Quarterly Investment Report Q1 2022

Crossing the peak

Commonwealth Private

Executive Summary

As we move into the new financial year, it's worth considering the past 12 months, where we are in the economic cycle, and whether we need to make any changes to our positioning for the coming year. Last year was quite exceptional in terms of market returns: global equities posted their best financial year return since 1983, up 37.7% (MSCI World Equity Local Currency Index). However, global bonds had their first negative financial year, down 0.2% (Bloomberg Barclays Global Aggregate Bond Index Hedged AUD), in data going back to 1990. This huge divergence in performance can be attributed to optimism about the vaccine-driven economic recovery, massive government and central bank stimulus, and a strong rebound in corporate earnings.

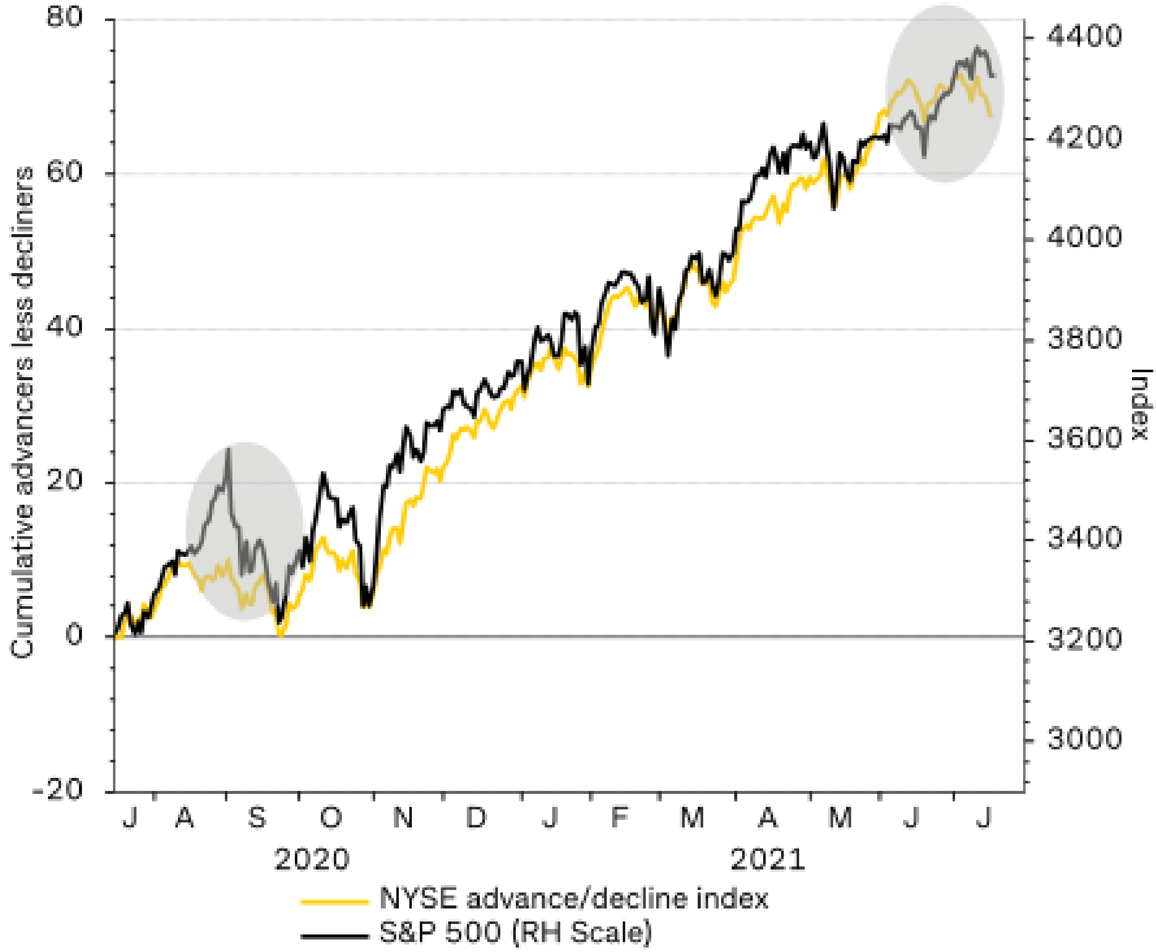
With these equity gains behind us, many are asking: are strong returns repeatable in the year ahead? Such strong equity returns are highly unlikely to be repeated this year, however, that doesn't necessarily mean returns will be negative, just lower. Although the global economy has improved significantly over the past year with falling unemployment, booming retail spending, and elevated levels of consumer and business optimism, we're unlikely to see such large improvements this year as the global economy returns to more normal growth rates.

