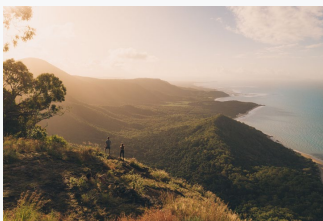

Quarterly Market Update

Hoisted by their own petard

Have central bankers been too successful?
What does this mean for investments?

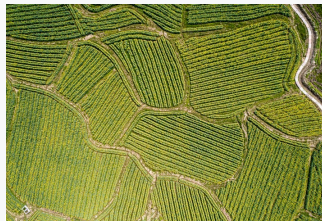
June 2023

Contents



03

Snapshot



06

Global economic overview



09

Australian cash rate and dollar



11

Australian and international equities



14

A-REITs and G-REITs
(listed property securities)



16

Fixed income



18

Alternatives

Snapshot



With central bankers having moved along the arc of public opinion, from saviours to villains, we find reason to believe that in some areas, they were not only effective, but too effective. Against this backdrop, we are faced with a combination of economic conditions that are not commonly associated with one another. Namely; low unemployment, high inflation, rapidly increasing interest rates, the stubborn resilience of consumer spending and subsequent continued economic growth.

This particular blend of characteristics increases the already high-difficulty of delivering an economic 'soft landing'. Despite the known danger of inflation, the desire to minimise negative impacts to economies in the process of efforts to slow it is not only important to the outcomes for households and businesses, but also to the social contracts that bind our central bankers. Particularly during this recent period when they have been on the receiving end of much criticism and threats to their crucial independence.

It is quite likely that a key determinant of our economic path will be linked to the pace at which consumers reduce their spending. Too fast, falling demand leads to job reductions, increasing the pace of purse-tightening. Too slow, central banks overtighten and metaphorically 'cut through the fat and into muscle'.

It is with these uncertainties, that we must move forward, seeking to make patient and considered moves, as markets present us with opportunities. Ensuring we avoid overreaction to every minor market ruction, whilst using the benefit of our respective time horizons, will allow us to see through short-term bouts of volatility and protect us against our own worst instincts.

Asset class performance – June quarter



Australian equities

Over the second quarter of 2023 Australian shares performed reasonably well with the S&P/ASX 300 Index returning +1.0%. Key drivers for the period included from positive risk sentiment stemming from an Artificial Intelligence (AI) related US equity rally, as well as signs the Reserve Bank of Australia (RBA) may be approaching the peak of the tightening cycle.

Reflective of equity market dynamics in the US, the Information Technology¹ sector was the standout, returning +18.5%. Health Care² was the weakest sector over the quarter, returning -3.1% weighed down by poor performance from CSL which makes up a large portion of this index. Materials³ also struggled, returning -2.6% as a sluggish Chinese economy weighed on demand for commodities.

Continuing the same trend seen over the first quarter of 2023, Growth⁴ outperformed for the second quarter returning +2.3% versus -0.4% for Value⁵. Despite this, Value remains ahead over a 1, 2, 3, 4, and 5-year time horizons.

¹ Measured by the S&P/ASX 300 Information Technology (Sector) Index

² Measured by the S&P/ASX 300 Health Care (Sector) Index

³ Measured by the S&P/ASX 300 Materials (Sector) Index

⁴ Measured by the MSCI Australia Growth Index

⁵ Measured by the MSCI Australia Value Index

⁶ Measured by the S&P500 Index

⁷ Measured by the Japan Nikkei 225 Index

⁸ Measured by the FTSE 100 Index

⁹ Measured by the Hang Seng Index

¹⁰ Measured by the MSCI World Growth Index

¹¹ Measured by the MSCI World Value Index

¹² Measured by the MSCI AC World Information Technology (Sector) Index

¹³ Measured by the MSCI AC World Consumer Discretionary (Sector) Index

¹⁴ In local currency terms

¹⁵ Measured by the MSCI AC World Materials (Sector) Index



International equities

International shares rallied over the quarter, building on gains generated over the first quarter of the year. Mega-cap tech names have dominated the US market as investors price in the potential positive impacts of AI innovation, seemingly disregarding the latent repercussions of significant monetary tightening over the last 18 months. The US share market⁶ rallied +8.6%, whilst the tech heavy NASDAQ posted a +13.1% gain. The NASDAQ has now returned +32.3% over the first 6 months of 2023. Japanese shares⁷ also performed very strongly, returning +18.5% as they benefitted from lower valuations, a weak currency and a central bank committed to maintaining expansive monetary policy. The German DAX and French CAC 40 indices followed behind with returns of +3.3% and +2.9% respectively. UK shares⁸ struggled, returning -0.3%, as sticky inflation will likely lead to more rate rises from the Bank of England (BoE). Chinese⁹ shares continued to struggle returning -6.1% as a slower than expected COVID reopening and ongoing tensions with the US weighed on the nation's economic outlook.

Mixed currency moves over the quarter altered returns for AUD investors. Due to a significant weakening in the Yen, Japanese share returns were halved to a still impressive 9.8%. A moderate strengthening in the USD gave a small boost to the S&P500 and NASDAQ, returning +9.3% and +13.7% respectively. The EUR strengthened against the AUD, increasing the German DAX and French CAC 40 to +4.4% and +4.0% respectively. Due to a hawkish BoE, the GBP posted the biggest gain against the AUD over the quarter lifting the FTSE 100 return to +3.1%.

Unsurprisingly given the tech dominance seen over the quarter, Growth¹⁰ returned +10.7% outperforming Value¹¹ which returned +3.4% in local currency terms. Value remains ahead over two and three years, with Growth outperforming over all other time periods.

Turning to global sectors, trailing the stellar performance of Technology¹² (+14.2%) was Consumer Discretionary¹³ at a commendable +9.0%¹⁴. Similar to the Australian market, Materials¹⁵ struggled over the quarter and was the worst performing global sector, returning -0.6% as confidence in the Chinese recovery faltered.



