ELEY GRIFFITHS GROUP

The Encyclical

March Quarter 2025

TO OUR PROFESSIONAL AND WHOLESALE INVESTORS

Market Review & Strategy

Historic highs were struck across global stock indices early in the March quarter, before stocks commenced a retracement from mid-February on raised geopolitical temperatures, notably Trump government hyperbole around Russia/Ukraine. Rising US recession fears also came into calculation during the period.

A peak in the US Dollar Index presaged a dramatic shift in investor risk preferences from February 19. Credit spreads began to widen, credit default swaps (a form of debt insurance) were bid strongly, stock correlations spiked, and volatility (across stock, bonds and FX) surged. The beginning of a growth/value stock rotation also took hold from this point forward.

The announcement that China's chatbot, Deep Seek, had released a cheaper and less complex AI-powered model to rival ChatGPT provided the spark for a Nasdaq correction and a pullback in over-extended uranium/nuclear energy names (ie likely less energy consumption).

China unveiled its next tranche of fiscal stimuli, focusing on domestic consumption and embracing the entrepreneur-class in the process, the first since President Trump's inauguration. Coincident with this was the *Bundestag* voting in favour of Germany's plan for fiscal reflation, a sizable package of government expenditures. European bond markets would stage their biggest sell-off in 25 years as the concept of deficit funding across Europe took hold.

Locally, the February reporting season dominated activity during the quarter. Generally regarded as the most volatile season in several years, result-day positioning played a key role in determining whether reporting companies' shares would rally or crater. Consumer-related names fared well, lower interest rate beneficiaries found favour (assuming they didn't downgrade) and banks reported divergent trading updates. Downgrades to forecasts tended to outnumber upgrades (1.2:1 according to Wilsons Advisory). In sum, FY25 EBIT revisions for the S&P/ASX All Ordinaries index approximated -4% whilst EGG investee companies saw +2% revisions to forward estimates.

The annual arrival of dividend cheques to household bank accounts (~$18.4bn in March) did little to buoy stock prices.

M&A activity was surprisingly brisk during the three months to March end, with foreign suitors again dominating takeover approaches.

US groups bidding included Cosette Pharma for **Mayne Pharma**, Propium Capital for **AV Jennings**, Co-Star for **Domain Holdings**, NinjaOne for **Dropsuite** and CC Capital for **Insignia Financial** (in a three-way tussle with Bain Capital and Brookfield). Montreal-based Dollarama bid for **The Reject Shop** and Tokyo domiciled MIXI, Inc.approached **PointsBet Holdings** (only to be outbid by **Blue Bet Holdings**).
Elsewhere, **Tyro Payments** approached **Smartpay**, **Ramelius Resources** proposed a merger with **Spartan Resources** and South African miner **Gold Fields** tried their luck with a $3.3bn tilt for **Gold Road**.

A pilot light burned dimly for the IPO market. The disappointing post-listing performances of recent debutantes, such as **DigiCo**, **Symal, Redox**, **Tasmea**, **Vitrafy** and **Cuscal** persisted during the quarter, corroding investor interest in pending deals. Nevertheless, **Koala**, **Mainland Group** (Fonterra consumer dairy brands) and **Virgin Australia** made plans to join the ASX in 2025.

Technical Summary

Stocks

It’s not often *The Encyclical* gets to sound its trumpet, but some of the precautionary jottings around the internal health of the US stock market in the December quarter report were prescient. In essence, deteriorating advance/decline ratios, poor stock correlations and the claim that ‘there simply aren’t any US market bears left’ has manifest in an aggressive retracement in US stocks.

The **S&P500** broke from support on March 4 with a late March revival stalling spectacularly in the early days of April. Price action in past weeks has probed down to 4835, significant not only because it is a valid support line originating from the important March 2020 low but recognizing it is the Fibonacci 50% retracement level of the October 2022-February 2025 bull-drive. That buyers turned up at precisely this level is very important for the continuing bull market thesis.

The seldom referenced **FT Wilshire 5000** in the US mirrors the technical set up of the S&P500 however it is interesting to note that the **S&P100** and **Nasdaq** are not quite as sure footed. Chris Verrone of *Strategas* identified the low of April 7 as a valid momentum low given 1. Sentiment extremes registered, 2. Classic holder capitulation on show and 3. Selling being indiscriminate, assuming the style of classic liquidity-hunt behavior. Lows of this nature are frequently re-tested but in a slower, more measured manner in subsequent months.