Government policy is likely to become less stimulatory over the next few years, as emergency support is withdrawn. Central banks will scale back bond purchases and consider lifting interest rates from near zero to rebuild capacity to deal with the next downturn. Although not headwinds for equities at the moment, tighter policy such as higher interest rates and lower returns from government bonds are likely. Indirectly, this can impact valuations of other asset classes. Although not our base case, as we wrote in our June Market Outlook, sustained inflation would require central banks to lift interest rates at a faster-than-expected pace. This would also negatively impact fixed interest assets and certain types of equities.

Corporate earnings, which we consider to be the main driver of medium-term share market moves, are similarly bouncing back strongly. But the rate of improvement, like the economy, is likely to fall away over time. For example, second quarter earnings in the US are expected to be more than 60% higher than the same period last year. However, analysts are forecasting that annual earnings growth for developed market equities are likely to decline to a still respectable 10% rate in 2022 and 2023.

Therefore, we've most likely crossed the point of peak economic and earnings growth. This raises the risk that we could see an equity market correction if investors become disappointed with economic data, and corporate earnings releases in the months ahead show lower rates of growth. Equity valuations are high relative to historical averages, reflecting significant optimism. The low interest rate environment and some short-term technical indicators are flashing warnings that we may be overdue a shallow market correction.
For example, recent record highs in the S&P 500 Index have been accompanied by a lack of market breadth, indicating a relatively small number of companies have been powering the market gains. Inflation surprises and virus setbacks could also act as a catalyst for a sell-off in fixed interest and/or equities.

US stock market breadth



Source: Refinitiv Datastream 19/07/2021

So although we see slightly elevated risks of a modest pullback in equities and/or fixed interest in the short term, our year-ahead view remains broadly optimistic. Further, we expect equities to outperform cash and fixed interest over next 12 months. We therefore retain our broadly neutral weighting between growth and defensive assets, with an overweight position in cash. This readies us for a possible sell-off in fixed interest and/or equities, providing a more attractive entry point.

Summary of Portfolio Positions

Asset Class	Portfolio Weight	Comments
Cash	Overweight	Provides capital protection and preferred to fixed interest
Fixed Interest	Underweight	Valuations are expensive, a watching brief as recovery continues
Australian Equities	Slightly Underweight	Mild preference for stronger growth outlook in International Equities
International Equities	Neutral	Broadly optimistic about outlook, but risks of a pullback as earnings growth peaks
Property	Underweight	Remain underweight with strategy tilted to preferred sectors
Alternatives	Overweight	Remain overweight for diversification purposes

Fixed Interest

Fixed interest assets posted relatively strong returns over the quarter, driven by a decline in longer-dated bond yields. The 10-year US Treasury bond yield fell from 1.75% per annum at the end of March, to 1.44% at the end of June, and the Bloomberg Barclays Global Aggregate Bond Index Hedged AUD gained 0.9% over the quarter. This came despite the June meeting of the US Federal Open Markets Committee, where the median participant increased the number of interest rate hikes expected by the end of 2023 from zero to two. This more optimistic outlook on the economy came after some very strong inflation reports in the United States, however, officials continue to maintain that recent inflation spikes are transitory.