Real estate

Domestic real estate markets continued to whipsaw over the quarter as investors grappled with the actions of central banks and shifting long term thematics. Strong performance in April following a pause from the RBA was pared back by negative returns in May and June as the RBA recommenced monetary tightening. Ultimately, the Australian market¹⁶ ended the quarter with a +0.8% return, a result which ranked broadly in the middle of international peers.

Global real estate market returns differed widely by region over the quarter. If we take out the effect of currency, Germany¹⁷ was the standout performer returning +6.8%. Although, this return was off a significantly diminished base as the German real estate market has returned -31.6% over the last 12 months due to rental caps impacting property owners' ability to service increasing mortgage repayments. The only other region with a meaningfully positive return was the U.S.¹⁸ which returned +2.9%. The weakest region was Hong Kong¹⁹, returning -9.1% as investors grow wary of spill over effects from growing tension between China and the US.

Similar to difference in regional outcomes, returns differed widely by sector. Health Care²⁰, Mortgage²¹ and Residential²² REITs posted the strongest results, returning +8.1%, +7.8% and +7.5% respectively. Diversified²³ REITs were the weakest sector over the quarter, returning -3.8%. Office property also continued to struggle, returning -2.4%. Office²⁴ property is now down -15.7% over the last 12 months as work-from-home thematics impact the long-term demand outlook for the sector.



Fixed income

Fixed income markets were relatively muted over the quarter as most central banks temper or pause the pace of rate hikes. As economies across the globe approach the peak in their tightening cycles, expect high quality, long duration fixed income instruments to provide more defensiveness in the event of an economic contraction. Global fixed income²⁵ returned -0.3% for the quarter. Hawkish tones from the RBA, as well as two additional rate hikes over the quarter, contributed to poorer relative performance for the Australian fixed income²⁶ market, which returned -2.9%. Domestic credit markets²⁷, which returned -1.1%, held up slightly better due in part to the heightened focus on domestic corporate balance sheets.



Alternatives

Despite pockets of uncertainty, alternative assets have continued to provide steady returns amidst more dramatic moves in traditional asset classes. Whilst not immune to the broader macroeconomic environment, these assets are inclined to be somewhat independent from market sentiment that can, at times, drive listed markets. Managers in these markets tend to be able to exhibit a higher degree of skill in driving value enhancement, as well as being more intimately engaged with the assets they control.



Cash rate

The Reserve Bank of Australia (RBA) increased the cash rate in two out of the four meetings that have occurred since the end of the March quarter, bringing the cash rate to 4.1%. A pause at the most recent meeting in July was bookended with hawkish commentary that "some further tightening of monetary policy may be required to ensure that inflation returns to target in a reasonable timeframe"²⁸ due to concerns about still high underlying inflation, sticky services inflation and very tight labour markets. Pausing gives the RBA time to assess the lagged impacts of actions taken to date, as they hope to not overtighten monetary policy and cause unnecessary slowing in economic growth.



Australian dollar

The Australian dollar weakened against most developed economies over the quarter, stemming from signs the RBA may be nearing the peak of the tightening cycle and that the domestic interest rate would finish the tightening cycle below peer countries. The AUD weakened against the GBP, CAD and CHF losing -3.3%, -2.8% and -2.7% respectively. Against the Yen (+7.9%) and Chinese renminbi (+5.1%), the AUD strengthened. The Japanese currency weakness stems from ongoing adherence to ultra-loose monetary policy by the Bank of Japan (BoJ). The Chinese renminbi fell in-part due to an easing in monetary policy by the Chinese central bank in attempts to stimulate the economy amidst a sluggish COVID recovery.

¹⁶ Measured by the FTSE EPRA Nareit Australia Index

¹⁷ Measured by the FTSE EPRA Nareit Germany Index

¹⁸ Measured by the FTSE EPRA Nareit USA Index

¹⁹ Measured by the FTSE EPRA Nareit Hong Kong Index

²⁰ Measured by the MSCI World Health Care REITs (sector) Index

²¹ Measured by the MSCI World Mortgage REITs (sector) Index

²² Measured by the MSCI World Residential REITs (sector) Index

²³ Measured by the MSCI World Diversified REITs (sector) Index

²⁴ Measured by the MSCI World Office REITs (sector) Index

²⁵ As measured by the Bloomberg Global Aggregate Index

²⁶ As measured by the Bloomberg AusBond Composite (0+Y) Index

²⁷ As measured by the Bloomberg AusBond Credit (0+Y) Index

²⁸ Statement by Philip Lowe, Governor: Monetary Policy Decision, 4th July 2023

Global economic overview

"There are two sides to every story... and then there's the truth"

Anonymous

"The effects of the expected further tightening in bank credit conditions, amid already tight financial conditions, would lead to a mild recession starting later this year "
 "The continued strength in labour market conditions and the resilience of consumer spending, however, the staff saw the possibility of the economy continuing to grow slowly and avoiding a downturn as almost as likely as the mild-recession baseline."

