Quarterly Investment Report Q4 FY2022

Inflation vigilantes are back

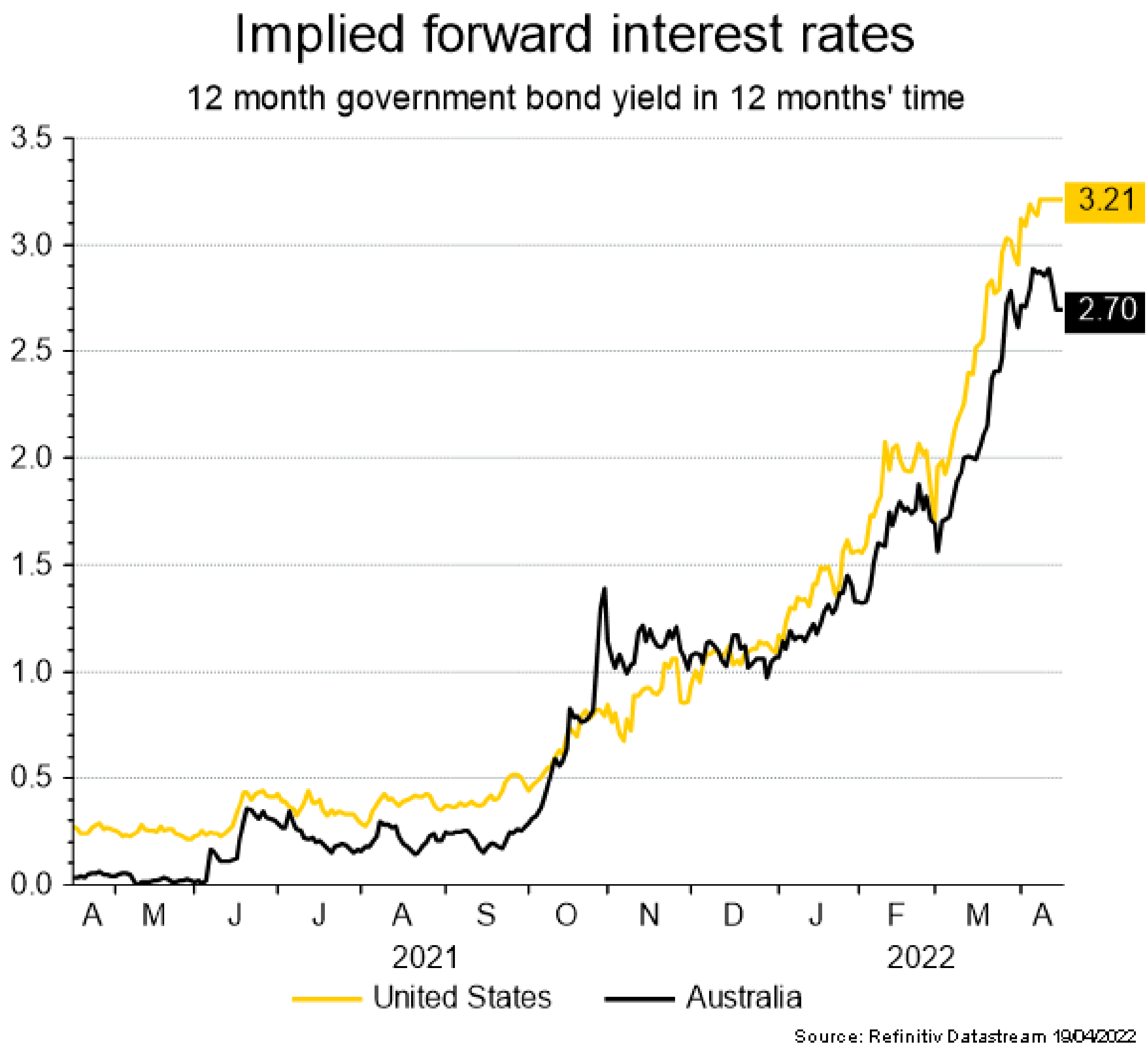
Executive Summary

In our previous Quarterly Investment Report we suggested that equity market volatility would rise in 2022, after remaining abnormally low last year. We also discussed factors that could lift market volatility including higher sustained inflation, faster monetary policy normalisation, further COVID-19 waves and variants, a sharper-than-expected slowdown in China, as well as geopolitical events in Eastern Europe.

As it turned out, most of these risks surfaced during the March quarter, including the outbreak of war in Ukraine, the emergence of the more transmissible BA.2 Omicron variant and COVID-related lockdowns in China, which add to Chinese economic growth concerns. These events prolong global supply chain disruptions, have pushed up commodity prices and scared central bankers into further action, with hints of even faster monetary policy normalisation than a few months ago. The result was that bonds and global equities posted material losses over the quarter, as volatility across financial and commodity markets increased significantly, reflecting the elevated economic uncertainty that we anticipated.

