Talaria Global Equity Fund Foundation Units

Quarterly Update March 2025

Signatory of:

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Investment Insights

Summary

What's Priced In

If we were asked to design a range of fridge magnets for investors, one would say, "it's not what happens that matters but what's priced in." We would oversize it and have red arrows pointing inward. Maybe there'd be flashing lights.

More seriously, we all know that risk management isn't about great forecasting; it's about great planning for contingencies. Yet many share prices make little allowance for the unexpected.

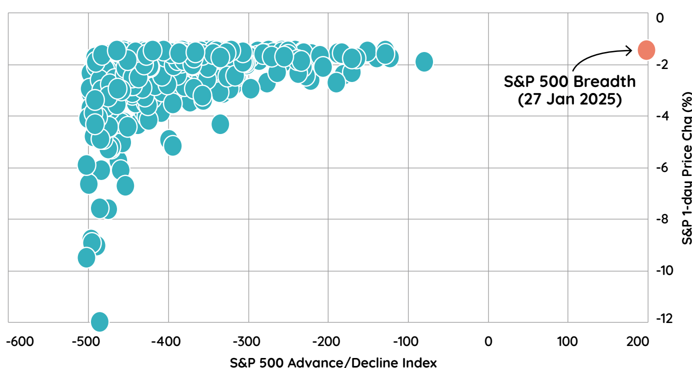
As we explore in this report, global equity investors have overwhelmingly bet on falling US long bond yields despite great uncertainty. The S&P 500 trades at a valuation historically associated with low or negative long-term returns. Consensus estimates embedded in US multiples assume double-digit earnings growth, yet these forecasts are easy to challenge.

Risks in plain sight

In the first quarter risks crystallised but did not fully play out and we believe plenty of challenges remain. As we have said before, many of these are simply hiding in plain sight.

Take the related risks of concentration and basis. March marked a quarter century since the S&P 500 peaked in the year 2000, before falling 40.5% over the next two and a half years. During that deep drawdown, 40.6% of index constituents actually rose in price. That gap between index returns and underlying performance is classic basis risk. We've seen days like it this quarter, the index falling about 2% while 350 stocks rose and only 150 declined.

S&P 500 Advance/Decline Index vs S&P 1 day Price Performance since 2001 (through to 14 Mar 2025)



Note: Data only shows days with S&P 500 Index failing 1.5% or more

Source: Talaria, Bloomberg

Vulnerable forecasts

With US equities making up over 70 percent of global equity market capitalisation, much of what we write focuses on the US. While earnings growth has been concentrated in tech-related sectors over the past two years, profits and margins remain high across industries. Revisiting consensus earnings estimates since the October 2023 peak in two-year rates, suggests growth forecasts are too optimistic. Downgrades could play a meaningful role in US equity returns this year. Earnings revision ratios are already pointing that way.

Valuation more relevant

Valuation is also a risk, though many now treat it as an outdated concept, de-emphasising it in the belief that it has lost much or all its explanatory power. Valuation sceptics can point to more than twenty years of rising multiples and falling spreads across equities, real estate, and high yield to support their view. But rather than dismiss valuation outright, they might ask whether the conditions that sidelined it still hold.

A first-principles approach suggests they do not. Conditions have changed in a way that makes valuation more relevant. Of all the messages in this report, this is perhaps the key strategic observation we'd like to convey. Nominal growth and the cost of capital are no longer diverging, reversing a trend that dates to the early 1990s. Consequently, dismissing valuation and adopting a set-and-forget mindset is no longer likely to be the answer.

Duration heavy market

Since 2020, the proportion of global equities positively correlated to falling US long bond yields has ballooned from just over 10 percent to around 70 percent today. The growing weight of an expensive US market in global equities, and within that, the increasing dominance of tech, which derives so much of its value from the out years, has made duration an ever more significant factor.

In outlining equally persuasive but opposing arguments for higher and lower long bond yields, we suggest that market pricing assumes a lot of directional certainty where none exists. Most investors in global equities have positioned themselves for falling yields. There is little contingency planning in that and a great deal of confidence.

In the bond yield discussion, we note that the US remains fundamentally reliant on large-scale foreign capital inflows to balance its external accounts, USD 1.9 trillion last year. That reliance is now under pressure from both shifting policy priorities and growing economic nationalism abroad.

A range of governments are looking to retain capital for domestic projects, with initiatives in Europe, the UK, Australia and elsewhere aiming to redirect savings away from US assets. If foreign appetite softens, the consequences could extend beyond US long bonds, challenging the broader US asset and currency superstructure.

