

# Market Outlook 2025

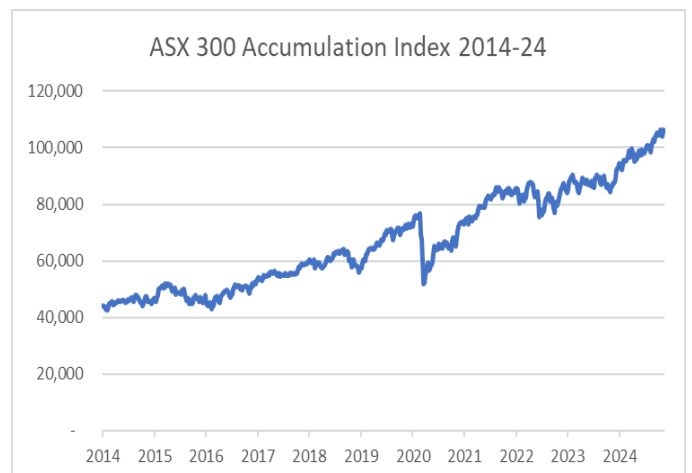
Reflecting on the last 12 months, we share our views on another strong year for Australian Equities and some sectors that are that are well positioned to deliver in the year ahead.

## Key drivers of the Australian market in 2024

The Australian market delivered an 11% return in 2024 to the start of November, slightly above the average return of the last 20 years (8%), representing another good year for investors in Australian equities. As always, there was a big divergence between the fortunes of different sectors. The financial sector contributed the bulk of market gains, as the major banks, insurers and Macquarie Group all delivered 30-50% returns to shareholders. Technology stocks also enjoyed outsized returns, while mining and energy stocks produced double digit losses as commodity prices fell.

The rally in major banks was especially intriguing because these companies reported lower profits in FY24 and have an unchanged outlook for flattish earnings over the next few years. The rally in their share prices is attributable to a re-rating to new all-time record PE multiples. We discuss this trend further below. It is worthy of some attention because banks comprise nearly a quarter of our market, so today's passive investors are putting a quarter of their portfolio into a sector that is trading at a historically extreme valuation on virtually any metric.

Pressure on consumers from inflation and higher interest rates translated into tougher conditions for some companies in cyclical or discretionary industries, but other companies shrugged off these pressures to deliver strong returns. JB HiFi, Wesfarmers and Qantas are examples of stocks that demonstrated reliance to tougher conditions, through a combination of market share gains and pricing power.



## Potential changes in 2025 Australian macro environment

We would expect some of the pressures on the economy to begin to ease in 2025. Inflation has been falling while wages continue to rise, and interest rates are expected to fall modestly. The historically tight labour market of recent years has been easing, while unemployment remains low.

Expectations for rate cuts have been scaled back recently. This partly reflects a robust economy, but it also suggests stubborn inflationary pressures. The RBA has pointed out a plunge in productivity in recent years, which implies that the sizable wage increases being negotiated in various sectors will tend to stoke inflation. While modest rate cuts are still priced in for next year, households and investors should prepare for the possibility of stable interest rates into the medium term.

A federal election is due by May 2025. While there is not much difference between the major parties on economic policy, the election itself typically dampens activity to some extent, while the inevitable election promises will make fiscal discipline even less likely in the near term and will tend to further reduce the chances of interest rate cuts. Almost all incumbent governments around the world have lost office over the last 12 months due to cost of living pressures, adding to the uncertain outlook.

The Australian macro environment will also be impacted by changing global economic conditions. In the US, the return of Donald Trump adds a degree of unpredictability to the outlook for the economy. The new administration is likely to favour lower taxes and deregulation and is generally seen as pro-business. However, Trump's policy agenda is generally seen as inflationary, due to the impact of tariffs, immigration restrictions, and bigger budget deficits.

China has announced support measures for its economy this year but seems reluctant to launch the

kind of big-spending infrastructure and property stimulus it has pursued in the past, due to concerns about over-investment in these areas. This implies a relatively weak demand outlook for Australian iron ore. A collapse in the Chinese economy and plunging iron ore prices are a recurring prediction from market pundits over the last 20 years. We are careful not to become too negative on this theme because we suspect China will continue to maintain its high level of steel output in order to protect jobs, but we acknowledge this is a risk to the outlook for Australia next year.

## Key Themes

Some themes relevant to the Australian market in 2025 are:

### Structural change

We are always on the lookout for sectors where a structural change to the industry could mean profits will be higher or lower than they have been historically. We have seen the impact of positive structural change in the airline sector where many years of overcapacity and poor profitability ultimately led to better capital discipline and pricing, and a weakened #2 player. Qantas, as industry leader, is set to continue benefiting from this positive structural change.

The supermarket industry is possibly on the wrong side of a structural change, as top line growth in some categories is under attack from formidable competitors such as Bunnings, Chemist Warehouse and Aldi. At the same time a mix shift to online sales has led to a negative impact on margins. Capital intensity may also have increased over recent years as supply chains become more complex.

### Regulatory Risk

Governments have attempted to shift the blame for cost of living pressures onto the corporate sector and

this has resulted in increased regulatory oversight. Regulatory risk may begin to ease as inflation moderates, but any industry seeking to pass on large price increases remains at risk, such as insurers and energy retailers.

### Artificial Intelligence

AI represents a potential source of structural change for many industries, but at this stage much of the focus is on providers of AI services and infrastructure. Companies perceived as direct beneficiaries of AI such as Goodman Group (a developer of data centres) have been embraced by the market in 2024. Valuations in this sector now seem to incorporate vast future profits based on limitless customer demand. It remains to be seen whether that demand will be met, or whether the risks associated with these developments have been adequately priced.