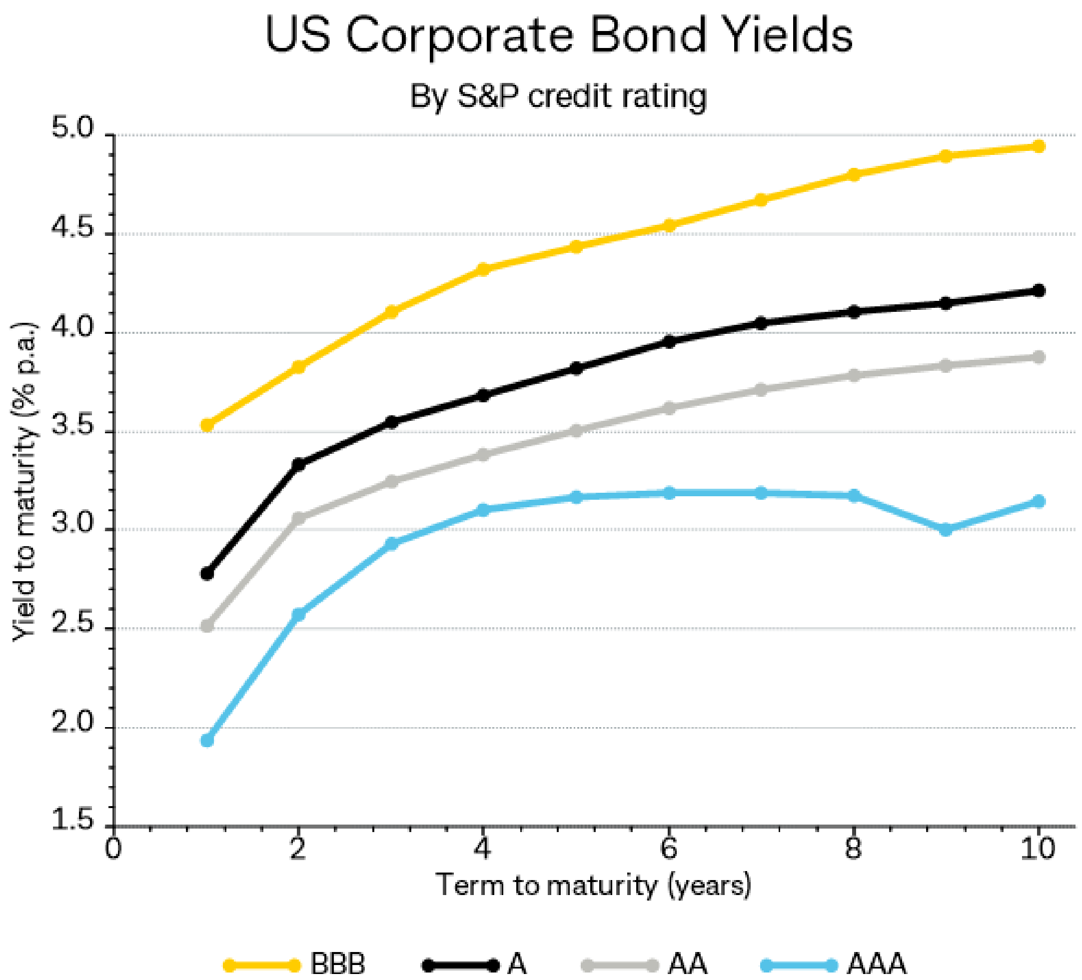
At its March meeting, the United States Federal Reserve lifted interest rates by 25 basis points, the first increase since late 2018, with participants also signalling interest rates are expected to rise to 1.9% by year-end, up from 0.9% previously. Since the March meeting, Fed speakers have become even more hawkish, suggesting that 50 basis point rate hikes could be possible at coming meetings, rather than the more typical 25 basis point moves. Fed officials have also discussed views that the Fed should aim to return policy rates to neutral levels (which they estimate is around 2.4%) by year-end, and that the balance sheet run-off would be faster and start sooner than had been previously indicated. Bond markets have taken these comments on-board and are largely pricing in 50 basis point rate hikes at both the May and June meetings, with year-end interest rates of around 2.6%.

In a few short months, the Fed has successfully restored its image from being too slow to lift rates – viewing inflation as transitory – to now being seen as an inflation-fighting vigilante. Bond markets are now pricing in the most rapid US tightening cycle since the late 1980s. However the Fed is not alone in trying to tame inflation, with the Bank of England, Bank of Canada and Reserve Bank of New Zealand well advanced on their policy tightening journeys. The European Central Bank has even set the stage for interest rate rises later in the year, despite the uncertainty created by the war in Ukraine and rising stagflation risks. In Australia, where inflation has been lower than many other countries, the RBA has altered its language to give it the option of lifting interest rates in coming months.



The question now for investors is whether central banks deliver on all these expected rate rises, particularly if inflation begins to decline in coming months as the most recent US consumer price index reading hinted at, despite hitting a new 40 year high. If inflation doesn't peak because of the strong excess demand for goods, housing and workers, then investors will be asking how far into restrictive territory interest rates will need to go. Their objective is to destroy demand, slow spending and reduce hiring. Can this result in a soft economic landing, or as we discussed in our April Market Outlook, will it lead to a recession?

In our view, after the recent sell-off in bonds, the risks to bond prices are now more evenly balanced with similar chances of rises or falls in bond yields over the next 6-12 months. There are arguments to suggest that inflation could start to decline and central banks won't need to lift interest rates more than is currently priced. Alternatively, they may find that they only need to lightly tap on the economic brakes, moving rates into restrictive territory briefly before cutting them again. The recessionary scenario presents where they need to slow the economy more forcefully, particularly if the brakes aren't working and the true neutral interest rate is higher than currently expected. In such a scenario the risks of an accident or recession increase, and in that case, investors need to own bonds as a form of portfolio airbag.



Source: Refinitiv Datastream 19/04/2022

Given our less negative view on fixed interest assets, and the now higher returns on offer from fixed interest, we are recommending clients adjust portfolio positioning to increase the allocation to fixed interest, particularly Australian fixed interest. In the Australian bond market, current market pricing suggests that interest rates will increase to 3.7% in early 2024, from 0.1% currently. In our view, this would result in significant mortgage stress and sharp property price declines. We therefore see the risks that the RBA needs to move interest rates this high over the next two years as unlikely. Our other portfolio change, which flows from the higher allocation to fixed interest, is to return cash allocations to neutral, given that returns on fixed interest assets, especially real or net-of-inflation returns in Australia, are more attractive compared with cash rates.

To protect portfolios against unexpected or prolonged inflation, and given the rise in bond yields, we are also recommending that clients consider returning allocations to both Australian equities and global property to neutral weightings. The Australian equity market's higher proportion of financial and resources companies, and the property sector's linkage to rental inflation and bond yields, both suggest that a more neutral allocation is appropriate, based on our now more balanced inflation and bond views. Please speak to your Private Wealth Manager before making any changes.