Federal Open Market Committee, Federal Reserve, 13-14th June 2023²⁹

As the dust settles

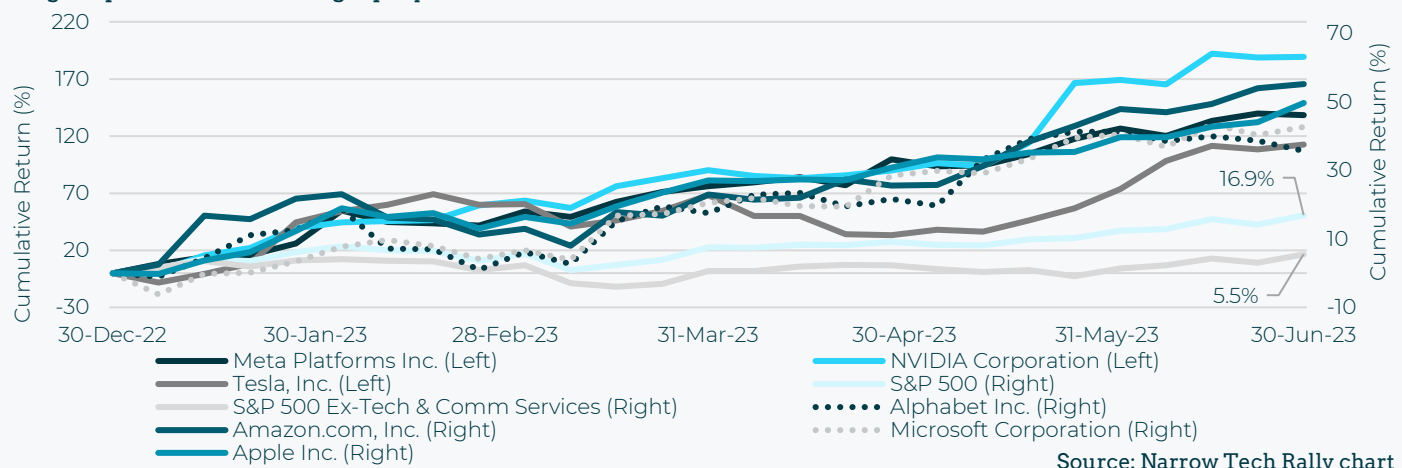
The second quarter of 2023 has been typified by countertrends. Born from the shock-and-awe approach taken by many central banks in 2022, conditions stabilised enough for market participants to gradually reengage with financial markets. Combine this with the emergence into the public consciousness of generative AI and the ensuing optimism for this new technology, and conditions have been relatively conducive for healthy returns for most of this calendar year. Of course, positive returns are always welcome. We are though concerned about the sustainability of current conditions and see this moment as more akin to an intermission than a conclusion.

If we return to consider the root causes of recent moves in markets, most can be traced back to increasingly easy monetary policies born out of the Global Financial Crisis (GFC) of 2007/08. As we have addressed that theme here, more than once, we will not dig too deeply into it on this occasion, only acknowledge that it formed the basis for a relatively long and stable period in many economies and capital markets.

As is now clear, having enjoyed meaningful success in protecting economies and the ties between economic agents (such as employees, employers, suppliers, etc), central banks initially misjudged inflation as 'transitory', before having to hurriedly tighten monetary conditions in an effort to prevent pricing pressures from becoming embedded. This sudden change in stance, reflected in the fact that for many countries 2022 saw the fastest increase of interest rates on record, drove many financial assets to reprice downwards.

By early 2023, investors began to acclimatise to the new landscape and felt emboldened to seek opportunities in markets. Having enjoyed years of outsized returns in Technology, it is unsurprising that they flocked back to the familiar, driving stocks in that sector up 18.5% in Australia and 14.4% globally. Indeed, there is early evidence that the improved sentiment that this narrow market rally (characterised by a limited number of constituents driving up the entire index), may be beginning to widen, as investors gradually build up holdings in companies from other sectors.

Mega cap tech stocks driving equity returns



Just 7 companies from 500 in the U.S. S&P 500 index have driven the vast majority of gains

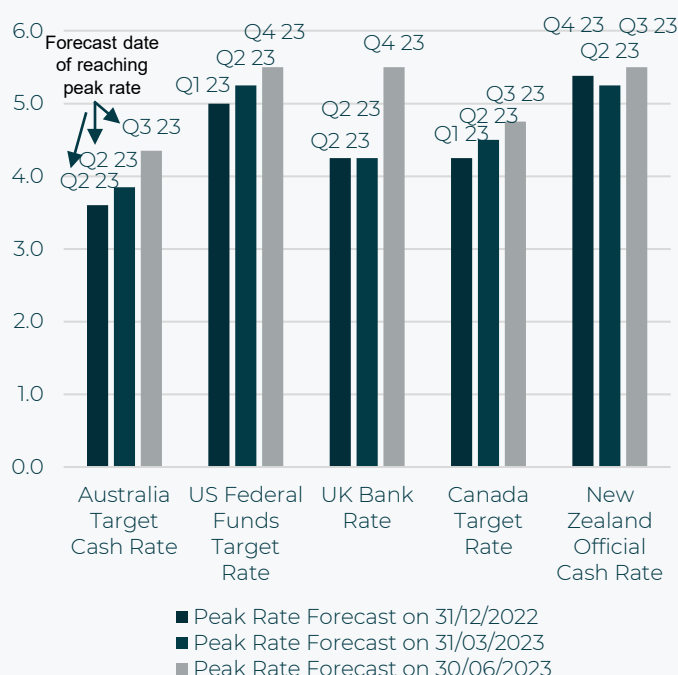
²⁹ Minutes of the Federal Open Market Committee, June 13-14, 2023, Federal Reserve, United States

Despite this, it is our observation that the recent history of markets being dominated by broad themes (first the pandemic, then inflation vs interest rates) is changing. Again, this can be traced back to the aftermath of GFC, where the terms “risk-on” and “risk-off” became prominent, reflecting a lower sensitivity to idiosyncratic (asset/company specific) risk. It would now appear that investors are approaching a more ‘normal’ risk paradigm where the nuances between different assets, different companies and different regions are again crucially important.