Risk is opportunity

All these risks present opportunities, and our regular reader will not be surprised to hear that we think it makes sense to have exposure to areas that benefit from uncertainty and mitigate the downside.

More than one of these areas is central to our strategy. The volatility risk premium persists across cycles, but it's always preferable to be writing options at higher implied volatility. Also important is having a process that allows for quick responses when opportunities present themselves. Together, these two elements are especially powerful in a sell-off, when premiums rise and the opportunity set expands. We would also say that value equities are attractive, as their short duration sets them apart.

Earnings

Negative earnings surprises could play a meaningful role in US equity returns this year. Analysts forecast double digit EPS growth for the next two years when history suggests the future will be more challenging. As we write, the MSCI ACWI 3-month earnings revision ratio momentum in the US is sharply lower by -4.6%.

Stepping back, the spotlight naturally focuses on tech related sectors, which have been the primary drivers of earnings growth for the last two years. But aggregate profits and margins remain at or near record highs across sectors, not just in tech, as is commonly perceived. From here, further growth would require a broad-based improvement from these highs.

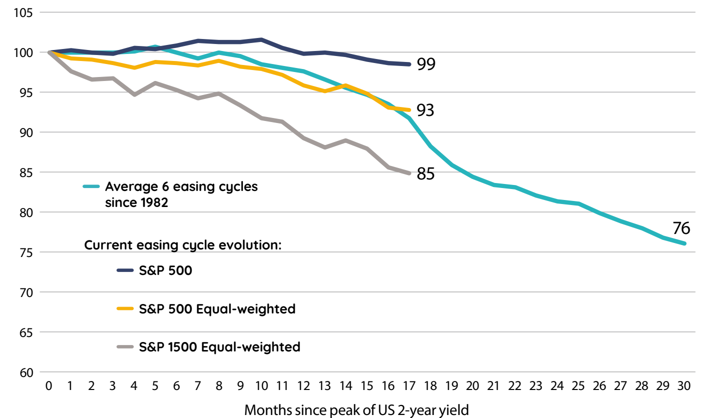
Even without examining individual contributors, downside risks are evident. The chart below, updated from our last quarterly, tracks how analysts' consensus EPS forecasts have historically evolved following the peak in US two-year bond yields, the typical marker for the end of a Federal Reserve tightening cycle. Since 1982, earnings forecasts have tended to decline significantly, by just under 25%, over the following two and a half years.

Now almost eighteen months past the most recent rate peak, the chart compares this historical pattern to the current cycle across three indexes.

The S&P 500, where tech has the greatest influence, has remained roughly flat, outperforming the historical trend. The S&P 500 equal weighted index, where tech's impact is reduced, is merely in line with past trends, trends that have historically reflected overoptimistic profit expectations following rate cuts. The S&P 1500 equal weighted index, where tech's influence is most diluted and the impact of rising interest rates is most acute, has significantly undershot past precedent.

Against this backdrop, current S&P 500 consensus forecasts of 11% EPS growth in 2025 and 14% in 2026 appear optimistic. A material shortfall in earnings should not be ruled out.

2yr forward EPS change, post end of tightening



Source: Piper Sandler, Bloomberg

The importance of US long bond yields to global equities

Earnings are not the only source of potential downside risk. US long bond prices also look set to be a key driver of equity returns because investors have overwhelmingly positioned themselves for falling yields.

% of market (MSCI World) that prefers falling bond yields

Source: Talaria, Société Générale

As the chart above shows, the percentage of MSCI World equities that benefit from lower bond yields has reached its highest level since 2000. This reflects the dominance of long duration assets, particularly from the US, where mega cap tech and other growth sectors have played an outsized role. More broadly since 2020, the increase in the price investors are willing to pay for shares has made a greater percentage of the market rate sensitive.

The positioning is counterintuitive. It's as if global equity investors were posed a not-so-multiple choice question. Do you think the future is

a. Certain
b. Uncertain

and mostly answered a.

Given the future is unknowable, this would be a surprise at any time, but today it is remarkable.

Arguments for and against higher US long bond yields

Implicit in the positioning is a degree of directional certainty that is at odds with a complex and finely balanced situation.

To illustrate the point, we set out below credible but opposing arguments for what could drive long bond yields higher or lower. We are not advocating a case, but using them to highlight just how difficult it is to “pick a side” and why, therefore, the prevailing positioning is so surprising.