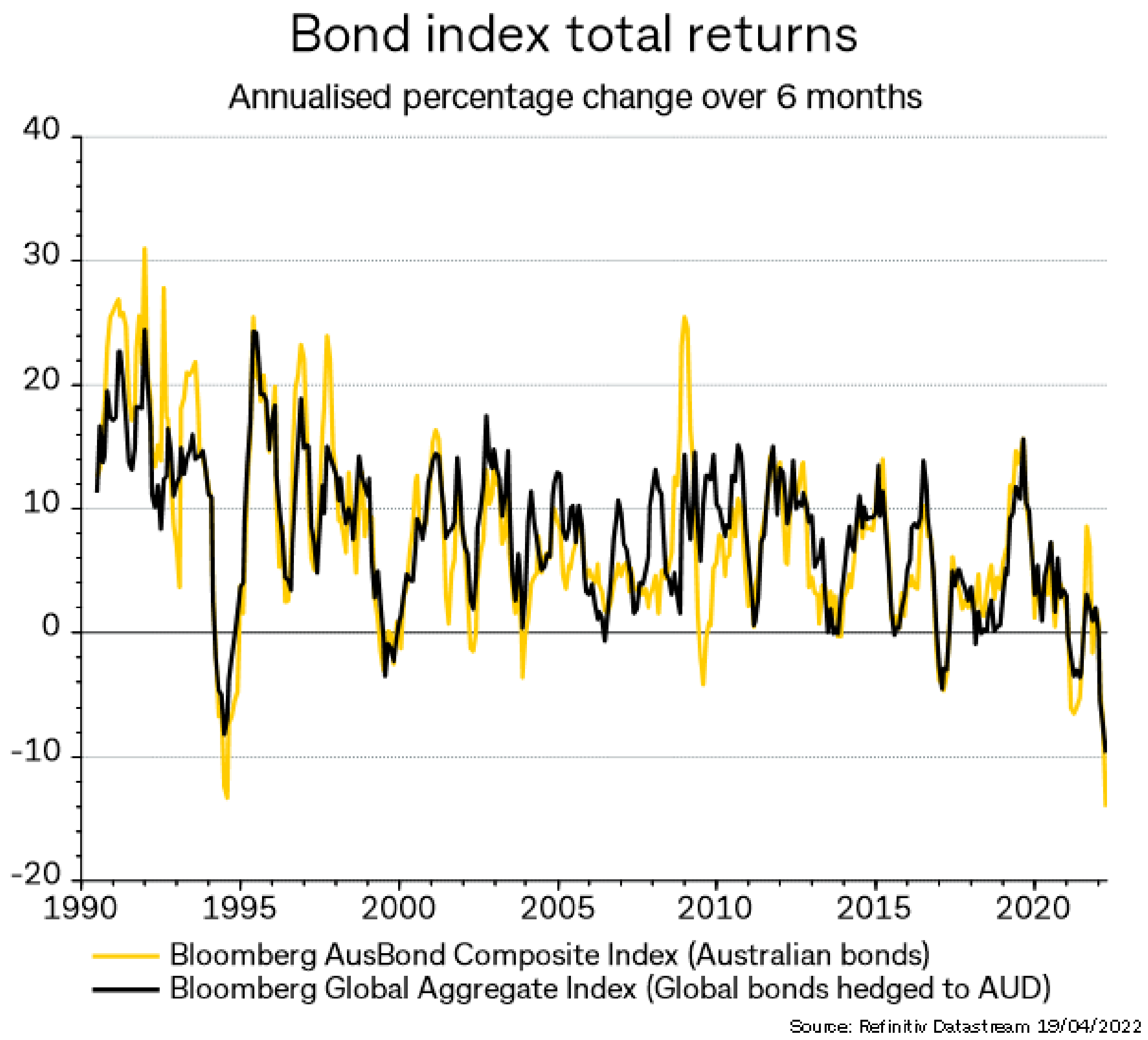
Overall, our outlook for equities remains mostly positive, although we are slightly more cautious than last quarter, given the headwind to equity valuations from higher bond yields and slightly higher recession risks. We also remain concerned that earnings growth forecasts over the next couple of years may prove overly optimistic if global growth slows more quickly, or companies find that they are no longer able to pass on further cost rises.

Asset Class	Portfolio Weight	Comments
Cash	Neutral	Decrease overweight to neutral as bonds offer more attractive returns than cash.
Fixed Interest	Underweight	Reduce size of underweight. Prefer Australian fixed interest over international as RBA is likely to raise rates less than current pricing. The risks that central banks lift rates more or less than market pricing are now more evenly balanced.
Australian Equities	Neutral	Increase allocation to neutral as higher commodity prices and rising short term interest rates should benefit local market with its larger weight to resources and financial companies.
International Equities	Neutral	Outlook is mixed with solid earnings growth expected but risks of downgrades due to margin pressures and slowing global growth.
Property	Neutral	Increase allocation to neutral. Valuation outlook improves with bond yields nearer fair value while inflation-linked rental income is more attractive.
Alternatives	Overweight	Remain overweight for diversification purposes. Infrastructure benefitting from inflation-linked income streams and higher bond yields now priced in.

Fixed Interest

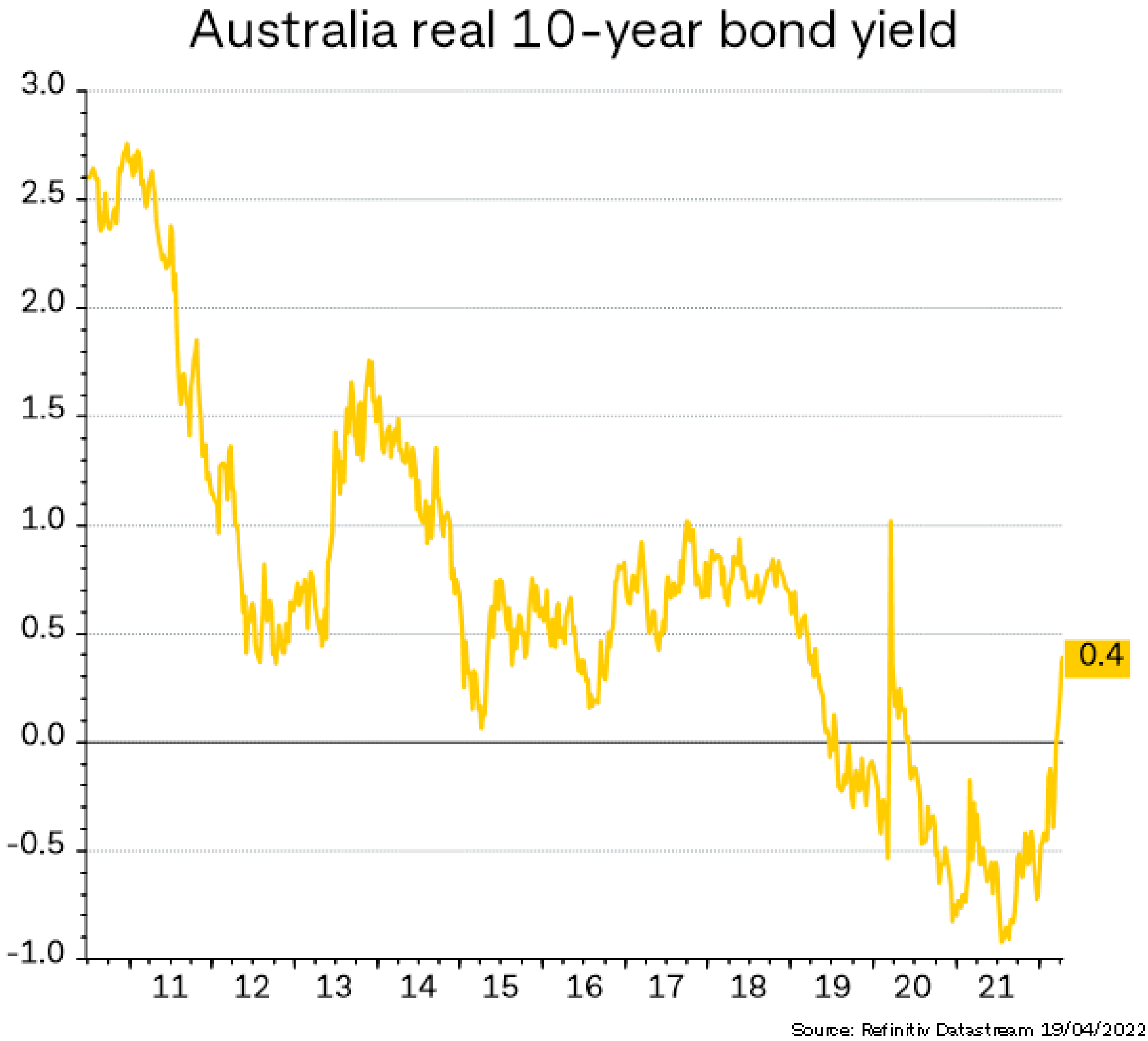
Fixed interest assets had their worst quarter in more than three decades as bond yields rose significantly, pushing prices lower. The Bloomberg Barclays Global Aggregate Bond Index Hedged AUD returned -5.0% over the quarter as the two-year US Treasury bond yield rose from 1.43% to 2.28% per annum. The 10-year US Treasury yield also increased significantly from 1.84% to 2.33% per annum, while 10-year bond yields in Germany rose from 0.16% to 0.55% per annum.

