Monthly Market Commentary
With Portfolio Manager, Andrea Ciaccio
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Market Review

Anthony Albanese's centre-left Labor Party won a historic second term in the federal election, securing 94 of the 150 House of Representatives seats (up 17 from 77 of 151 in 2022), that is, 62.7% of the total, its highest share since 1943. One-term federal governments in Australia are rare, with the most recent instance of defeat after a single term having occurred back in 1931. That said, re-election normally comes with lower popular support. In fact, every first-term government since World War II has suffered an adverse two-party-preferred swing, and governments have tended to lose consensus the longer they remain in office. That was not the case in 2025. Albanese, the first-term prime minister seeking re-election with the narrowest majority in modern history, defied the so-called 'incumbency curse'. The Labor Party won in a landslide, seizing the highest-ever seat count in the party's history and the most seats ever won by a political party in an Australian election. In addition, he became the first prime minister to win back-to-back elections since 2004. His stunning comeback was partly due to voters' backlash against Donald Trump, as the leader of the opposition Peter Dutton was seen adopting policies and rhetorical strategies strongly resembling those of the US President, with critics arguing that this approach was divisive and unsuited to the Australian context.

After having led in the polls for months, Dutton, who had taken the conservative Liberal-National Coalition (LNP) further to the right, suffered a crushing blow, becoming the first federal opposition leader in history to lose his seat at a federal election. The public appeared to reject his vision rather than endorsing the direction taken by the Labor, especially considering the widespread discontent with the handling of the cost-of-living crisis by the incumbent. The Coalition collapsed to 43 seats (down 15 from 58 in 2022), that is, 28.7% of the total, its lowest share since the beginning of the two-party system in 1910. According to the Australian Electoral Commission (AEC), Labor won the two-party vote in metropolitan seats by 60.7–39.3, a 4.1% swing to Labor, while the Coalition won the two-party vote in non-metropolitan seats by 52.3–47.7, a 1.8% swing to Labor. Liberals lost key city seats to independents; in fact, the shift away from the two major parties toward smaller political blocs intensified, as minor parties and independents collectively received more votes than the Coalition for the first time ever at the national level. However, the so-called "crossbenchers", saw their rankings reduced to 13 (down 3 from 16 in 2022). The Greens in particular were decimated to 1 seat after losing the seat of their leader Adam Bandt in Melbourne and two of the three Queensland seats they gained in 2022.

Besides weighing on the Australia election, the "Trump effect" continued to dominate the news cycle during the month. On May 8th, the UK and the US announced the "Economic Prosperity Deal", a limited trade agreement rolling back certain tariffs imposed by the US President in March and in April 2025. However, the 10% flat universal tariff remained in place, despite the US running a trade surplus with the UK, and the UK representing only 3% of US trade. On May 12th, the US and China agreed to a substantial reduction of the inflated tariffs imposed since April 2nd. Bilateral tariffs were slashed from previous peaks as high as 145%, and a 30% baseline tariff on China-origin goods, consisting of a 20% fentanyl-related tariff and 10% reciprocal tariff, was set for 90 days. The new duties will be levied on top of the 25% Section 301 tariffs on most Chinese goods in place since 2018, with the total import tax adding up to 55%. On May 23rd, Trump threatened Apple and other phone makers with a 25% tariff on devices sold in America that are not manufactured locally. On the same day, he recommended a "straight 50% tariff on the European Union (EU), starting on June 1st" owing to the trade negotiations between the first and the second largest economies in the

world “going nowhere”. He backed off a few days later, pausing the implementation of the latest penalty until July 9th, after a “very nice call” with Ursula von der Leyen, the President of the European Commission.

On May 28th, a panel of three judges at the US Court of International Trade in Manhattan issued a unanimous ruling blocking most of Trump’s global tariffs on the grounds that the US President had exceeded his authority under the International Emergency Economic Powers Act (IEEPA). However, one day later, the US Court of Appeals for the Federal Circuit temporarily reinstated the “Liberation Day” tariffs, granting a so-called “administrative stay” while it considers the administration’s appeal. Amidst the chaos and the uncertainty surrounding the future of tariffs, global equities continued the powerful rally initiated in the first half of April, with the S&P 500 and the Nasdaq 100 returning in positive territory in USD terms since the beginning of the year. An article penned by Robert Armstrong for the Financial Times attempted to rationalise the (apparent) inconsistency between buoyant financial assets and the more sober economic fundamentals coining the now-infamous “Taco trade”. The theory suggests that “Trump Always Chickens Out” when his announcements “cause pain” and that the markets have (correctly) realised that “the US administration does not have a very high tolerance for market and economic pressure”. Not surprisingly, when asked about the tongue-in-cheek acronym, the US President was not pleased and retorted to the “nasty question” that his tariffs flip-flops are “called negotiation”.