On the one hand, a contraction in global dollar liquidity, rising unemployment, and declining industrial capacity utilisation suggest the potential for slowing growth and disinflation, creating conditions for lower yields. Liquidity tightening across major economies has historically led to weaker demand, which could prompt the Fed to ease.

On the other hand, a resilient US economy, monetary stimulus, and dependence on foreign capital suggest upward pressure on yields. If growth remains robust and inflationary risks re-emerge, the Fed may be forced to shift from wait and see to tighten further. At the same time, the US relies on vast foreign capital inflows to finance its deficits. Any weakening in appetite for US assets, or any unfavourable shift in their demand and supply, could also push yields higher.

A case for lower US long bond yields

Global contraction in money supply, economic stagnation and excess industrial capacity are creating conditions that point to lower U.S. long bond yields.

World dollar liquidity has undergone a record contraction, with real money growth declining sharply across major economies, including the US, the Eurozone, China, Japan, and the U.K. Historically, monetary contractions of this scale have preceded economic downturns and prolonged disinflation.

Velocity has collapsed, reducing the effectiveness of monetary policy. These conditions suggest a prolonged period of weak economic activity and subdued inflation, putting downward pressure on yields.

At the same time, a global manufacturing capacity glut is amplifying deflationary risks. Industrial capacity utilisation has fallen sharply worldwide, with U.S. manufacturing capacity utilisation dropping below levels seen at the onset of past recessions. Outside the US, industrial capacity utilisation is even weaker, with, for example, Japan’s industrial output running materially below its historical norm. Combine this declining factory utilisation with China’s depreciating currency and you have deflationary pressures transmitted globally, particularly through falling goods prices.

Rising unemployment adds to the argument for weaker economic growth. In the U.S., the unemployment rate has climbed from 3.4% to 4.1%, with global joblessness following a similar trend. This deterioration in labour markets is a classic recessionary signal.

The ongoing contraction in liquidity and monetary aggregates, reinforces the case for further disinflation and economic weakness. As excess industrial capacity persists, weak money growth limits demand and inflation softens, long-term U.S. bond yields are likely to decline. If monetary conditions remain tight, the Federal Reserve may have to cut rates further to counterbalance the tightening financial environment.

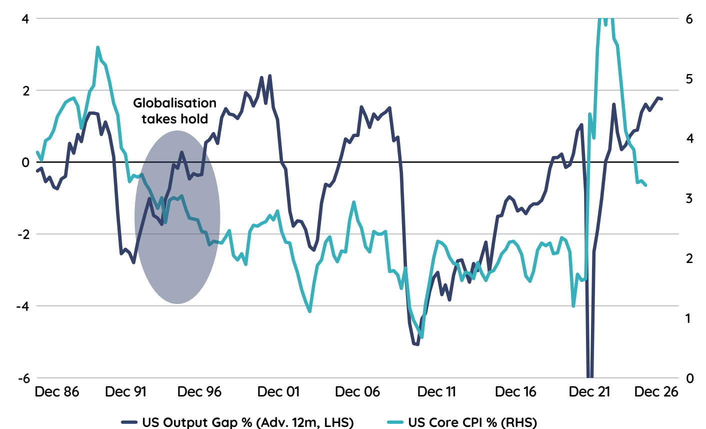
A cyclical case for higher US long bond yields…

The case for higher US long bond yields is supported by both cyclical economic conditions and structural reliance on foreign capital.

On the cyclical front, the US economy has demonstrated surprising resilience despite significant monetary tightening. GDP growth of 2.5%, 2.9%, and 2.8% from 2022 to 2024 underscored its strength in the face of the Fed raising rates by a cumulative 5.25%, before easing in the second half of 2024. Now, with 100bps of rate cuts feeding through to the economy, and with signs of looser bank lending standards, there is the potential for a pick-up.

This is unlikely to be good news for inflation or interest rates. The economy never experienced a significant slowdown, leaving little spare capacity. The output gap (actual versus potential total economic output) is now at its most inflationary level in nearly 40 years. Additionally, labour market data, such as unemployed workers versus job openings and the Miller Labor Slack Index, suggest further wage pressure is possible.

Little Excess Capacity: Output gap at its most inflationary in decades



Source: Talaria, FactSet, The Macro Institute

Recent comments from Chairman Powell signalled a continuing pause in rate cuts, but should inflation pick up, the central bank’s next move is more likely to be a hike than another cut. Worse, given its wait-and-see stance, it risks falling behind the curve, requiring more aggressive action than would otherwise be needed.

…and a structural case for higher bond yields

At the same time, structural pressures reinforce the case for higher yields. Beyond cyclical factors, capital flows and policy shifts are adding to the strain on US long bonds.