The moves higher in global bond yields, particularly shorter maturity yields, were driven by expectations that major central banks would need to lift interest rates and run down balance sheets more aggressively. This is to tackle rising risks that longer term inflation expectations could become unanchored, creating an uncontrollable wage-price inflation spiral. This has seen US bond markets move from pricing around three 25 basis point interest rate rises in 2022 (back in December 2021), to now pricing in over nine increases.



Australian government bond yields rose more than global bonds over the quarter, as the two-year Australian government bond yield rose from 1.12% to 1.80% per annum. The 10-year government bond yield rose from 2.16% in December to 2.79% per annum at the end of March and has subsequently risen even further to over 3% in April. The rise in yields meant that the Bloomberg AusBond Composite Index returned -5.9% over the three months, while Australian cash returns, as measured by the Bloomberg AusBond Bank Index, returned just 0.01% for the March quarter as the RBA cash rate remained steady at 0.10% per annum. Local bond markets are currently pricing in eight 25 basis point interest rate rises over the remainder of 2022 to around 2.2%, and further rises to reach 3.7% in early 2024.

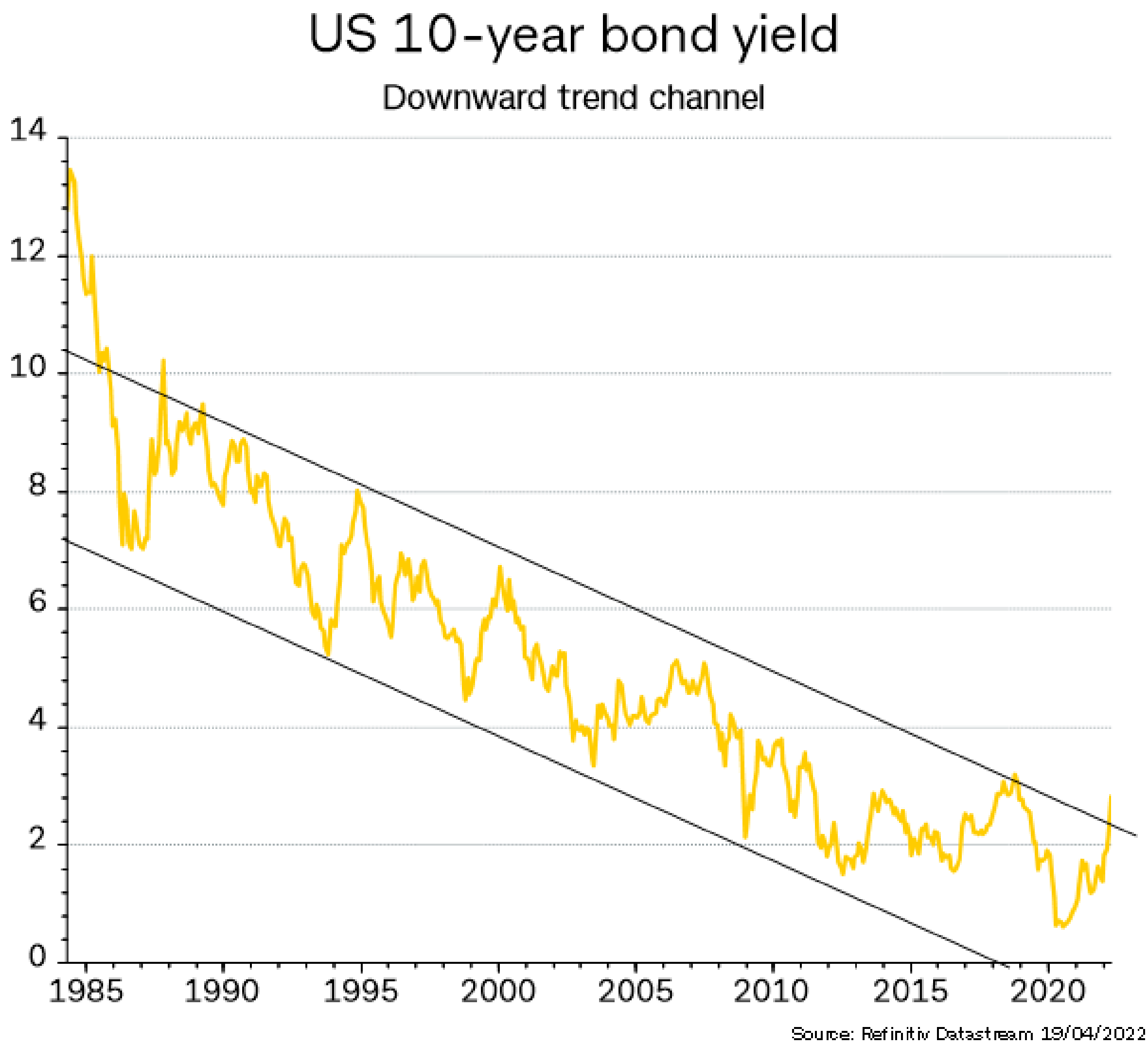
Australia's underlying inflation rate rose from 2.1% in the September quarter to 2.6% in the December quarter, which is around the mid-point of the RBA's 2-3% target range. However, the RBA has been waiting to see wages growth rise above 3% per annum (currently 2.3% per annum) in order to be confident that inflation could remain sustainably within its target range. With Australia's unemployment rate declining to new 50-year lows of 4% in March, the RBA has moved away from its prior language about being patient. This has given it the option to lift interest rates in coming months, depending on March quarter inflation and wages data.