Reasons for hope

From the early months of 2022, when central bankers began to increase cash-rate targets, many investors have looked hopefully to the horizon, for a time when interest rates might again ease. Of course, that date continues to be pushed out, whilst the expected level of peak interest rates continues to climb. Investors should be under no illusion, central banks are determined to address inflation and have stated as much, time and again. As stated by Governor Lowe in early July, and in no uncertain terms, “The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that.”³⁰ This messaging is consistent across the major central banks we monitor, with comments from Europe’s Christine Lagarde (“we cannot waver, and we cannot declare victory”³¹), Jerome Powell of the U.S. Federal Reserve (“Getting inflation back down to 2% has a long way to go”³²) and Andrew Bailey of the Bank of England (“I’ve always been interested that the market thinks the peak will be short-lived in a world where we’re dealing with more persistent inflation”³³), all consistent in their tone. Of course, there are likely to be elements of ‘communication policy’ (otherwise known as jawboning), interwoven in the messaging. However, whilst we believe it to be a factor, we interpret this as accentuating the meaning, rather than driving it. What this likely means, is that considerations regarding inflation and interest rates will continue to be prominent. Even as their importance is reduced.

Figure 2: Peak Rates chart

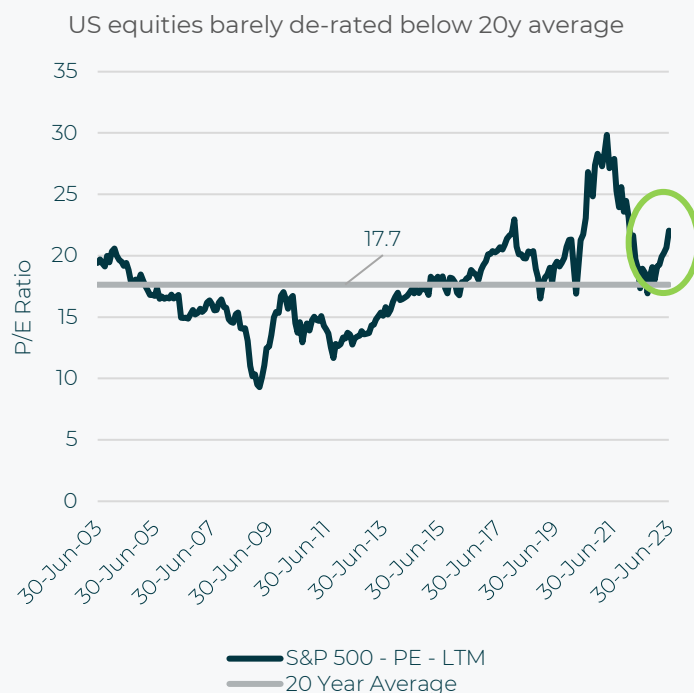


As we step forward in time, forecasts for peak interest rates continue to increase

Emerging from this, as they are prone to do, investors have found cause for hope. It’s important to note, that on many fronts we too find cause for a constructive view on the outlook for markets. Despite our caution, we see it as important, to be cognisant of the upside risks that are likely to play key roles in the way the path ahead evolves.

- **Desensitisation to risk** – Actions during the pandemic that sought to buffer economies from the shock of The Great Lockdown, may have had the unintended consequence of driving people, businesses and investors to feel inherently safer, potentially leading to value damaging biases to certain risk factors and/or themes. Indeed, we suspect that some of the recent enthusiasm for Technology assets may have been encouraged by such a bias, with the theme of A.I. as a cover (our thoughts on A.I. below). Indeed, whilst prices for many of the big tech names have moved dramatically, their expected earnings have not. This suggests higher expected growth rates, of which we find little visibility and are therefore inclined to discount, particularly given the assortment of economic headwinds.

Figure 3: U.S. equity multiples



Recent gains attributable to multiple expansion rather than improved earnings expectations

³⁰ RBA, Statement by Philip Lowe, Governor: Monetary Policy Decision, 4th July 2023
³¹ ECB, Christine Lagarde: Breaking the persistence of inflation, ECB Forum on Central Banking, 28th June 2023
³² Testimony to the House Financial Services Committee, Jerome Powell, Chair, Federal Reserve, 21st June 2023
³³ Panel Discussion, ECB Forum on Central Banking, Andrew Bailey, Governor of the Bank of England 28th June 2023

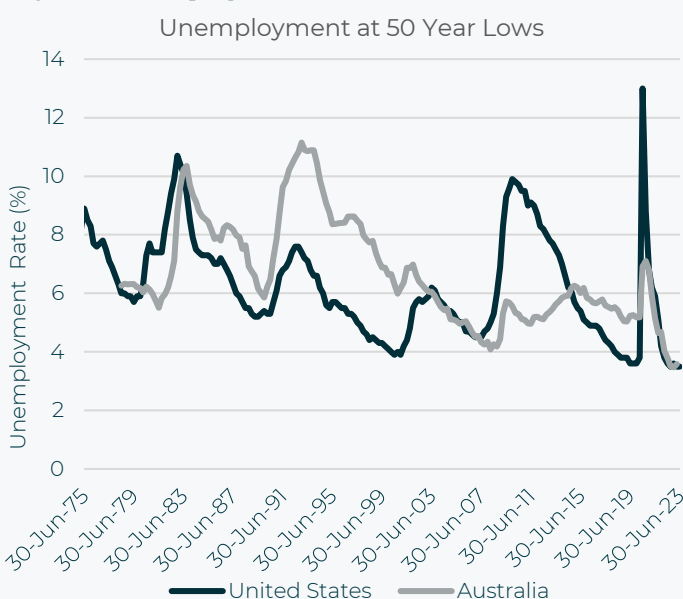
- **A.I.** – It is hard to find examples in recent decades of a technology that has such obvious applications and potential. It is challenging to even begin to contemplate the impacts it is likely to have on businesses, economies and even societies. Ironically, such is the complexity of the question it raises, it is presently unclear as to how quickly it will become pervasive throughout society and the human experience. Many exciting new technologies fail to prove themselves sufficiently useful for mass adoption. Even those we now know to be successful, such as the internet and mobile phones, have taken many years to reach mass adoption. We do though recognise that in this instance, generative AI is being introduced into a much more welcoming environment with low barriers to entry and ease of access. As we watch for corporate and societal trends to begin to emerge as a result of this new tool, we caution our usual sensibility around such things. Good business and good products do not necessarily make good investments. Valuation, on whichever basis is being applied, is a serious business and should be a dominating consideration in all investment decisions.
- **Low unemployment** – Having been one of the core focuses of fiscal policy during the pandemic, it is curious that employment is now proving to be so stubbornly persistent. Similar to the “desensitisation to risk” factor mentioned above, it could be a further example of policy being more effective than intended. This, in conjunction with ‘labour hoarding’ by businesses in response to lack of staff during the pandemic, make feasible explanations for continued tightness in the labour market. Finally, with some incidental developments such as a pay-rise fuelled sugar hit to consumer demand and softening pressure on the ‘goods’ half of the inflation puzzle, it is plain that despite a sense of the labour market defying gravity, there are many and varied explanations for the condition. This is consistent with the view that businesses only tend to shed employees (by choice) as demand falls, and we have seen demand across economies continuing to be strong. Particularly within those sectors that utilise high levels of human capital.
- **Robust consumer demand, particularly for services** – Whilst we anticipate consumers reducing their discretionary spending in response to higher expenses, the data does not yet fully support that thesis. Particularly here in Australia where interest rate increases directly impact the household sector (via the prevalence of variable mortgages), it is a further peculiar feature of the current environment that consumer demand continues to be as strong as it is. Households have had to pay higher prices for staple goods and whilst wages have adjusted upwards, they have not sufficiently compensated for the entire magnitude of cost increases and as such disposable income has plummeted. Meanwhile, we’re yet to see a meaningful drop-off in consumer demand from its long term average. Whilst it seems logical to expect that this will begin to dissipate with time, there is also reason to think it may only come down belatedly, and once households have burnt through most of the excess savings built up through the pandemic (some studies suggest as much of 80% of such savings have since been spent).