To balance its external accounts, the US required USD 1.9 trillion in foreign capital inflows last year. While policies such as tariffs, reshoring, and investment restrictions may reduce the current account deficit somewhat, and while corporate tax cuts or deregulation could improve the relative attractiveness of US investments, the fundamental reliance on foreign capital should remain high.

All else equal, foreign investors will need to add roughly USD 2 trillion this year to their already breathtaking USD 62 trillion holdings of US assets, just to maintain the status quo. If foreign appetite for US assets weakens, or if demand and supply dynamics become less favourable, the consequences could extend beyond US long bonds, putting pressure on the entire currency and asset superstructure.

The risks are growing. Beyond market-driven forces, economic nationalism is becoming increasingly plausible. Governments outside the US face mounting pressure to retain capital within national borders to fund domestic priorities and limit reliance on the US. This pressure could lead not just to capital retention, but to governments actively encouraging or even requiring the private sector to sell overseas assets and repatriate proceeds.

Recent evidence points in this direction. We have seen suggestions in the press that Norway's sovereign wealth fund should consider reallocating capital from US bonds into European defence bonds, aligning with Europe's push for greater military self-reliance. Germany has approved a EUR1 trillion investment in defence and infrastructure, marking a major shift toward domestic priorities that require significant funding. The EU is also considering steps to retain capital, with new initiatives aimed at keeping more of the EUR360 billion in annual outflows within its own markets. Meanwhile, the UK is exploring proposals to encourage pension funds to allocate more to domestic equities.

These moves highlight the growing momentum behind economic nationalism. If capital is redirected to meet domestic needs, the strain on US bond demand could intensify, pushing US long bond yields higher.

Valuation

High US valuations are, to us at least, also a concern. For example, the current cyclically adjusted Shiller PE in the mid-thirties has historically been a strong indicator of low or negative long-term future returns.

Yet pointing this out can provoke a dismissive "Shiller, Shmiller" response from those who argue that mega cap tech's dominance justifies today's high multiples, as well as from those for whom stock and flow dominate fundamentals. To these, valuation must seem like an outdated or even irrelevant concept.

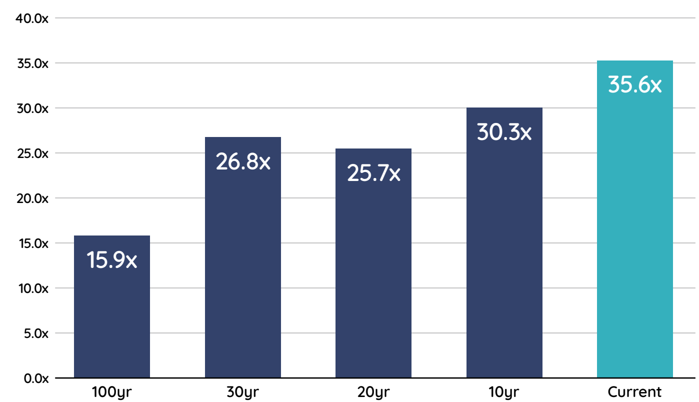
Experience has reinforced the complacency behind this response. As the charts below show, not just in equities but also in high-yield bonds and real estate, more than two decades of set-and-forget investing have delivered strong results, as multiples expanded and spreads narrowed. But to conclude from this that valuation no longer matters is to miss the point: the point that what matters is understanding the conditions that allowed valuation to become subordinate and asking whether those conditions still hold.

If we break valuation down to first principles, it is driven by just three things: the required return, nominal cash flow growth, and the cost of capital. Assuming the required return remains constant over time, we are left with just two. The decades long widening spread between these two, has driven higher valuations across asset classes.

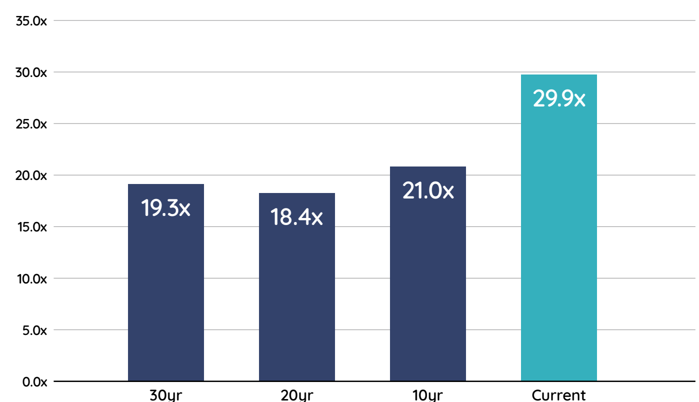
But the conditions that allowed valuation to be deemphasised are shifting. On the nominal cash flow growth side, where the delta has arguably never been that great, the forces that once supported it, globalisation, free trade, recycling of cash reducing the cost of finance and access to low-cost production, are reversing. Supply chains are reshoring, trade barriers are rising, and labour costs are climbing.