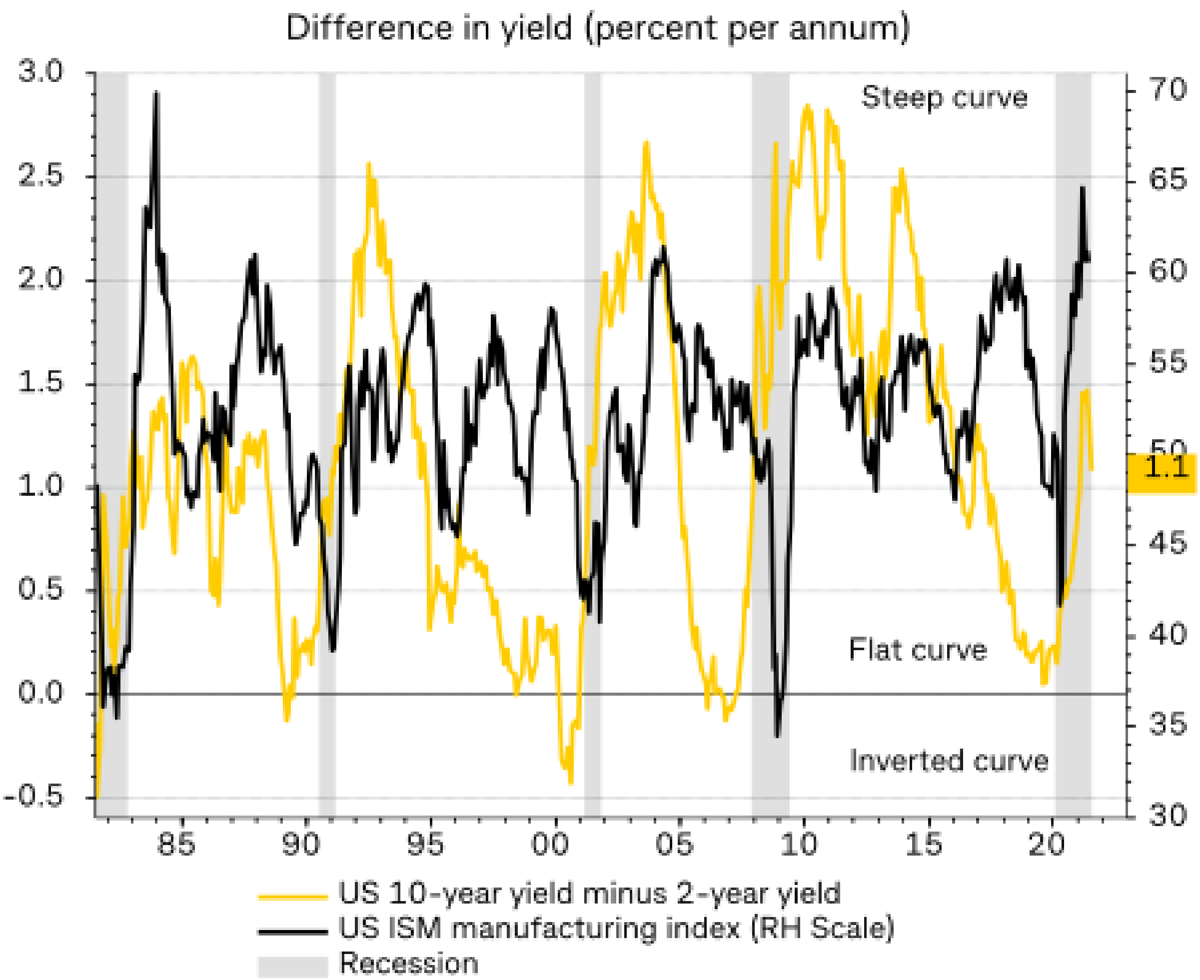
Bond prices and equity prices often move in opposite directions, as they did over the past 12 months. However, fixed income moves this quarter have been counterintuitive and could relate to fears about the spread of the delta virus variant, slowing Chinese growth, or reduced optimism about the size of future fiscal stimulus packages in the United States. Alternatively, the decline in yields may be due to technical factors such as forced buying by investors that were significantly underweight fixed interest.