In our opinion, the recent sharp sell-off in bonds means that bond prices provide much better risk/return characteristics where risks of further moves in prices are more evenly balanced. Central banks, particularly in Australia, may not need to deliver as many rate hikes as are currently priced over the next few years, particularly if supply chains, labour markets and spending patterns normalise and inflation begins to ease.

The flipside of lower bond prices is higher future returns. With the US ten-year bond now yielding around 2.9%, this is above the US Federal Reserve's estimate of the neutral rate of 2.4% per annum and closer to fair value, in our opinion. In Australia, current 10-year bond yields of around 3% are providing a return above long term inflation expectations of around 2.6%, which is the first time that real yields have been positive since the pandemic and similar to average real yields in the decade before the pandemic.

Given the moves in bond prices and the corresponding increase in both nominal and real yields, we have moved to reduce our underweight to fixed income and reduce our overweight to cash. The result is that we are moving to increase overall interest rate duration (or sensitivity to changing bond yields) to take advantage of the steepness in the front end of the yield curve and higher expected income on offer. We feel that this positioning is also appropriate if inflation declines as supply pressures abate and, in the case of Australia, the RBA finds that it only needs to lift interest rates by 100-200 basis points, rather than to 3.7% to slow the economy, given Australia's higher levels of household debt and greater sensitivity to rising short term interest rates.



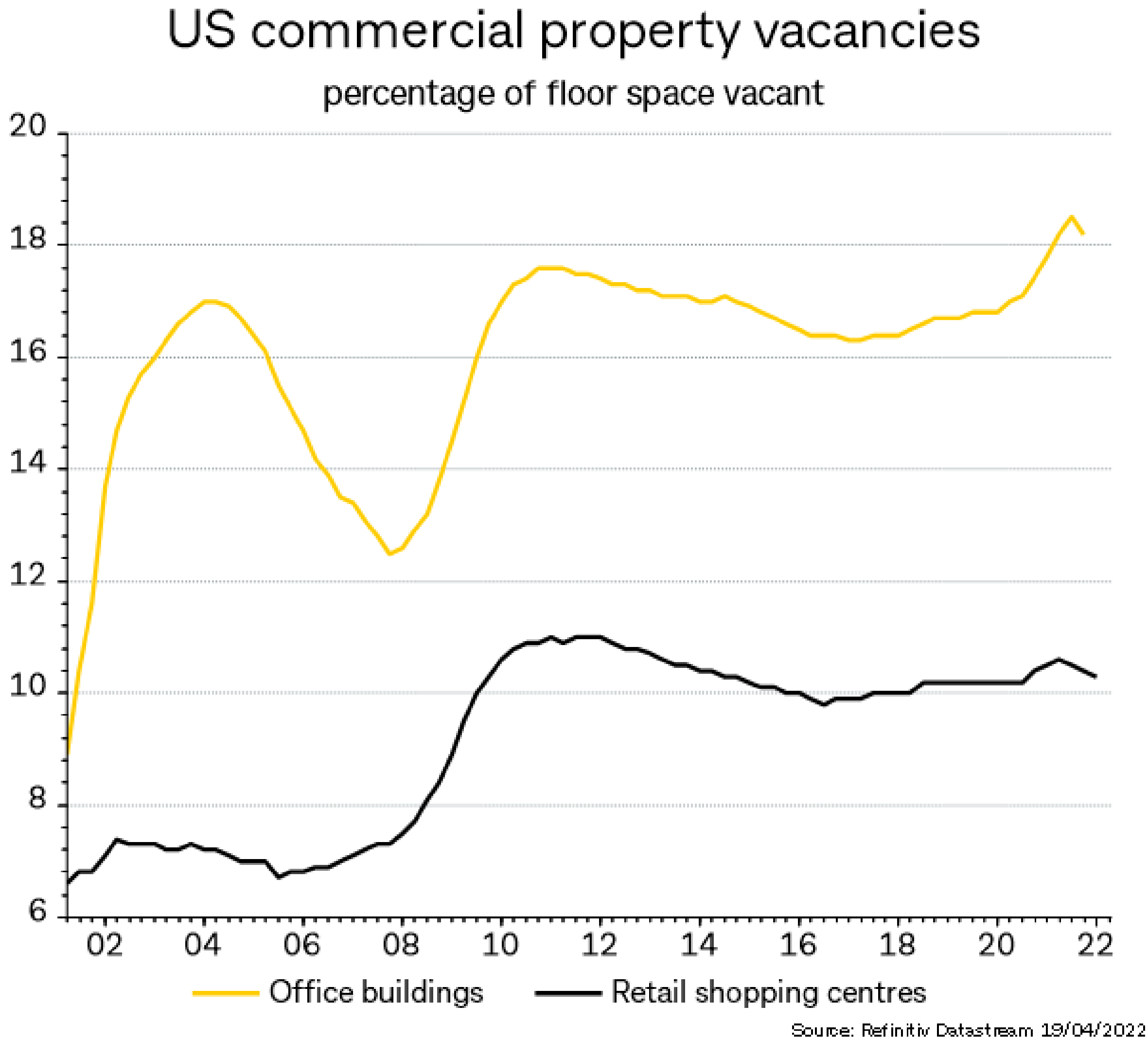
Alternatives and Property

Hedge funds declined by 0.3% during the March quarter according to the HFRI Fund Weighted Composite Index, but significantly outperformed both equities and fixed interest benchmarks over the quarter, providing solid portfolio diversification.