On the financing side, interest rates have risen sharply and may remain high. The era of near-free capital is over. If growth faces structural headwinds and financing costs stay elevated, then the forces that pushed valuations ever higher no longer apply in the same way.

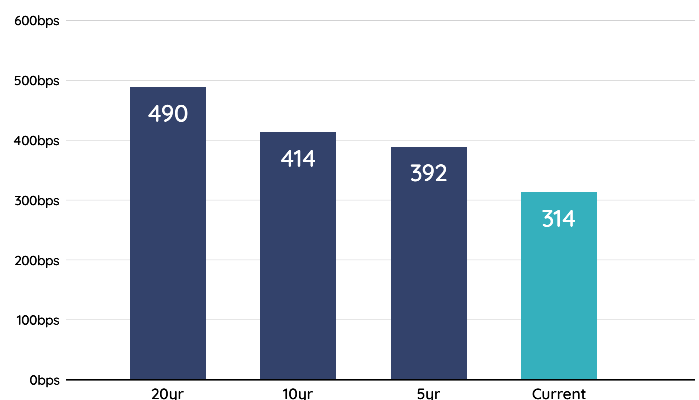
Equities: Average Shiller P/E



Real Estate: Average P/E



HY Bonds: Average Credit Spread



Source: Talaria, Bloomberg

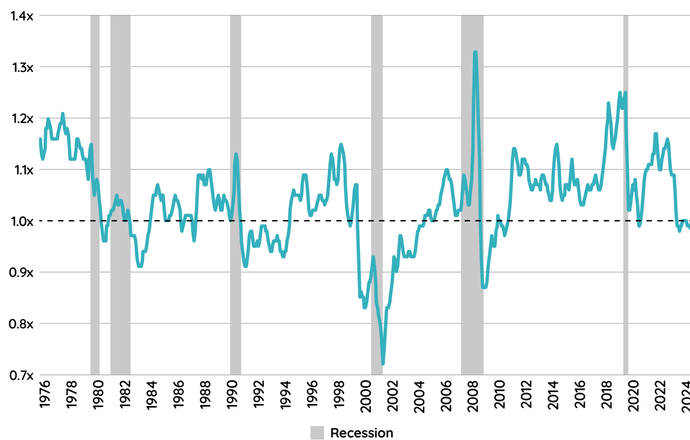
Conclusion

In this piece we have covered earnings, duration, valuation, concentration, rising bond yields, falling bond yields, economic nationalism and so on. We haven't forecast a future, but we have contrasted the uncertain outlook with the confidence priced into many shares.

Our key strategic message has been that the conditions that allowed valuation to become a sideshow for so many investors no longer apply. The investment landscape has decisively changed as the globalisation in evidence the last 30 years is in reverse, making capital scarcer. In terms of first principles, nominal growth and the cost of capital are no longer diverging; dismissing valuation and adopting a set-and-forget mindset is no longer likely to be the answer. The recent performance of our strategy has shown the importance of a valuation sensitive approach against this changing backdrop.

The market is always a "two-handed engine", what it takes away with one it gives with the other. There are opportunities from the recent sharp moves in global equities. For example, stocks that have the stability desirable in challenging times are trading at a rare discount to the market outside of recessions (chart below). But taking advantage of these opportunities requires a willingness to engage with areas of the market that have been out of fashion, and to use levers of return that actually benefit from volatility.

Large-Capitalization Stocks
Top Quintile of Fundamental Stability
Relative Forward-P/E Ratios[1]
1977 Through Mid-March 2025



[1]Equally-weighted data, smoothed on a three-month basis.

Source: Talaria, Empirical Research

March 2025 Quarterly Performance

The first quarter of 2025 was marked by the abrupt unwinding of the momentum trade that dominated markets throughout 2024. Big tech was sharply down. Rising global trade policy uncertainty triggered a risk-off response by investors. Stagflation worries emerged. Investors sought protection by rotating into gold, bonds and equities with defensive characteristics. European markets were the only bright spot in an otherwise dismal quarter for global equities.