International Equities

The old adage “sell in May and go away” did not hold true in 2025, with US equities logging their best month year to date. The S&P 500 (+6.15% in USD terms) recorded its 5th best May ever, while the Nasdaq 100 (+9.04%) rose the most since November 2023. The Dow Jones Industrial (+3.94%) underperformed both averages for the second month in a row as UnitedHealth Group, which at the end March was the largest constituent within the index, halved from its mid-April highs. The “Magnificent Seven” rallied by double-digits in May, trouncing the rest of US large caps. Semiconductors shone with Nvidia reporting another blockbuster quarter of 69% sales growth. After having bought the dip aggressively in April, retail investors snapped up highly speculative stocks, with the GS Non-Profitable Tech, the GS Liquid Most Short and the ARK Innovation ETF, a proxy for high-multiple, “long-duration” stocks, jumping the most since November 2024. As a result, the S&P 500 High Beta outperformed the S&P 500 Low Volatility TR Index by the most since December 2023 as the so-called “momentum trade” regained its mojo. Technology, communication services, consumer discretionary and industrials outperformed the general index, while consumer staples, real estate and energy lagged. Healthcare bucked the trend and biotech fell on drug policy concerns.

US equities topped the rest of the world (as exemplified by the MSCI AC World Index ex USA TR Index) for the first time in 2025 despite global allocators continuing to diversify away from the former and into the latter. According to LSEG Lipper, equity mutual funds and ETFs domiciled in the US experienced outflows of $24.7 Billion USD in May, the largest in 12 months, while European funds attracted $21 Billion USD, lifting inflows since the beginning of the year to $82.5 Billion USD, the highest in four years. All major regions outside of the US posted solid gains but underperformed the general index. The MSCI World Growth Index recorded its 11th best monthly outperformance ever vis-à-vis the MSCI World Value Index. All in all, the MSCI AC World Daily TR Index was up +5.75% in USD terms and +5.26% in AUD terms.

Australian Equities

Australian equities continued to rebound in May, with the S&P/ASX 200 ending the month up +17.65% from its April lows. The strength was broad based with over 150 of the index's constituents in the green, including 50 which posted returns of 10% or greater. Returns were largely driven by multiple expansion. In fact, Macquarie calculates that, following the rally, the forward price-to-earnings (P/E) ratio of the market had come back to 18.8, matching the highs reached in November 2024. The S&P/ASX 300 surged +4.20%, buoyed by technology, energy, telecom, financials and industrials. Banks were a mixed bag, with CBA and NAB rising and ANZ and Westpac ending the month in the red. Technology was the best performing sector owing to well received results from Life360, Technology One and Xero. Utilities, consumer staples, healthcare, materials and consumer discretionary trailed the general index. Gains for miners were subdued with the prices of iron ore and copper stabilising after the large drop suffered in April. Gold stocks rose by double-digits on the back of continued earnings upgrade and despite a small dip in the price of the yellow metal. Finally, Mid-caps and smaller companies beat the Top 20 and growth stocks outperformed value stocks for the second consecutive month.

International Fixed Income

Two of the four major global central banks that met during the month lowered interest rates. On May 8th, the Bank of England's (BOE) Monetary Policy Committee (MPC) voted 5-4 to lower its official bank rate by 0.25% to 4.25%. Two members leaned towards a bigger 0.50% cut, while two voted to keep rates on hold. On May 28th, the Reserve Bank of New Zealand (RBNZ) lowered its Official Cash Rate (OCR) by 0.25%, from 3.50% to 3.25%. The Bank of Japan (BOJ) and the FED left interest rates unchanged. The former met on May 1st and reiterated its intention to pursue additional interest rate hikes. During the second half of the month, the super-long end part of the Japanese yield curve moved sharply higher, with the 20-, 30- and 40- year yields spiking to multi-decade highs or to all-time highs, signalling weak investor demand for those maturities. A comment from Prime Minister Shigeru Ishiba, who rebuffed tax cut demands by remarking that his country's financial condition was worse than Greece's, heightened concerns. Eventually, yields started to decline after the nation's Ministry of Finance suggested that the government may lessen the issuance of long-term debt and sell more shorter-term notes to keep longer-term yields anchored. The FOMC met on May 8th and held the line at 4.25%-4.50%, citing increased risks of higher inflation and higher unemployment, in other words, of "stagflation", in part due to trade policy. On May 16th, Moody's downgraded the US' sovereign credit rating due to mounting government debt and rising interest expenses. The rating agency first gave the US its pristine "Aaa" rating back in 1919 and it is the last of the "Big Three" to downgrade it. On May 22nd, Trump's "One, Big, Beautiful Bill Act" was approved by the House of Representatives and will now proceed to the Senate. The OBBBA makes permanent the tax cuts passed in 2017, increases defence spending, and cuts spending on social programmes such as Medicaid. The Congressional Budget Office (CBO) projects that it will add approximately 2.7 Trillion USD to the federal deficit over the next decade.
The Bloomberg Barclays Global Aggregate Index hedged back to AUD declined -0.36% for the month, as the US yield curve transposed higher and flattened. In addition, the so-called "term premium" which is the compensation required to buy and hold a 10-year Treasury as opposed to simply rolling over short term paper at prevailing rates, rose to 0.75%, its highest level since June 2014.