Macro hedge funds led the gains during the quarter with strong contributions from commodity, discretionary and trend-following strategies. Equity hedge fund strategies posted losses over the quarter with only the market-neutral and energy-focused strategies producing positive returns. Event-driven strategies also had a tough quarter with activist and special situations strategies the worst performers, while distressed debt and merger arbitrage strategies posted gains.

Fixed income hedge funds advanced over the quarter with asset-backed strategies posting positive returns, while strategies exposed to credit or interest rate duration generated losses over the three months.

Global listed infrastructure returned a strong 7.3% during the March quarter defying the fall in equity and bond markets, according to the S&P Global Infrastructure Index. The gains were significantly boosted by the performance of midstream energy infrastructure stocks which tends to benefit from rising oil and gas prices. Toll roads and airports also posted positive returns despite rising bond yields. Utilities were more mixed with gas utilities, particularly in China, declining over the quarter, while water and electricity utilities generated positive returns.

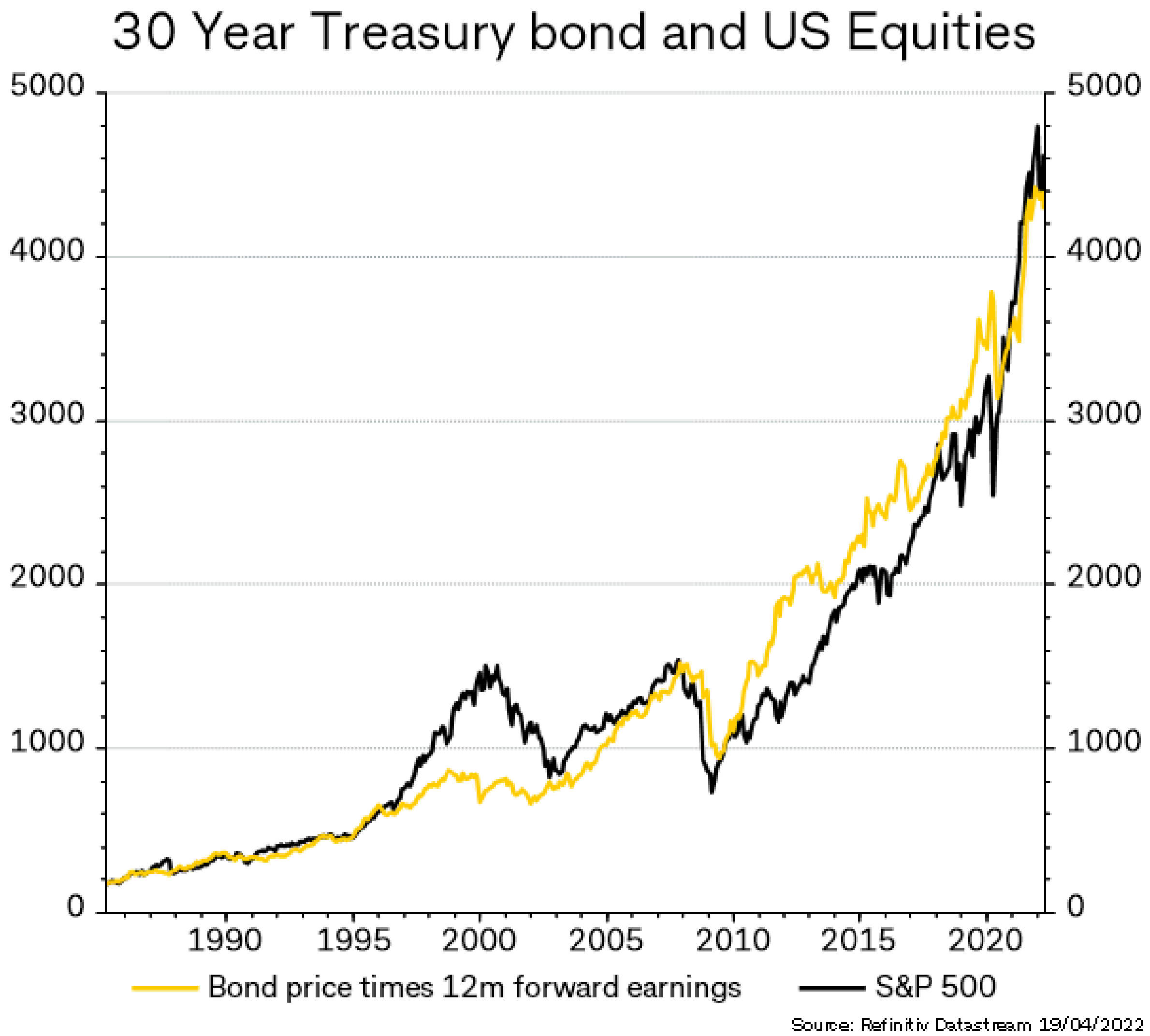


Listed property, which has both bond and equity characteristics, had a difficult quarter, returning -3.5% according to the FTSE EPRA NAREIT Developed Market Index. Retail properties, particularly regional malls, and residential property securities suffered the largest declines. Rising interest rates have lifted mortgage rates in the United States and, along with inflation pressures, this has hurt consumer confidence and impacted the outlook for regional shopping centres. Office properties, healthcare properties and hotels/resorts all posted positive returns over the quarter as economies continued to reopen.

Given our views that bonds represent better value at around current levels, and that inflation pressures are at risk of remaining elevated for longer, we are recommending that clients consider reducing the underweight to property and return allocations to a neutral weighting. While office and retail fundamentals remain challenged by the work-from-home and increased online shopping that emerged during the pandemic, we feel that these risks are largely priced into listed property valuations. Additionally, property remains a reasonable hedge against inflation with rents, construction costs and property values influenced by inflation over the medium term.

International Equities

Global equity markets posted losses over the March quarter as rising bond yields, elevated inflation and the war in Ukraine impacted investor sentiment. Over the March quarter, international equities as measured by the MSCI World ex-Australia Index, returned -8.4%. The return was negatively impacted by a 2.4 US cent rise in the Australian Dollar, largely due to rising commodity prices, with the currency-hedged version of the same index declining 5.0% over the same period.