The growing valuation gap between US and European equities reversed somewhat in the first quarter. Big Tech led the sell-off in America as the AI hype took a breather, not least because of the emergence of competition from China. Trade policy uncertainty sapped consumer and business confidence, dimming growth prospects. At the same time, sticky prices and higher tariffs drove inflation expectations up. Investors reached for protection, bidding up the price of gold to an all-time high while bond yields fell. Europe did well, partly from simple mean reversion but also on catalysts such as Germany signaling plans for significant fiscal expansion.

By region, the Stoxx600 was up 5.2% driven by optimism of European economic recovery. The German DAX rose the most, up 11.3%, as investors cheered the removal of the “debt brake”. The French CAC and the UK’s FTSE were also up 5.6% and 5.0%, respectively. The US, on the other hand, had a very poor start to the year driven by weakness in Mega Cap tech. The tech-heavy NASDAQ entered correction territory, down -10.4% while the broader-based (but still heavily concentrated and dominated by a narrow cohort of tech) S&P500 fell by -9.3%.

In Asia, the Nikkei also entered correction territory, falling by -10.7% as tariffs dimmed the prospects of exporters while tighter monetary conditions dampened overall growth prospects. China’s Shanghai composite had a muted quarter, down -0.5%, with DeepSeek fueled AI optimism offset by the imposition of higher US tariffs.

Against this backdrop the Fund delivered a return of +4.68% for the quarter.

Distributions: The Fund paid a March 2025 quarterly distribution of 1.79 cents per unit taking its 12-month income return to 6.65%.

By sector, big tech was the biggest loser last quarter. The three tech-heavy sectors IT, consumer discretionary and communication services were down the most by -12.0%, -10.5% and -4.6%, respectively. On the positive side was a mix of defensive and cyclical sectors. Energy fared best, up 9.2% and supported by a surge in natural gas prices. Utilities and Staples also delivered strong performance, up 6.6% and 5.5%, as investors rotated out of tech and sought relative stability amidst rising geopolitical risks.

The US 10-year yield fell 36 basis points to 4.21% while corporate credit spreads widened by 40 basis points to 181 as worries about economic growth resurfaced. At the same time, commodity prices rallied 7.7%, hinting of rising inflationary pressures. The VIX reached 22.3, a few points above the long run average and up from 17.4 in December. Finally, the US dollar weakened by -3.9% relative to most major currencies, a somewhat unusual development in a risk-off environment.

The largest contributor to returns in the quarter was Roche, a Swiss pharmaceutical company that reported strong FY24 numbers, improved growth guidance and a number of successful pipeline drug trials. Another contributor to returns was Newmont, the largest global gold miner, on the back of a strong gold price. We continue to hold and add to both positions.

The largest detractor to performance in the quarter was Sodexo, a French catering and facilities manager on the back of a downgrade to their full year guidance. Despite this setback, the company continues to demonstrate solid growth potential and remains attractively valued. Another detractor to performance was Henkel, a German consumer goods company that also reported a disappointing growth outlook. Valuation support keeps us invested in both companies.

The Fund initiated six new positions during the quarter, capitalizing on higher market implied volatility and compelling valuations. The new investments include Essity, a Swedish consumer goods company with a dominant market position in adult incontinence and feminine care products, and Pfizer, a U.S. pharmaceutical giant trading at a discount to its fair value. In the technology and energy sectors, the fund added HP Inc., a prominent U.S. personal computer maker, and EOG Resources, a large oil and gas producer. Rounding out the new positions are Citigroup, a major U.S. bank and Robert Half, a global human resources consulting firm benefiting from strong demand for staffing solutions worldwide.

The Fund exited five positions during the quarter. Two utilities, WEC Energy Group and Redeia Corporación, were sold after shares reached very full valuations. Similarly, health care giant Gilead Sciences was exited following a strong run. In Japan, the fund divested from KDDI, a major telecommunications operator, and Sumitomo Trust Bank, both of which were trading at elevated valuations compared to their intrinsic value.

Stock in focus: Everest Group

Everest Group is one of the largest global reinsurance companies. It is headquartered in Bermuda and listed on the New York Stock Exchange. Everest serves customers in 115 countries, including Australia and the US.