Australian 10-year government bond yields followed their US counterpart lower, declining from 1.81% to 1.51% over the quarter, and the Bloomberg AusBond Composite Index returned a solid 1.5% over the three months. Australian cash returns, as measured by the Bloomberg AusBond Bank Index, returned 0.0% for the March quarter.

In early July, the Reserve Bank of Australia (RBA) announced changes to its monetary policy framework. The RBA will no longer keep the three-year maturity government bond yield locked at its 0.1% cash rate target. Rather, it will keep the April 2024 maturity government bond yield at 0.1%, which with the passage of time, will become progressively shorter than three years. The RBA also announced it would reduce its $5 billion per week bond buying program to $4 billion per week from September, with an additional review scheduled for November. Despite these moves, the RBA is holding firm on its prior view that interest rates will not rise before 2024, despite unemployment falling to a decade low of 4.9% in June.

The decline in longer-term yields has created what is referred to as a "bull flattening" (when longer-dated yields fall more than shorter-dated yields). Bull flattening is more typical in the more mature stages of economic cycles, where growth indicators such as manufacturing surveys have peaked. So perhaps the fall in longer-term yields may be explained by this, even though the recovery remains relatively young. In our view, longer-dated government bond yields – especially real yields after subtracting expected inflation – remain too low, relative to the economic and monetary policy outlook.