Locally, the **S&P/ASX 200** had spent over 3 years trading hidebound between 7620 and 6760 before confirmatory breakout action in August 2024 propelled the index to historic highs on February 14 2025. April’s correction put price briefly back into the aforementioned range before the bounce-out swept prices back above the primary support line from March 2020. In a momentum sense, this is reassuring to see.

Small and **mid cap** names have staged recoveries from the sharp sell-off, but breadth is proving challenging with only 24% of the constituents of the Small Ordinaries Index above the ‘investment line’ or 100 day moving average. A sustainable rally will require broader stock participation.

The performance of emerging markets **(EM)** has been notable during the recent rout. These markets typically perform well when the US dollar enters a bear-drive phase (refer Commodities/Currencies below). The MSCI **EM** Index is beguiling, holding nicely to a support line originating from 2003. This is a bullish set up and appears below for your reference.

Source: Bloomberg

Among EM markets I took a shining to would be the **Morocco Casablanca CFG25 Index.** Don't ask me how to place an order here but price action is rather constructive!

Commodities/Currencies/Bonds

It is easy to take solace from long term, well validated trend channels. The air is rarified, the foundation firm to the touch, the mood generally buoyant, well, in bullish trend channels anyway. Such is the story of the US Dollar Index (DXY). At the time of writing the lower bound had failed to hold with the unit trading at 100. Important because it has proven dependable since 2011, ignoring a fraught period in 2021. Naturally the clues to its direction reside in the cross rates and the USDJPY and the USDEUR each look precarious, but we await further price action before making a call here.

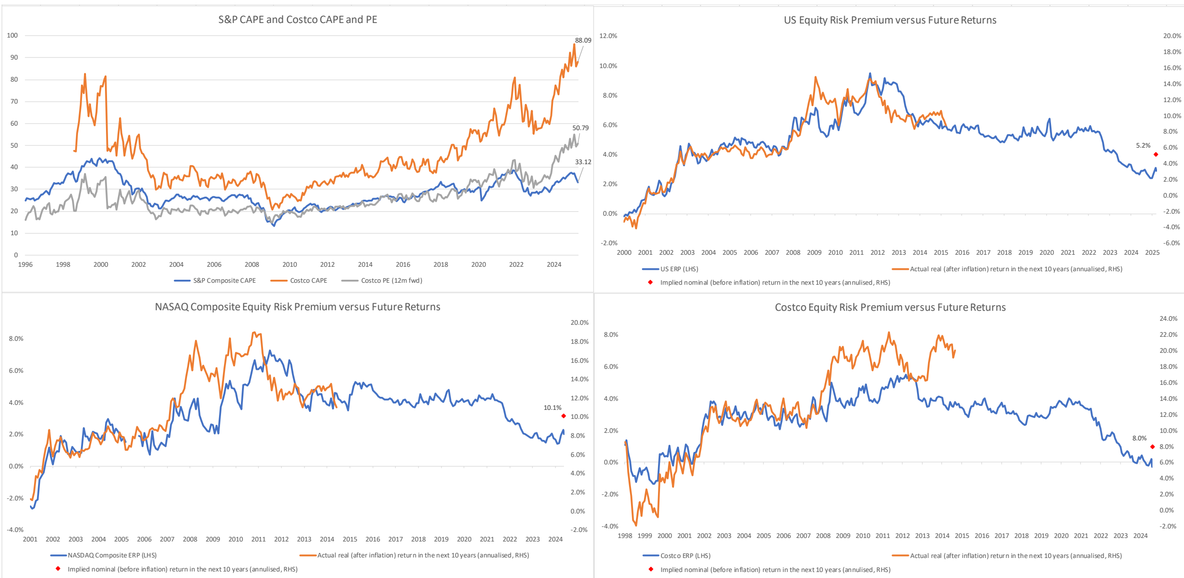
Not many will have missed the rally in the US dollar Gold price but a few will be forgiven for not noticing the extraordinary performance put in by Gold in AUD terms. Historic highs of $5013/oz at the time of writing and not showing any indications of it wanting to slow its advance.

It is interesting to note the healthier positioning for USD gold among traders. Profits have obviously been banked along the way with current long/shorts set at 3.7:1 compared to a nose-bleed level of 8.1:1 at the end of December. Gold reversed course on March 4 in the midst of a trader liquidity hunt. Gold stocks moved similarly but only after the GDX US (stock ETF) completed a textbook measured up move from the 9-year trading range. A correction in these names was past due.

