reporting season in Australia one of the more volatile historically, with outsized movements in share prices in many cases not in line with changes in valuations from the earnings reports. This phenomenon parallels what has been observed in the US markets around quarterly earnings reports for some years.

Summary

The 2025 FY produced for the most part, satisfactory portfolio returns for Burrell clients. The portfolios that performed best increased their overseas weighting, particularly to the USA which, produced higher returns than Australian domestic returns on average. The listed property trust sector made a long awaited positive comeback and fixed interest continues its handy contribution, albeit a little less than the previous two years. Going forward, the Australian market should produce satisfactory returns, although earning growth will be lower than overseas and commodities and some of the banks will show low growth.

The AI theme continues to gain traction. The BWET28 portfolio shows that there are an array of stocks outside the large chip stocks which will benefit software, consulting, switching gear and chip machines to name a few. So we're looking at a stock selection environment and being careful of those who would price companies based on sentiment and momentum.

Happy investing.



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