US yield curve shape



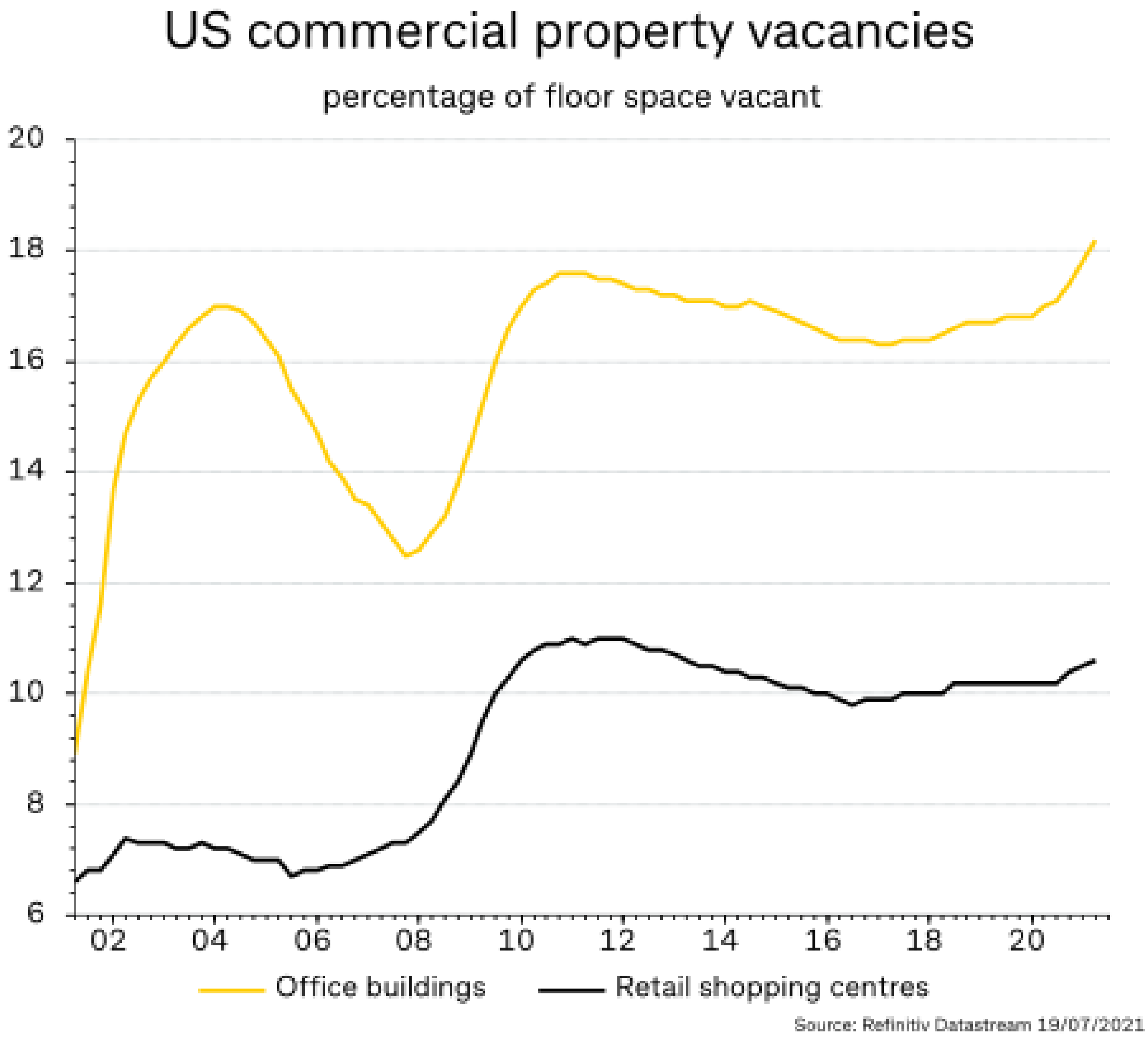
Source: Refinitiv Datastream 19/07/2021

Alternatives and Property

Hedge funds, as measured by the global HFR index, extended gains into June to complete the strongest first half of a calendar year since 1999. Although, performance drivers and market sentiment shifted for the month, with a moderation of the broader macroeconomic reopening, higher interest rates, and inflation trends. Equity hedge funds, which invest long and short across specialised sub-strategies, extended recent gains over the past quarter, as many equity markets reached record highs. Sub-strategy performance has been led by Energy and Basic Materials focused strategies. Credit and relative value hedge fund performance was subdued during the quarter. Event-driven strategies, which often focus on deep value equity exposures and special situations, extended gains during the quarter. Sub-strategy gains were led by distressed and re-structuring focused strategies. Macro-based strategies had mixed performance over the quarter, with commodity-focused strategies performing well, while discretionary thematic strategies (which can contain contrarian or volatility-focused themes), declined.

Global listed infrastructure printed a positive 1.8% return during the June 2021 quarter, according to the S&P Global Infrastructure index. Performance was aided by generally resilient earnings numbers and rapid progress in the US vaccination rollout. Towers and data centres rose strongly on positive earnings results, moderating bond yields and the anticipation of higher earnings growth as telecom operators ready themselves to deploy 5G equipment onto tower sites at scale. Pipelines also outperformed, reflecting strong March quarter earnings numbers, a disciplined approach to capex spending, undemanding valuation multiples and a higher oil price. Airports underperformed as the spread of the delta coronavirus variant added uncertainty to the timeframe for a return-to-normal travel and economic activity. North American freight rail stocks achieved consistently strong volumes, but lagged on concerns that unusually hot weather in the US and Canada may affect agricultural haulage volumes.

Global listed property, as measured by the FTSE EPRA NAREIT Developed Markets Hedged AUD Index produced a strong return of 9.0% over the June quarter, and over 30.2% for the 12 months. Although we remain underweight in property – given the outlook for several sectors such as office properties and retail shopping malls remains unclear, and property is more sensitive to rising bond yields – we see opportunities for active managers to generate attractive returns in sectors such as healthcare and logistics. With rising inflation, we remain attracted to properties that have rents tied to inflation. This gives the asset class some inflation hedging properties.



International Equities

Investor optimism about the vaccine-driven economic reopening and stronger earnings saw another strong quarter in global equity markets. The MSCI World ex-Australia Index returned 9.5% over the quarter, helped in part by a decline in the Australian Dollar with the currency-hedged version of the index returning 7.6% over the same period.