Complicating matters

Interacting with these more constructive economic and return drivers, are various considerations we must overlay. Key examples and regular points of contemplation for us include:

- **Russia/Ukraine** – Continues to be a tragic humanitarian development. From an economic perspective however, its impact has significantly fallen in materiality (though remains a tail-risk). In our investigations, we’ve found suggestions that it may even be somewhat stimulatory in certain western economies, as governments increase military spending for improved defensive capability as well as simply back-filling equipment donated to Ukraine. Despite some excitement that Wagner’s (a Russian state backed Private Military Company) brief rebellion might catalyse a significant change in the conflict, it ended about as quickly as it began with the organisation’s leader, Yevgeny Prigozhin, reportedly receiving some form of negotiated clemency from President Putin. Coincidentally, 2023 is the 250th anniversary of Pugachev’s Rebellion, a two-year period where a disaffected ex-lieutenant of the Imperial Russian Army, led a rebellion against the Russian state (at the time under the rule of Catherine II), also seizing a regional capital for a period. Their stories diverge there, as unlike Prigozhin who may be in Belarus, Russia or parts unknown, but is reportedly alive and kicking; Pugachev was promptly executed once his momentum faltered, and he was forced to surrender.

Figure 4. Unemployment chart



Low unemployment continues to surprise

- **China** – Despite increasing economic activity following China’s belated post-COVID reopening, key economic statistics from the country that for so long had been relied upon as an underlying engine for global growth, continue to underwhelm. Underscoring this point, China’s June CPI figure announced in early July, came in at 0%, increasing the likelihood of Beijing implementing more forceful stimulus measures. Fortunately, the country’s debt levels continue to be low, providing significant capacity for such an effort. Combine this with a U.S. presidential election being contested in only 16 months, and we see this as a potential bright spot in the near term. U.S. presidents don’t tend to get elected for a second term, if the country is in a recession. As such, President Biden has already begun a charm offensive, with Antony Blinken, Secretary of State, and Janet Yellen, Secretary of the Treasury, both having made trips to the country in just a three week period across June/July. Had China’s economy been firing on all cylinders, it’s questionable as to whether they might entertain a thawing of relations. Given that is not the case, we expect behaviour from both sides to be ‘expedient’.

- **Stubborn inflation** – Despite its fading importance, inflation will certainly continue to be the single most important factor for investors. To date, there has been much excitement about headline inflation having receded away from its highs. Concerns though linger, as core/underlying inflation (and its peers around the globe) continue to be elevated, effectively dictating ongoing monetary tightening. Progress made to date, combined with actions which are yet to make their full impact, has given both the Reserve Bank of Australia and the U.S. Federal Reserve, the policy freedom to take a pause from cash rate increases. In the current environment, the more promptly the issue of high inflation is resolved, the greater the chance employment and economic activity might avoid a downturn. Governor Lowe was clear in his statement following the July Monetary Policy Decision “High inflation makes life difficult for everyone and damages the functioning of the economy. It erodes the value of savings, hurts household budgets, makes it harder for businesses to plan and invest, and worsens income inequality. And if high inflation were to become entrenched in people’s expectations, it would be very costly to reduce later, involving even higher interest rates and a larger rise in unemployment.”³⁴

The exact path for inflation to return to target ranges continues to be unclear, however vigilance in monitoring its development will be key in being positioned correctly in the months and years to come.

- **Recession** – There has been much debate as to whether there will be, and if there is, how severe any recession might be. These scenarios have broadly been defined in terms of economic ‘landings’:

- **No landing** – refers to an environment where inflation is tamed and we avoid the technical definition of a recession (two quarters of negative GDP growth)

³⁴ RBA, Statement by Philip Lowe, Governor: Monetary Policy Decision, 4th July 2023

³⁵ Testimony to the House Financial Services Committee, Federal Reserve Chair, Jerome Powell, 21st June 2023

- **Soft landing** – A scenario where inflation is broadly brought under control but the economy experiences a short and shallow recession
- **Hard landing** – The true underlying fear, whereby a non-trivial recession is brought about with all of the negative considerations that entails

Though many observers continue to attempt to estimate both the probability and the severity of recession, we retain a sceptical opinion of the value of such analysis. Historically, economists have been poor at predicting just the occurrence of a recession, let alone its magnitude or duration. That is not to say we are disinterested. It simply means we are cognisant that even entities such as central banks (as evidenced by our opening quotes) with their substantial and specialised teams, cannot confidently make predictions of economic contraction.