### Vulnerable sectors in 2025

The market starts 2025 on a relatively high valuation compared to history. The ASX Industrials Index (the market excluding Resources) is on a forward PE ratio of 21, which compares to the ten-year average of 17. Within this, we see some companies and sectors trading at extreme valuations while others look relatively attractive.

The most vulnerable sectors, in our view, are those which have seen a major stock price rally which has not been fully supported by fundamentals. Alternatively, some companies which have run on a specific theme can be vulnerable if the macro outlook changes and the thematic falls out of favour.

Banks have been a major driver of returns in our market this year, and share prices are well in excess of our long term valuations. Recent bank profit results have been underwhelming, and we do not see any prospect of a significant improvement in profitability or returns. Consensus forecasts imply eps growth of 1-

2% p.a. for the banks over the next 5 years. Return on Assets (ROA) has fallen sharply from a peak in 2015 and has now stabilised at a much lower level. Competition in retail banking is intense due to pressure from outside competitors such as Macquarie Group which are not burdened by legacy IT systems. Bad debt expense ratios are at cyclical lows, and banks are facing rapidly increasing technology spend. Sector leader CBA is now trading at a similar Price/Book value ratio as in 2015 despite ROA being approximately 1/3 lower, which seems anomalous to us. Its PE ratio has risen to the previously unthinkable level of 25, a level usually associated with growth stocks and by far the highest of any developed market bank in the world. The momentum behind the banks may continue for a while, but we would expect some mean reversion over the next 12-18 months.

The technology sector is another which has rebounded strongly over the last 2 years, supported by solid organic sales growth, high margins and good opportunities for re-investment. The outlook remains buoyant but current valuations have been pushed to elevated levels, with no margin of safety. An external shock such as a correction in US technology stocks due to concerns over future returns from AI capex or a sharp global economic slowdown could trigger a sell-off in the Australian tech sector.

### Sectors Best Positioned to Deliver in 2025

In the year ahead we see opportunities in the health care and infrastructure sectors as well as individual stocks such as Brambles, Qantas, and James Hardie.

We hold positions in four healthcare stocks – CSL, Cochlear, Fisher & Paykel Healthcare and Resmed. Cochlear should benefit from previous investment in a range of market development initiatives and we are confident it can grow revenue at a low double digit rate over the medium term, which exceeds consensus expectations. We believe CSL is

undervalued as the market under appreciates the potential improvement in profitability over the next few years. CSL's ROE should increase as profits recover, supported by operating efficiency and strong underlying demand for its medications, and completion of major capital projects. Fisher & Paykel Healthcare (FPH) offers long term appeal as recent heavy investment in new product development is beginning to pay dividends. The addressable market in respiratory humidification is large and barriers to entry are high, allowing FPH to continue growing at a low double digit rate.

Our portfolio has a meaningful infrastructure exposure via our holdings in Transurban and Auckland International Airport. These stocks have lagged the market in 2024 and now offer excellent value given reasonable valuations and an outlook for defensive long term dividend growth. Auckland Airport is well positioned to benefit from a recovery in international passenger numbers as global airline capacity improves. A large investment by the company in a new domestic terminal is enabling strong pricing growth and should drive growth in passenger numbers and retail spending over the long term.

Transurban is a core position in our portfolio and is now in a strong position to grow dividends consistent with free cash flow following completion of a number of major toll road extensions. Potential NSW toll road reform has weighed on Transurban's share price but a recent review has confirmed its strong contractual position. We would expect a neutral outcome for Transurban in the event of any toll changes within the Sydney toll road network.

Qantas remains an important position in our portfolio. Persistent strength in travel demand, combined with limited global aviation capacity, is resulting in ongoing favourable operating conditions. In addition, at the full year result, Qantas was able to quantify

benefits to operating efficiency, customer satisfaction and staff engagement from the first batch of new generation aircraft. This provides additional confidence that the extensive fleet renewal program the Qantas Group has planned over the rest of the decade can be undertaken simultaneously with the reinstatement of dividend payments for shareholders. Qantas continues to trade at a large discount to the broader equity market, which in our view undervalues the enduring strength of the business.

Brambles remains a large position in our portfolio and looks attractive even after rising 45% in 2024. It delivered a standout result demonstrating structural improvement in revenues, margins and free cash flow generation. While the equity market has been sceptical of the sustainability of these improvements, our own research efforts have confirmed these trends well ahead of the re-rating. Stronger free cash flow should enable a combination of higher dividend payments and ongoing share buybacks.

James Hardie offers appeal as we believe the share price is now discounting more weakness in the US housing market following 2 years of steep decline. As always, it is difficult to forecast the timing of an eventual recovery, but the share price currently offers considerable long term valuation appeal and some downside protection in the event of a deterioration in the cycle. James Hardie is in a strong competitive position with available capacity and an excellent relationship with building contractors to capitalise on an eventual upturn.

### Conclusion

The outlook for the Australian equity market in 2025 is somewhat mixed as some of the pressures on the economy ease, but the outlook for interest rate cuts gets pushed out. Overall profit growth is likely to be muted given lower commodity prices so far and a weak outlook for bank earnings. Other sectors are

likely to fare better, with some profit growth expected for the Industrial, Healthcare and Infrastructure sectors.

be resilient over the business cycle.

Buying a passive fund is seen by many as a low risk strategy. However it currently involves significant embedded risk, as the index return in 2024 has been concentrated among relatively few large stocks and these now trade at elevated multiples. Our approach is to be highly selective and avoid these over hyped stocks. We are focused on companies which have been neglected in 2024 but still generate a solid return on capital with opportunities for growth. In the current economic setting it is critical to select stocks which will

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