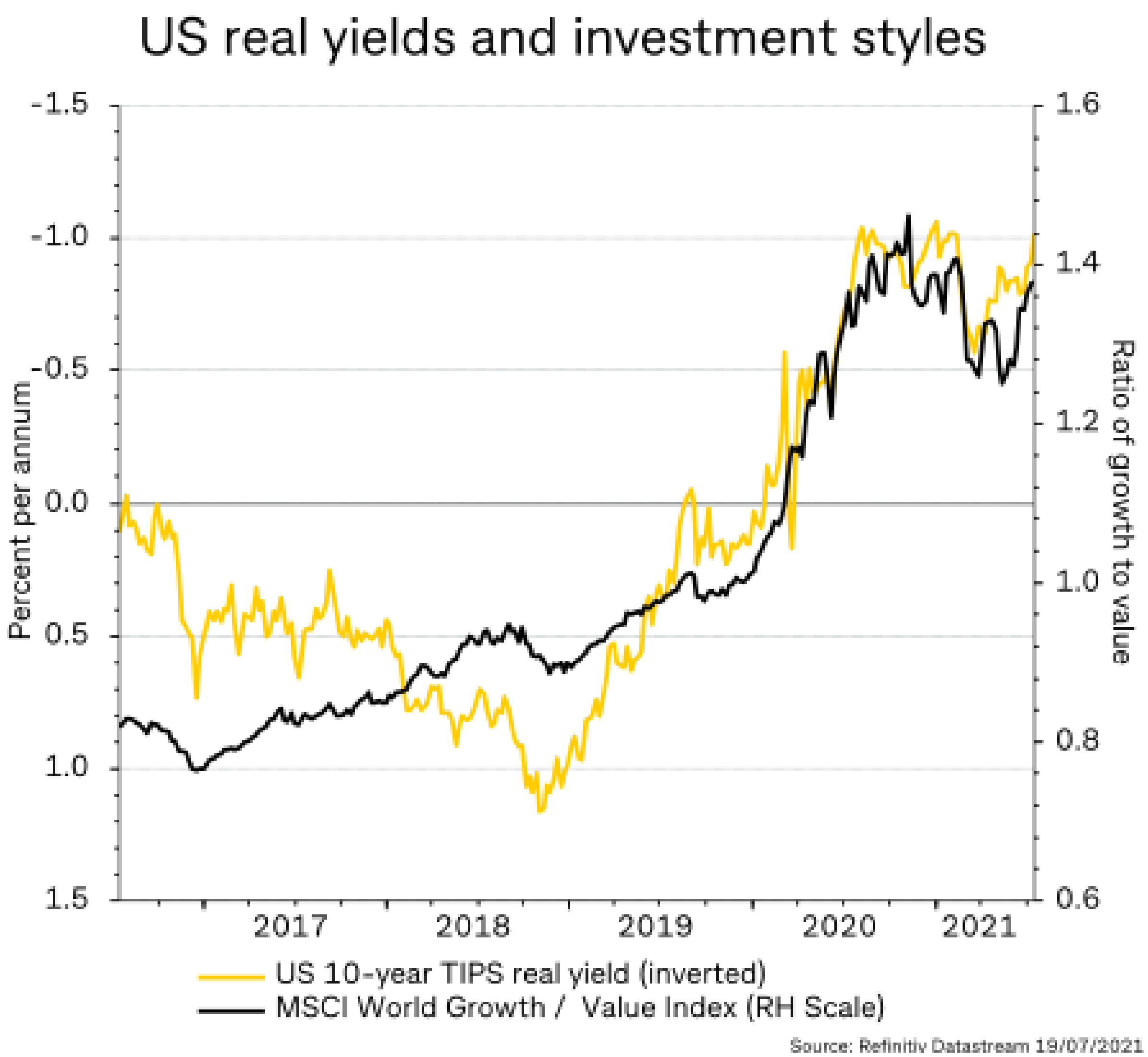
The decline in long-term government bond yields benefited the growth style of investing this quarter, with returns from growth stocks more than double the return from value stocks. This helped make information technology, healthcare and communication services the best-performing global sectors over the quarter. Global energy stocks also performed strongly over three months, helped by a 24% rise in the West Texas Intermediate crude oil price.