As such, we prefer to allow our selected managers to utilise the benefits of their proximity to company management and asset specific data, to position our portfolios in response to the clearest contemporaneous signals they can identify. It is our belief that the drives more timely and more situationally precise investment implementation.

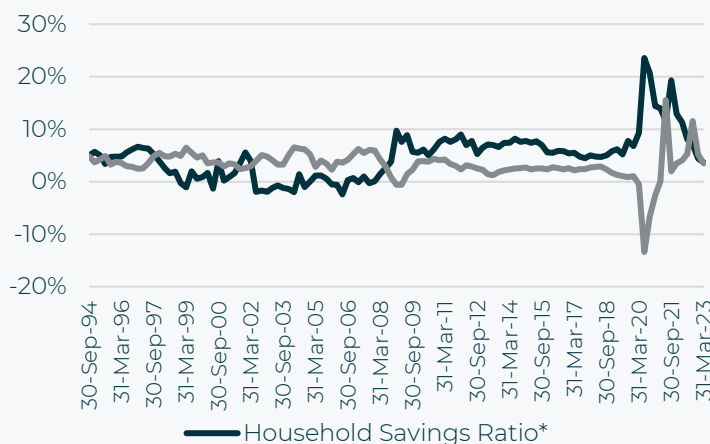
Decision-making under uncertainty

“Now we’re moderating that pace, much as you might do if you were to be driving 75 miles an hour on a highway, then 50 miles an hour on a local highway, then as you get closer to your destination, you try to find that destination — you slow down even further”³⁵

These words from Federal Reserve Chairman, Jerome Powell, concur with many alternative sources and types of data. The changing monetary landscape has now moved from a period of bold, aggressive moves to that of nuanced fine tuning.

To our minds, the most likely source of weakness in economies here and in most of our trading partners, is that of the consumer. Armed with the confidence of living through a pandemic, and having enjoyed a period of high levels of savings, alongside both security and opportunity in the labour market, consumer behaviour (as reflected in heightened levels of consumption being maintained) continues to exhibit optimistic traits.

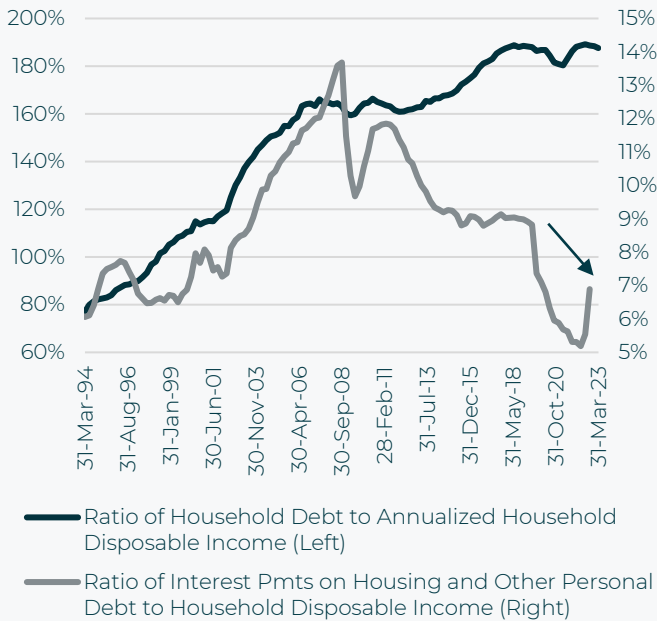
Figure 5. Consumer health – Household Savings and Consumption



Consumption still at levels above the pre-pandemic average

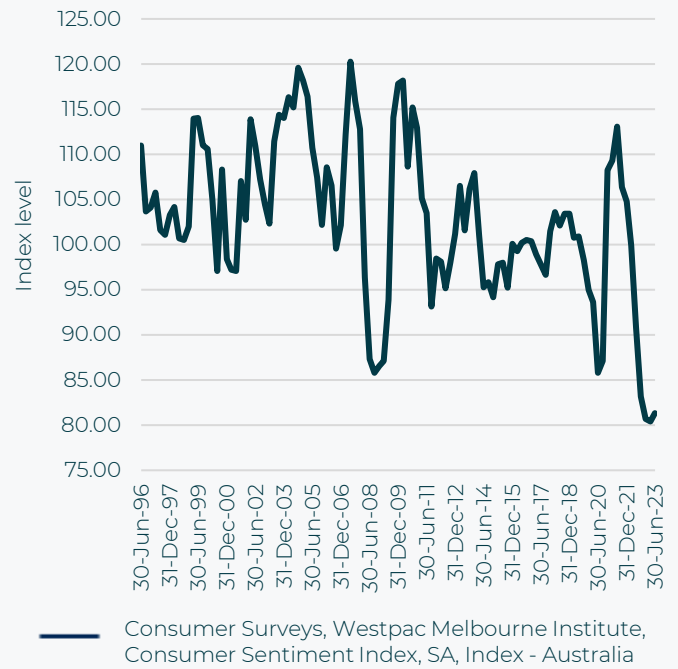
Whether that is sustained remains to be seen, as household debt burden is clearly biting (Figure 6.) whilst consumer sentiment is particularly low (Figure 7.).

Figure 6. Consumer health – Household debt and the burden of interest payments



Despite these figures being derived from delayed time series, the direction of travel is clear. Interest payments are eroding household spending power.