Taking its lead from gold, silver has continued to taunt investors. Positioning is reasonable (at 3:1) but long-standing resistance in the area of US$35.40/oz-US$37.40/oz, (a trader's red-letter zone) is proving to be a challenge for the metal. Not surprising that ETF silver ounce holdings haven't grown at the clip of gold this calendar year. Patience is required here.

The Log

In the March 2024 edition of The Log, we looked at market valuations. Since then, we've had the US election in November, and the announcement of US tariffs and a US-China trade war has sent the S&P 500 -9% YTD. In this edition, we update some of those valuation metrics to see if equities are still expensive. We also comment on the extraordinary rise of the US supermarket giant Costco, which in addition to Coca-Cola, was one of the late Charlie Munger's favourite stocks[1].



Source: Eley Griffiths Group, shillerdata.com, FactSet. Past performance is not a reliable indicator of future performance. All data in the charts and in the text is as at 14 April 2025.

[1] For our comment on Coca-Cola see the December 2024 edition of The Log here.

Let's start with the S&P 500. One year on, the Shiller PE (CAPE), which uses 10-year moving average earnings, has gone from 34.4x to 33.1x. The Equity Risk Premium (ERP)[2] has gone from 2.8% to 2.9%. With the CAPE still high and the ERP still thin, US stocks haven't got much cheaper. In the case of the CAPE, the 10-year moving average earnings has rolled off 2014, and now starts with the 2015/16 "earnings recession" period, where earnings declined due to falling oil prices and sluggish global growth. In the case of the ERP, bond yields have increased, meaning bonds also got cheaper. The result is that the ERP is lower than it otherwise would have been. However, the current ERP still implies a nominal return of 5.2% p.a. over 10 years, based on history. While this return is a far cry from the 14% p.a. over some prior decades, many would still consider it worthwhile.

The NASDAQ's ERP comes in at 2%. While its predictive power of future returns has been less reliable than the S&P 500, it's worth noting that it implies a nominal return of 10.1% p.a. over the next 10 years, based on history. It overshot the ERP signal after the GFC.

Lastly, Costco. Its near record PE of 50.8x sees its ERP come in at -0.3%; the lowest since the tech bubble in 1999. History implies an 8% p.a. nominal return from here but likely with considerably more uncertainty as it is a single stock and not an index. It undershot the ERP signal after the tech wreck but overshot after the GFC. Costco's membership model and global expansion has seen the market ascribe it a valuation akin to a tech stock with massive and growing annual reoccurring revenue. The stock has outperformed in the recent pullback, suggesting it also retains its defensive status as a consumer staples company. Time will tell if Costco can continue to outperform in both up and down markets. The Costco CAPE is 88.1x.

Outlook

We commenced our outlook commentary in the last *Encyclical* by decrying '*professional investors enter 2025 with more than the usual number of variables to brood over, not the least being the solid performance of US stocks in 2024, extended valuations and the acutely low cash weights among US asset managers*'.

These variables would indeed prove problematic for stocks. What we and most global investors had discounted was the pace and venom that would accompany the Trump Government's introduction of its trade policy, notably its Liberation Day tariff programme on April 2. It wasn't long before a confrontation with US bond market investors prompted a harried 90-day tariff suspension replete with concessions.

A sentiment-jarring 11.0% collapse in US stocks then a 9.5% one-day rebound, a reciprocal tariff response from China and then mounting evidence of an immediate curtailing in US economic activity/planning has only served to dampen investor sentiment (as evinced in the weekly AAII Investor surveys) and consumer sentiment (as seen in the University of Michigan Consumer Confidence stats). Significant fund flow movement between equity classes has also added to volatility and confusion around the market's immediate direction.

The path forward seems opaque at best right now.

The US March quarter reporting season is upon us and professional investors fully expect corporates to go 'dark' on forward guidance. This will not assist market visibility.

Despite this challenging backdrop it is heartening to be able to craft a constructive case for the Australian sharemarket following its recent, modest valuation re-set. The Federal election will shortly be behind us and the inevitability of lower interest rates should sponsor a stabilization of the east coast property market, buoying consumers. The short-medium term prospect of Chinese economic stimulus *trickle-down* combined with a new-fashioned Sino charm offensive should yield dividends for the Australian economy and sharemarket.

---

[2] We have calculated the ERP as the 12m fwd earnings yield + US 10Y Breakeven Yield – US 10Y Bond Yield, where the earnings yield is 1/PE. Breakeven yields reflect market expectations of future inflation and are added to the earnings yield to make it comparable with the nominal bond yield, which does not account for inflation.