In the US, the technology-laden NASDAQ Composite Index returned 9.7% for the quarter, outperforming the broader S&P 500 Index which returned 8.5% over the same period. Helping boost US stock prices were the very strong first quarter earnings, with 86% of companies in the S&P 500 Index reporting better-than-expected earnings per share and aggregate earnings per share 22% better than expected (according to FACTSET data).

In Europe, the STOXX 600 Index returned 6.7% for the quarter, the fifth straight quarterly gain, and the index closed the quarter 4.4% above its pre-pandemic high. The price rises were helped by acceleration of vaccination programs across Europe. The strongest equity sectors were energy, materials and industrials, driven by the healthy rises in commodity prices as well as strong manufacturing and export activity.

Asian equities were somewhat mixed. The Japanese equity market declined over the quarter, as rising coronavirus cases weighed on the market. The Nikkei 225 Index was down 1.2%. After strong first quarter gains, shares in Singapore were largely flat, with the Straits Times Index returning only 0.1% over the three months. Chinese shares rose 4.3% (Shanghai Composite Index) over the quarter, as economic activity in the second-largest economy continued to expand at a rapid rate. This was boosted by strong manufacturing and exports, and recovering consumer activity as the vaccination program ramped up.

With the risks of sustained inflation remaining low in our view, we continue to retain a mild preference for growth stocks. This view also favours the more growth-heavy US equity market, with its higher weighting to technology and biotechnology stocks, over more value-driven markets such as Europe and Emerging Markets.



Australian Equities

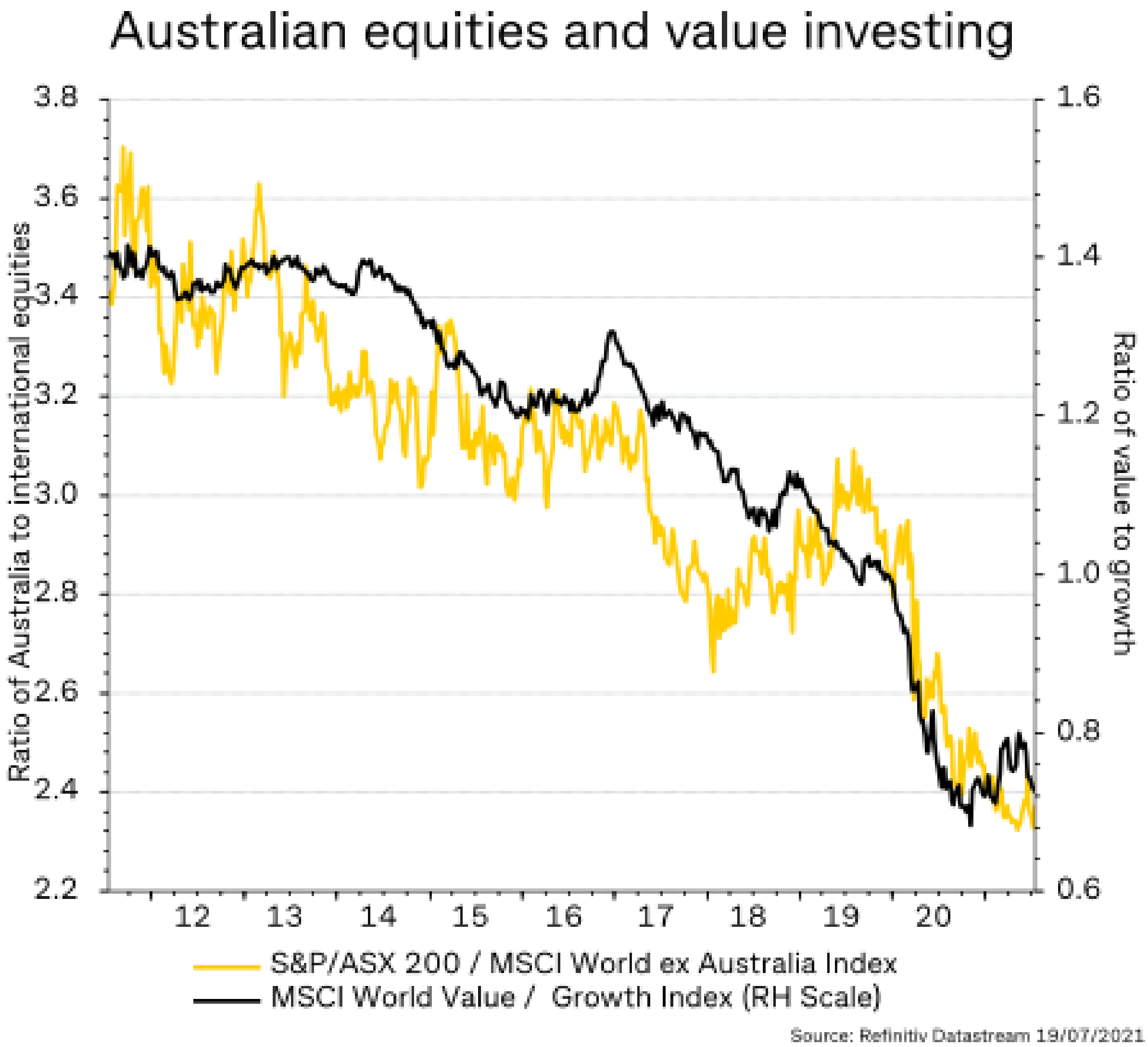
Our local equity market, as measured by the S&P/ASX 200 Index, returned 8.3% over the quarter and 27.8% over the year – including dividends. This makes it the strongest financial year return since 2007. The market hit a fresh record high of 7,406 in mid-June, before the meeting at which the US Federal Reserve surprised investors by bringing forward the expected timing of interest rate rises. This boosted growth stocks, but hurt more cyclical and value-driven markets like Australia's, with its larger weighting in the financials and materials sectors.