Business Overview

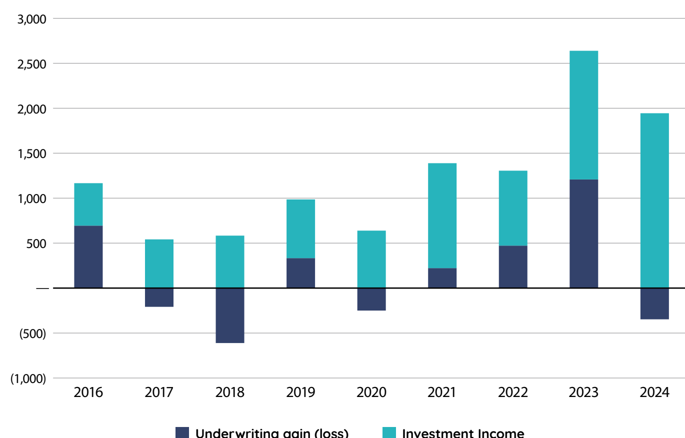
By spreading risk across a global portfolio, reinsurers enable primary insurers to underwrite more policies with confidence. When disasters strike—whether hurricanes, wildfires, or financial crises— reinsurers help the system remains resilient, safeguarding economies and policyholders alike.

Reinsurers, just like primary insurers, generate income from two main sources – premiums written and income on investments.

Premiums written offer reinsurers a differentiated source of income – teams of actuarial scientists help work out the likelihood of insurance events that have no correlation with the business cycle. A cyclone strikes regardless of whether the US economy is in a recession or not. The underwriting gain (or loss) is the profit generated from premiums written after paying out claims and operating costs (see dark bars in chart below). The ratio of claims and costs over premiums written, has averaged 98% for Everest Group since 2016 – not the best in class but still profitable (anything below 100% suggests a profit).

Investment income is the income reinsurers generate on their assets. When insurance premiums are written, a reinsurer invests the cash proceeds into investments that help generate additional income and is an important component of overall returns. Most of Everest Group's investment assets are safe, liquid, investment grade fixed income securities with a relatively low duration of 3.5 years. Higher interest rates are typically good for insurance businesses because they boost the income generated from their fixed income investments. The exhibit below shows the significant increase in investment income since 2022, driven by the higher interest rate environment.

Everest Group: Sources of Income



Source: Company Reports, Talaria

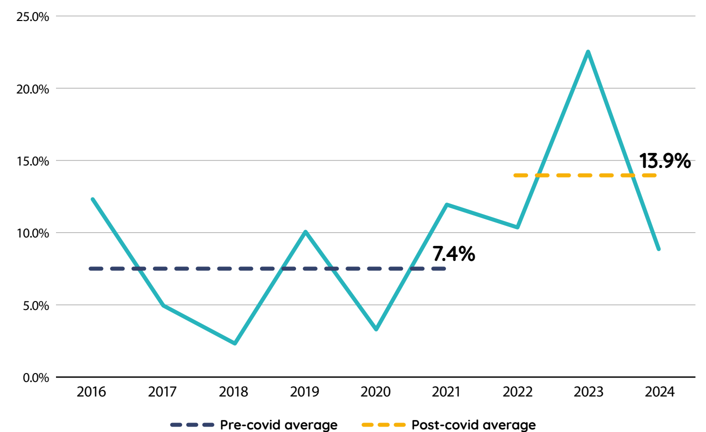
Investment Case in a Nutshell

Everest Group shares are trading at 0.9x Price to Book while we believe the business can sustainably generate ROE of 13% to 15% over the coming years, offering a compelling upside to investors.

A dividend payout of 15% to 20% on normalised earnings currently yields 2.4%. The retained earnings of 80% to 85% help grow the book value per share at a rate of 10% to 13% per annum. In the absence of a multiple re-rating, we expect these two components to drive mid-teen returns for shareholders per annum over the medium term.

While ROE has averaged 7.4% in the pre-covid period, the much higher interest rate environment supports a higher ROE going forward, all else equal.

Everest Group: Operating ROE



Source: Company Reports, Talaria

Risks and Stress Scenarios

The greatest risk for any insurance business is the potential for higher-than-expected claims from major events, which can significantly impact the balance sheet. In recent years, catastrophic risk has risen with the increasing frequency of Category 5 hurricanes. Everest Group mitigates this by adjusting underwriting premiums to reflect changing risk conditions. Short cycle-renewal periods ensures that the market can quickly recalibrate premiums based on updated actuarial data.

Another key risk for insurers is investment losses. Everest Group is relatively well-protected in this area, as most of its investment portfolio consists of highly liquid, short-duration, investment-grade fixed-income securities. While credit events are always a possibility, we are comfortable with the quality of assets that Everest holds.