Figure 7. Consumer health – Australian consumer sentiment



Ultimately, we believe the spending ability and prowess of the household sector are likely to be key indicators for, if not drivers of, market outcomes as we move through the coming months. Unfortunately, we see multiple viable economic paths ahead (ultimately aligned with the ‘no-landing, soft-landing, and hard-landing, descriptions above), and none of them are clear enough for us to base assertive investment decisions upon. As such, whilst we continue to find value within capital markets, we are embracing a healthy degree of defensiveness across our portfolios. There will be times in the months ahead where we will be compelled to act. In the meantime, we will monitor the data with both vigilance and patience, so that we are able to act on the best of those opportunities.

Australian cash rate and dollar



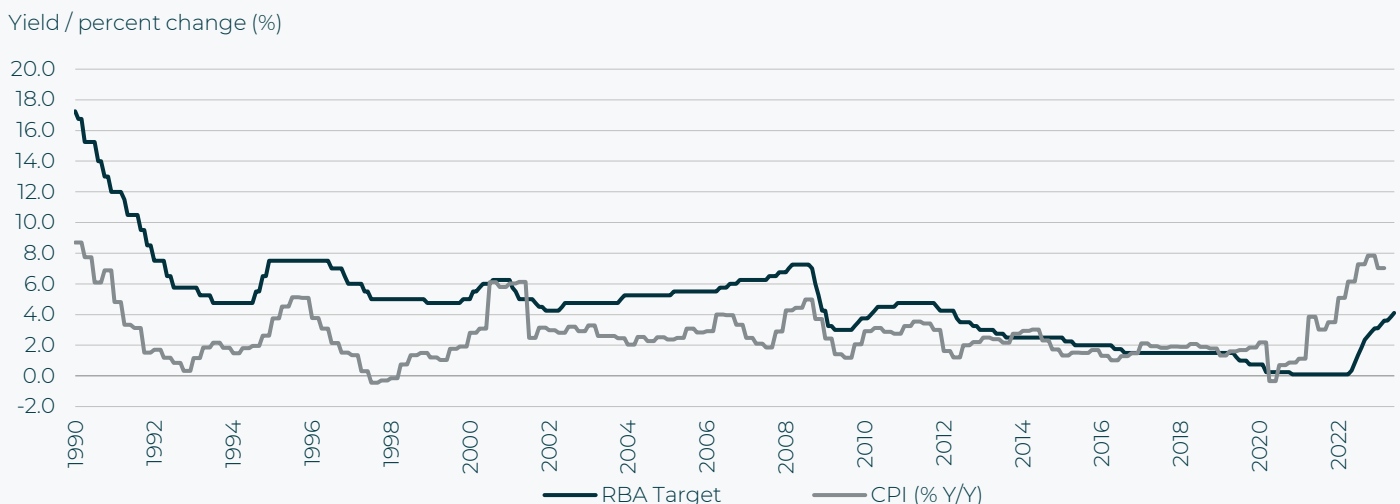
Australian cash rate

Twelve increases and two pauses, over 15 months, it's fair to say that the cash rate has gained strongly over a condensed period. That inflation proven to be significantly less temporary than initially thought, drove the RBA to take drastic action. Our peers across developed countries faced a similar, and in some cases more acute, predicament (which somewhat goes to explain an Australian dollar wallowing below its long-term U.S. dollar exchange rate).

With large numbers of mortgagees facing payment adjustments over the coming months, the bank's decision to pause in July, can be seen as somewhere between 'meek' and 'measured'. To our minds, the wait-and-see approach has its merits (and will rightfully be

welcomed by those families struggling with their sudden loss of spending power). From a policy lens point of view, a large reason for the development of central bank communication policy, was the acknowledgement that market stability is closely related to confidence. The presence of sustained demand, despite rapidly increasing prices, suggests that confidence remains too high. Having flexed their muscles post GFC and during the pandemic, monetary and fiscal authorities appear to have a pretty well worn playbook to stimulate confidence; reversing that appears more problematic. This combined with the understanding that resolving inflation is better done, before it begins to compound in the actions of economic actors, leads us to feel that it would have been better to get it over with, then seek to take a meaningful pause as conditions caught up.

Figure 8: Australian long-term interest rates – Long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