Locally, information technology was the best-performing sector, as it was globally, with a return of 12.1% over the quarter. This performance was driven by lower bond yields and a $5 billion takeover offer for Altium from US group Autodesk. The consumer discretionary sector also posted a solid 11.2% return over the quarter, as retail spending continued to remain strong – helped by falling unemployment, low interest rates and high levels of savings. Communication services was another strong sector, with a 10.5% return over the quarter, as Telstra announced a partial sale of its phone tower assets for $2.8 billion with half of the money to be returned to shareholders.

Utilities lost further ground with a decline of 4.5% during the quarter, and the 12-month return was also the worst-performing sector at –18.6%, primarily driven by the poor performance of AGL.

AGL shares fell another 9% at the end of June, after announcing it would split itself into two separately-listed businesses: a power generator that would own coal-fired power stations, and a carbon-neutral energy retailer.

Thanks to continuous earnings upgrades, the valuation of the Australian market has eased slightly from the highs seen a few months ago. The aggregate forward price–to-earnings multiple reduced from around 20 times at the start of 2021, to 17.5 times in mid-July 2021. The forward dividend yield improved from 3.4% in early 2021, to approximately 3.9% currently, and the spread between the cash dividend yield and the 10-year bond yield has increased from 2.4% to 2.7% so far in 2021. This suggests local valuations are becoming more attractive as the higher earnings and dividends come through.



The latest lockdowns in Sydney and other parts of Australia have reminded us the economic recovery remains bumpy, and there are likely to be setbacks as we move towards higher levels of vaccination coverage. The rotation into value and cyclical stocks we spoke about in last quarter's Quarterly Investment Report appears to be have been relatively short-lived, along with fears about higher inflation and interest rates. We remain alert to the possibility of a mild correction in equities if economic growth or earnings disappoint, now that growth rates appear to have peaked. Other risks we're monitoring include higher sustained inflation, virus variants and vaccine setbacks, as well as geopolitical events that may lead to a period of risk aversion.

Source: All data referred to in this report is taken from the following sources; Iress, Mornngstar, Bloomberg and Refinitiv unless otherwise stated. Author's calculations are dated 19 July, 2021.

For more information

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