Rising bond yields impacted growth stocks which significantly underperformed value stocks over the quarter. The largest decline across global equity sectors was the consumer discretionary sector, followed by communication services and information technology. Consumer discretionary stocks have been negatively impacted by rising inflation and higher expected interest rates, which are expected to slow consumer spending. With the invasion of Ukraine pushing up crude oil prices by 33% over the quarter, the energy sector was the best performer, followed by the materials and utilities sectors which were also helped by higher commodity and energy prices.

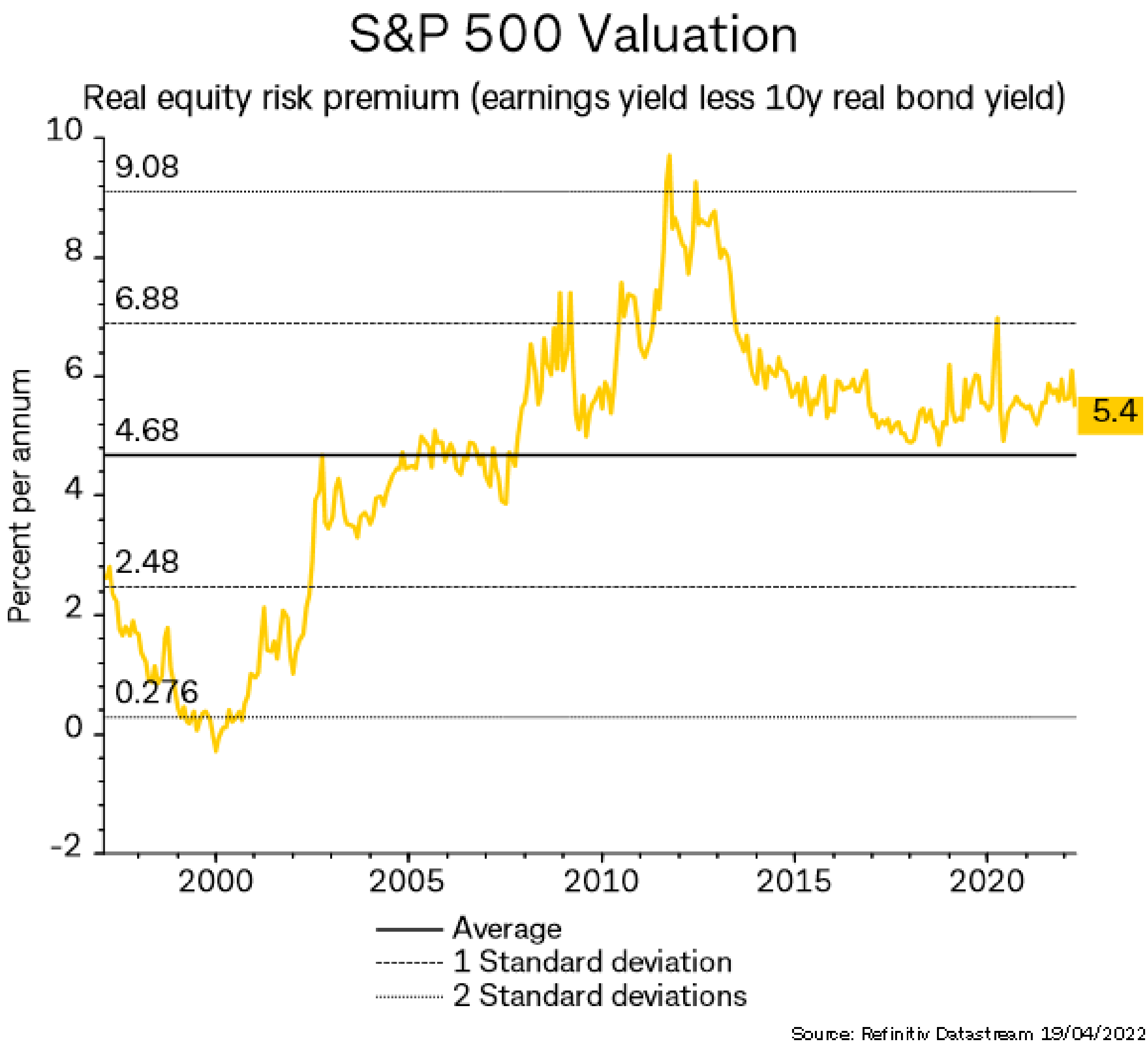
In the US, the technology-laden NASDAQ Composite Index returned -8.9% underperforming the broader S&P 500 Index for the third quarter in a row, which returned -4.6% over the same period. Fourth-quarter earnings reports in the US showed that 76% of companies in the S&P 500 Index reported better-than-expected earnings per share and aggregate earnings per share were 8.1% higher than had been forecast. Looking forward, the earnings outlook is a little more uncertain with many companies warning of inflation and supply chain issues, and yet analyst earnings expectations for 2022 remain largely unchanged. In our view, earnings forecasts are at risk of being trimmed in coming months if growth slows and profit margin pressures remain elevated.

In Europe, the STOXX 600 Index returned -5.9% for the quarter, underperforming the US due to Europe's greater exposure to the conflict in Ukraine and Russian energy supplies. Energy was the best-performing sector over the quarter, while technology was the weakest sector as investors rotated into more cyclical companies in the materials and industrials sectors, which both posted positive returns over the quarter. Financials and utilities suffered due to the exposure to Russian borrowers and Russian energy supplies respectively. As in the US, companies in Europe reported better-than-expected fourth quarter earnings with 68% of companies beating analyst earnings estimates, which is ahead of the five-year average of a 53% beat ratio.

Asian equities were again somewhat mixed. The Japanese equity market fell again over the quarter with the Nikkei 225 Index returning -2.5%. Shares in Singapore rose strongly after several prior quarters of flat returns, with the Straits Times Index returning 9.6%. Chinese A-shares lost 10.6% over the quarter, based on the Shanghai Composite Index, as rising COVID cases caused lockdowns in some regions due to the Chinese government's zero-COVID policy. Hong Kong's Hang Seng Index fell 5.7% over the quarter and is down 20.4% over the past 12 months, making it one of the worst-performing markets over the past year.

As we wrote in the April Market Outlook, the prospects of a recession in the next 12-18 months have risen due to economic headwinds created by high energy prices and rising interest rates, but we continue to view near term recession risks as being relatively low. If central banks do make a policy mistake and overtighten monetary policy, this is more likely to occur in mid to late 2023, which could lead to a mild recession in 2024. Given this view, we continue to expect that global equities should generate positive returns over the next 6-12 months, despite the headwinds from higher interest rates and elevated uncertainty about central banks being able to successfully manage the trade-off between high inflation and slowing growth.