Australian Fixed Income

On May 20th, the RBA delivered its second 0.25% cut of the year, lowering the cash rate from 4.10% to 3.85%. While the decision was widely expected, the dovish tone struck by Governor Bullock during her press conference caught market participants by surprise. In fact, she made known that the central bank had "put aside pretty quickly" the option of a hold, choosing instead to debate the appropriateness of a larger reduction. "The discussion then was about 50 and 25" she stated, but eventually "the board was of the view that 25 was the right number on this occasion." Domestic fixed income rose for the seventh consecutive month, with the Bloomberg AusBond Composite 0+ Yr Index adding +0.16% on the back of tighter credit spreads. The yield curve steepened modestly with the 2-, 5- and 10- year yields 1, 1 and 10 basis points higher at 3.28%, 3.55% and 4.26% respectively. At the end of the month, the cash futures were pricing a third 0.25% cut in Q3, and one additional reduction in Q4. The Australian Dollar managed to reclaim the 64 cents threshold vis-à-vis the US Dollar but continued to hover around extremely depressed levels against European and Asian major currencies.

Real Assets

Global property was up +2.41% in USD terms and +1.93% in AUD terms in May. At the regional level, Australia topped the list, followed by Europe. At the sector level, economically sensitive property types such as offices, hotels and industrials outperformed the more defensive, longer duration sectors the likes of healthcare and cell towers.

Global infrastructure soared +4.16% in USD terms and +3.68% in AUD terms for the month. Transportation stocks, primarily railroad, caught a bid owing to the de-escalation of trade tensions. Energy infrastructure and electric utilities outperformed the general index, while communication infrastructure and water utilities trailed.

Alternatives

Alternatives (+1.12%) underperformed global equities in May. Returns were mostly positive across strategic mandates, with Event Driven and Long/Short equities successfully leading gains. Conversely, discretionary macro and trend following mandates failed to take advantage of the decline in implied volatility, extending their losing streak.

Market Outlook

US Treasury Secretary Scott Bessent has a problem: there is now a broad consensus that the trajectory of the US national debt is unsustainable, with excessive government spending identified as the principal cause. During the 2024 fiscal year, the federal government expended 6.75 Trillion USD while collecting 4.92 Trillion USD in revenues, resulting in a budget deficit of 1.83 Trillion USD, which equates to 6.4% of GDP. Worse still, 881 Billion USD, representing 48.14% of the total deficit, was allocated solely to interest payments, as the cost of servicing the debt has ballooned compared to the pre-COVID era. At the end of May, the average interest rate on marketable US debt stood at 3.36%, and it continues on a steady, upward trajectory. That is the reason why, at the beginning of the year, our expectations were centred around a gradual slowdown of the US economy prompted by a (modest) curb of Uncle Sam's profligacy coupled with the implementation of tariffs designed at boosting government's coffers. In such a scenario the FED would have room to reduce rates, thereby mitigating the impact of the "growth scare" and facilitating mortgage refinancing, thus reviving the housing market. Crucially, it would also lessen the US Treasury's interest payment obligations and this,

in turn, could initiate a virtuous cycle ultimately leading to long term debt stabilisation. However, the introduction of Trump's "Liberation Day" tariffs triggered widespread economic and financial disruption, resulting in a sharp decline in equity markets and in a "confidence shock" among consumers and businesses. As a result, our base case became that of a technical recession, defined as two consecutive quarters of negative GDP growth. Due to the political and economic backlash against the trade war, both from the business community and the electorate, the administration abandoned its use of tariffs as a tool to restructure global supply chains. Simultaneously, the self-defined "deficit hawk" Secretary Bessent clarified that spending reductions would occur only gradually. In an interview with CNBC, he stated that, since "every 300 Billion USD is equivalent to 1% of GDP," a 1 Trillion USD spending cut in the current fiscal year would produce "a 3% shock to GDP." A contraction of this scale would likely cause a severe recession. Consequently, he outlined a plan to reduce the deficit by approximately 100 basis points per year over four years, aiming to return to the long-term average deficit level of 3.5% of GDP.