Talaria Global Equity Fund - Foundation Units

Top 10 Holdings*

Company name	% weight
Johnson & Johnson	4.8%
Bunzl	4.6%
Sanofi	4.5%
Everest Re	4.5%
Newmont	4.4%
Roche	4.4%
Henkel	4.1%
Brenntag	3.9%
CF Industries	3.6%
FEMSA	3.5%

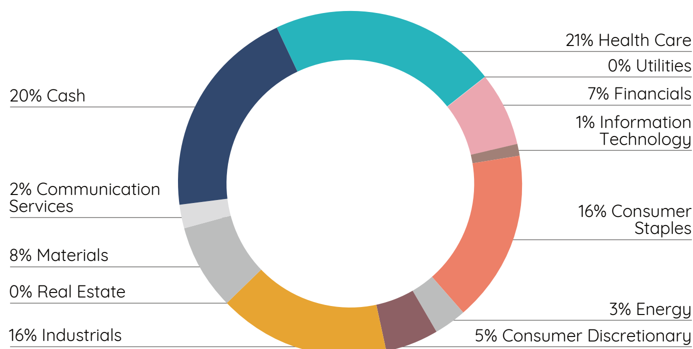
* Weightings include option positions held and cash backing put options. It assumes that put options will be exercised. Should the put option not be exercised the cash will revert to the unencumbered cash portfolio or may be used to cover further put options.

Performance at 31 March 2025[1]

Period	Total Return	Average Market Exposure[4]
1 month	0.16%	64%
3 months	4.68%	67%
6 months	7.00%	67%
1 year	8.88%	65%
3 years p.a.	10.17%	59%
5 years p.a.	10.86%	57%
7 years p.a.	8.88%	59%
10 years p.a.	7.40%	59%
Since Inception p.a.[2]	7.74%	61%

1 Fund Returns are calculated after fees and expenses and assume the reinvestment of distributions.
2 Inception date for performance calculation is 1 October 2005.
3 Past performance is not a reliable indicator of future performance.
4 Average Market Exposure calculated on delta-adjusted exposure of underlying portfolio.

Sector Allocation[5]



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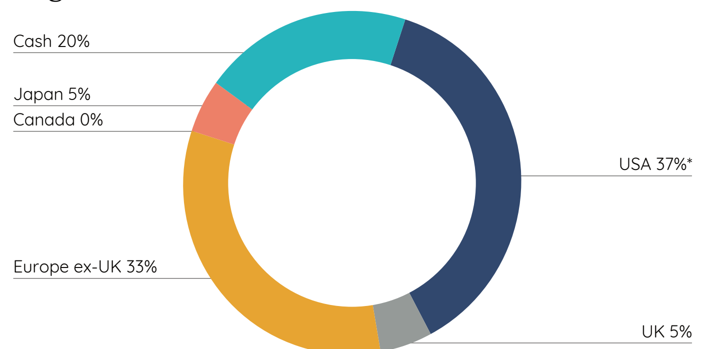
Regional Allocation[5]



* USA includes American Depositary Receipts (ADRs) listings.

Quarterly distribution

Period	Cents per Units	Reinvestment price
March 2025	1.7888	$5.5518
December 2024	8.5585	$5.3207
September 2024	5.3809	$5.2890
June 2024	17.3304	$5.0482
March 2024	7.1577	$5.4311
December 2023	9.8624	$5.3614
September 2023	5.80605	$5.4423
June 2023	8.1576	$5.3852
March 2023	5.3700	$5.3080

Asset allocation	% weight
Global equity	57.0%
Cash – put option cover	23.0%
Cash	20.0%
Total	**100.0%**

Portfolio contributors	Portfolio detractors
Roche	Sodexo
Newmont	Henkel
Nestle	Bunzl
Johnson & Johnson	CF Industries

Portfolio contributors and detractors are based on absolute quarterly contributions to return, including option positions

Talaria Global Equity Fund - Foundation Units

Fund snapshot

Management Fee	Nil	**Inception Date**	1 October 2005
Performance Fee	20% - subject to High Watermark	**Liquidity**	Daily
Distributions	Quarterly	**Availability**	Wholesale Clients Only
Minimum Investment	$50,000	**Buy / Sell Spread**	0.20% / 0.20%

Important Information

Equity Trustees Limited ("Equity Trustees") (ABN 46 004 031 298), AFSL 240975, is the Responsible Entity for the Talaria Global Equity Fund – Foundation Units. ("the Fund"). Equity Trustees is a subsidiary of EQT Holdings Limited (ABN 22 607 797 615), a publicly listed company on the Australian Securities Exchange (ASX: EQT).

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