Given the prospects of higher short term interest rates, inflation remaining higher for longer and slowing economic growth, we currently favour more defensive stocks with pricing power, such as healthcare and profitable technology shares, as well as companies that benefit from rising interest rates such as financials. We also favour resources which are more attractive following the Ukraine conflict, given risks that commodity prices remain higher for longer and expectations for stronger global spending on defence and energy transition, in addition to elevated infrastructure stimulus spending in the US and China.



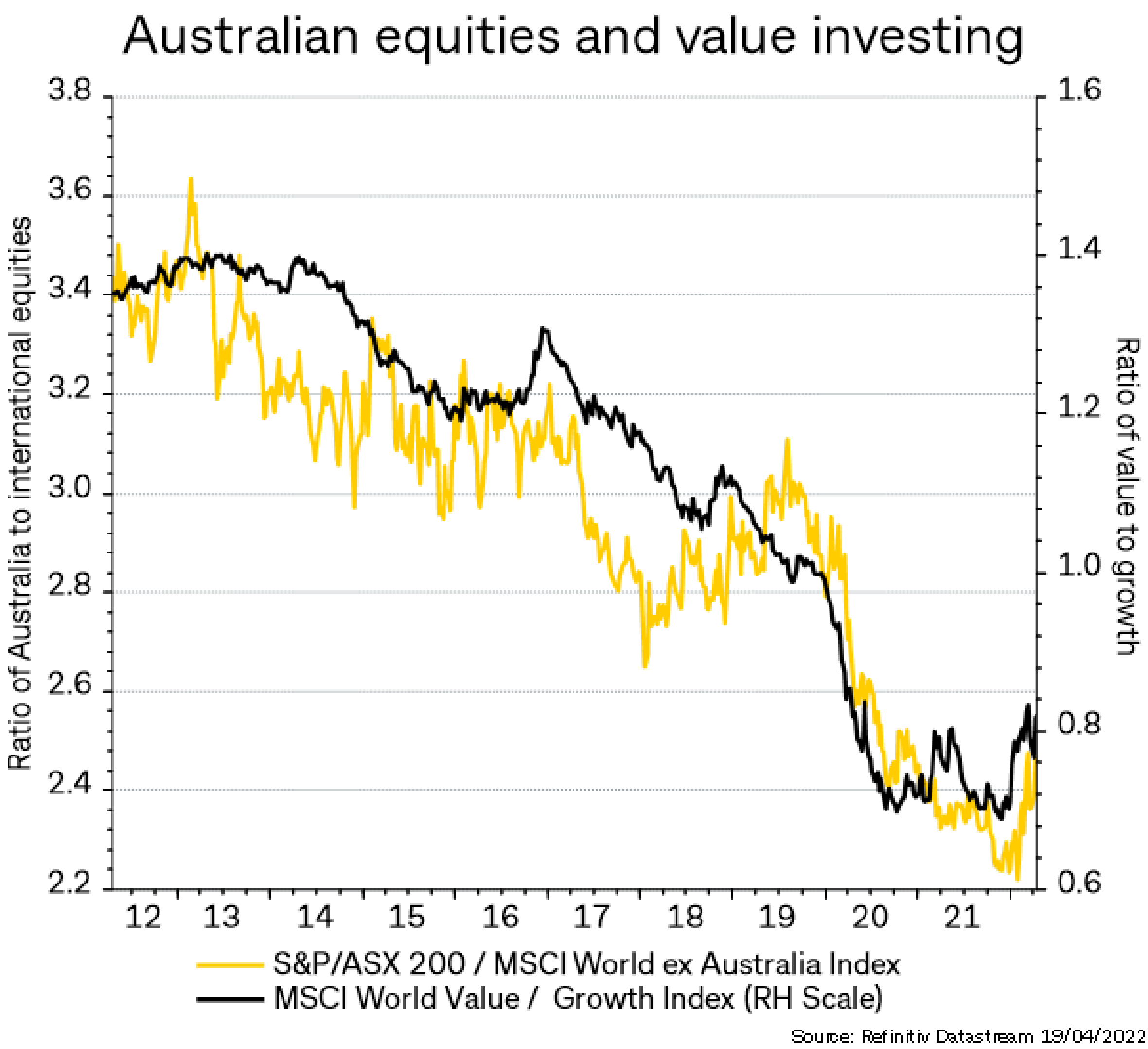
Australian Equities

The domestic equity market, as measured by the S&P/ASX 200 Index returned 2.2% over the quarter, outpacing international equities, in what was a volatile and eventful three months. During the quarter the February earnings season provided a barometer of underlying company health in light of the Omicron COVID wave and broadly exceeded expectations with earnings upgrades of 2% in aggregate.

There were mixed fortunes in sectoral terms. As in international markets, the energy sector was the standout performer as geopolitical conditions exacerbated already buoyant energy prices. Materials and utilities were the other outperforming sectors, helped by stronger iron ore and energy prices. Financials also posted positive returns over the quarter, helped by strong housing and business lending growth. The higher growth healthcare and information technology sectors were the worst-performing sectors, followed by consumer discretionary.

Valuations for the S&P/ASX 200 fell over the past quarter, due to stronger earnings estimates that have been boosted by rising commodity prices and solid half-yearly earnings reports. Despite lockdowns and inflation challenges, 44% of firms in the S&P/ASX 200 beat earnings forecasts, which was slightly above historical averages. Notwithstanding rising input costs, profit margins only fell modestly, leading to 36% of companies upgrading earnings, which is well above the long-run average. Over the quarter, expected aggregate earnings for the S&P/ASX 200 in 2022 were revised up by 8.5% and this reduced the aggregate 12-month forward price–to-earnings multiple from 18.1 times to 16.3 times, while the forward dividend yield rose from 3.7% to 4.1%.

Given the better valuations and earnings outlook for the Australian equity market, along with our views around increasing exposure to materials and financials which can potentially benefit from higher commodity prices and rising interest rates, we are removing our small underweight to Australian equities. In addition, the rising recession risks due to higher interest rates and energy costs are less likely to impact the Australian economy. This is due to our greater energy independence and our view that the RBA is likely to be less aggressive than the US Fed in tightening interest rates, given Australia's higher levels of household indebtedness and greater sensitivity to rising short term interest rates.



Source: All data referred to in this report is taken from the following sources; Iress, Morningstar, Bloomberg, Refinitiv Datastream unless otherwise stated.

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