The fiscal U-turn did not stop there. Not only the "austerity" narrative was unceremoniously ditched, but stimulus took centre stage once again. Bessent went so far as to assert that "what's important is that the economy grows faster than the debt", suggesting that sustained economic expansion could stabilise debt levels relative to GDP. Investor sentiment shifted rapidly from pessimism to euphoria, with markets pricing in expectations of an impending economic boom. The key flaw in this line of reasoning, however, is the assumption that the US can "grow its way out of debt" without undertaking any fiscal consolidation. For this strategy to succeed, nominal GDP growth must outpace the federal deficit as a percentage of GDP. That is precisely what occurred in 2022, when nominal GDP rose by 9.82% while the budget deficit stood at 5.29% of GDP. The debt-to-GDP ratio declined during that year, but the fixed income market suffered a meltdown, and "safe" bonds the likes of US Treasuries and investment-grade corporate bonds suffered their worst annual performance on record. This outcome aligns with historical patterns, wherein the 10-year yield tends to converge over time with the average nominal GDP growth rate observed over the preceding decade. Under current conditions, where the federal government maintains an annual deficit near 6%, nominal GDP would need to grow by at least 6% annually to merely stabilise the debt-to-GDP ratio. Achieving this would place considerable upward pressure on yields, making it highly unlikely for the 10-year yield to remain at current levels, let alone fall below 4%. In such a scenario, the FED would not have room to cut rates, and, in our opinion, that could be the real motive behind the central bank's decision to maintain its pause on the interest rate easing cycle since the beginning of the year. In fact, we believe that the central bank may be concerned about a potential repeat of what transpired in Q4 2024, when it lowered its target rate by a cumulative 100 basis points while the Biden administration was intent on running the economy hot via massive public handouts. In the end, the dovish pivot had the opposite effect than intended on the US government yield curve, as it was followed by a 60-80 basis points jump across the board. We suspect that the "surprise" movement happened not despite, but precisely on account of the reduction in cash rates, as investors perceived that the FED was enabling excessive government spending and demanded higher returns for holding longer maturities.

We continue to think that Secretary Bessent is targeting "lower rates", with his primary focus being the 10-year yield, and not solely the cash rate. In fact, 21% of marketable government bonds is currently Treasury bills, up from 15% back in Q3 2022, and the US government must refinance 11 Trillion USD in the next 12 months; if interest rates do not come down quickly, it will have to do so at a progressively greater cost. In fact, the entire yield curve is trading at

least 50-60 basis points above the 3.36% that it is currently paying on average. Rolling over the debt at current levels could initiate a vicious cycle in which the budget deficit increases because of mounting interest rate expenses, prompting a hawkish reaction on the part of the FED to combat falling demand for USD denominated assets, which will push rates even higher. In the end, the increase in yields would crowd out the positive contribution of tariffs. However, we contend that today public finances are in better condition than they were 6 months ago. Things may change when the OBBBA is passed, whether in its present or in a revised form. But as a matter of fact, the budget deficit of the last 6 months, that is from December 2024 to May of this year, while still very high from an historical point of view at 741 Billion USD, is down 9.88% compared to the same period one year before. In other words, since the election of Trump, the so-called "fiscal impulse" has been negative, that is, the government has injected less money into the economy at the margin. Putting all things together, this "roller coaster" has brought us back to where we started: the US economy is slowing, modestly but steadily, driven by mature-cycle dynamics, not recessionary forces. The global economy appears to have come full circle since January, with other regions, particularly Europe and emerging markets, but also Australia, showing signs of improvement. The rest of the world remains on track to outperform the US economically and financially. Central banks outside the US are cutting rates, and fiscal stimulus is being deployed in several countries. This creates a constructive environment for global equities and supports our strategy of maintaining a diversified exposure, including allocations to real assets.

Finally, US inflation is not currently a major concern, with the Personal Consumption Expenditures (PCE) Price Index, the FED's preferred indicator, reported at +2.3% YoY in April. Of the three main drivers of inflation, two remain disinflationary as wages are cooling off in the US and shelter is trending lower. Oil has now started to move up, but we find it difficult for crude to stay above 75 USD per barrel unless the situation in the Middle East escalates to an all-out war. Furthermore, in times of geopolitical shocks or conflict, central banks have tended to respond by cutting rates, looking through temporary commodity price spikes as exogenous shocks. As a result, we think that the bond market became overly pessimistic in May, with fears of a booming US economy pushing up long yields. Some of this was technical, as investors who had bet on a recession were forced to unwind positions. Our outlook on fixed income remains neutral as we see rates as likely to be range-bound or even lower. We remain comfortable maintaining a fixed income exposure characterised by a duration comparable to that of the benchmark. We favour Australia, which we consider a "quiet" winner in the current environment, benefiting from stable politics, a AAA credit rating and a central bank in easing mode.

AZ Sestante
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