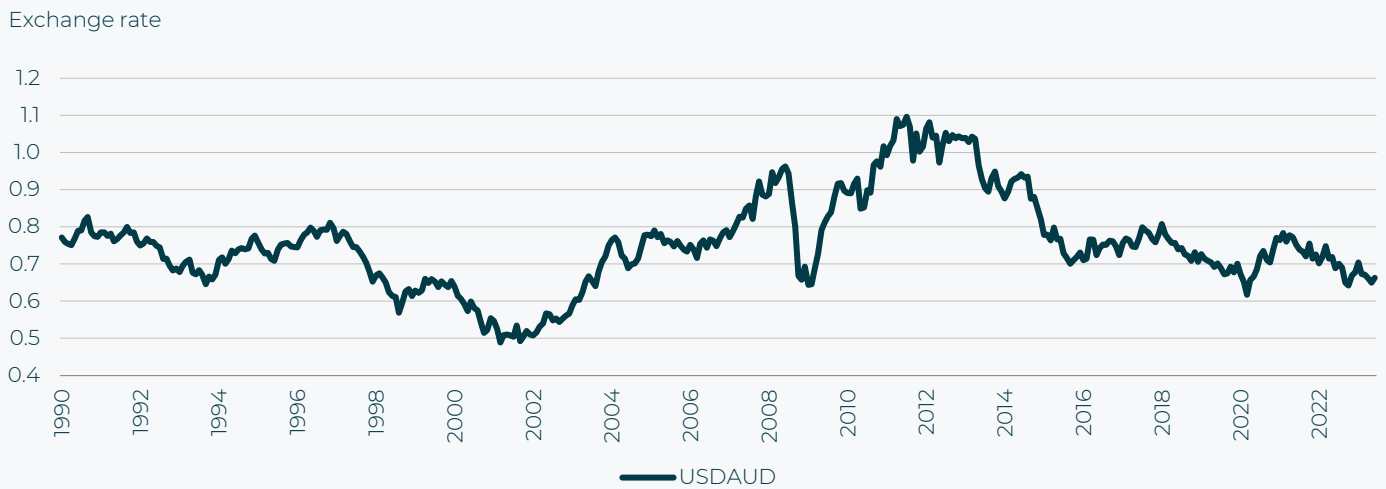
Australian dollar

In U.S. dollar (USD) terms, our dollar experienced a relatively benign trading environment, finishing almost precisely at its average for the period. With the combination of a global economic downdraft (usually negative for the strength of AUD) and an increasing degree of motivation for Chinese authorities to aggressively stimulate their economy (likely positive for AUD), we see scope for trading up or down, depending on the order of events as they play out. The Australian dollar in terms of British pounds, on the other hand, weakened (2.8%) as the prospects for higher interest rates in the UK, attracted yield-chasing currency flows. The other side of this coin, saw the Japanese Yen punished in AUD terms, as a continuation of ultra-loose monetary policy lead the cross to depreciate by 8.3%.

Australian dollar outlook

We rarely take strong views on the Australian dollar, unless it has moved meaningfully away from its long-term averages. This approach simply acknowledges that over the short to medium term, foreign exchange moves tend to be dominated by trade flows and momentum. As such, we expect it to appreciate towards 76c over the longer term with the potential for large swings either side of this, depending global economic activity, risk aversion and the magnitude and degree of Chinese stimulus

Figure 9: Australian dollar U.S. dollar (daily) long term



Source: FactSet, Perpetual Private.

Australian and international equities



Australian equities

Australian equities edged higher over the June quarter, with the S&P/ASX 300 Accumulation Index increasing by 1.0% over the period. Australian shares underperformed global shares, with the MSCI All Country World Index by comparison increasing by 6.6% in local currency terms (6.8% in AUD terms) over the same period.

We continue to see a wide dispersion of returns by stock and sector with sustained volatility. Despite broader concerns around the economic and geopolitical outlook globally and future corporate earnings, the key force driving equity markets continues to be inflation data and forecasts and the subsequent monetary policy actions taken by central banks.

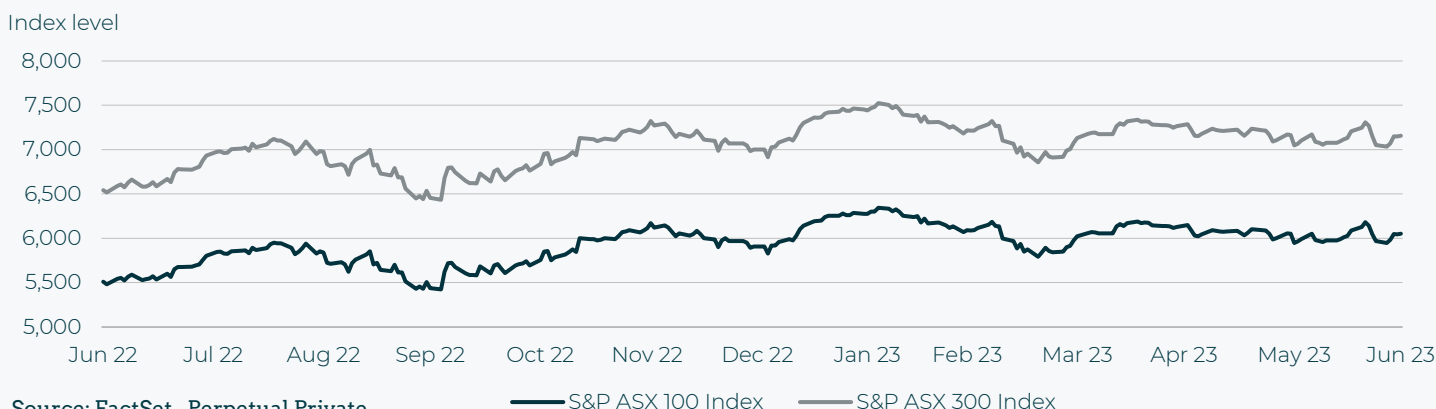
Domestically, inflation has continued to moderate from its peak in late 2022 and after 10 consecutive rate hikes through to March the RBA decided to pause interest rates. This saw Australian equities rally strongly in April led by a solid recovery from a number of de-rated Growth stocks, within the Technology and Healthcare sectors, and other more cyclical exposures.

Despite higher rates, we saw particularly strong returns from the Technology sector over this period underpinned by an uplift in investor sentiment on the growth outlook, largely driven by the hype around the futuristic benefits of Artificial Intelligence.

Over this period, we saw Growth stocks outperform Value stocks and large cap names outperform small cap companies. Returns at a sector level were quite mixed, with the stand-out performer being the Information Technology sector (+18.5%). They were followed by Utilities (+5.5%), Industrials (+4.3%) and Energy (+4%). Weaker sectors for the period were Healthcare (-3%), Materials (-2.6%) and Consumer Discretionary (-1.7%).

The Ausbil Australian Emerging Leaders Fund was our top performing domestic equity manager, returning +5.8% for the quarter, bouncing back from a softer first quarter of the year. Overweight positions in the Information Technology and Utilities sectors contributed to outperformance, as well as underweight positions to the Consumer Discretionary and Consumer Staples sectors. The Bennelong ex-20 Australian Equities Fund was our lowest returning manager, returning a flat 0.0% return over the quarter.

Figure 10: Australian shares



Source: FactSet, Perpetual Private.

Australian equities outlook

We expect movements in the Australian equity market will continue to be influenced by inflation data and forecasts, as well as the path and pace of interest rates both domestically and abroad. The market will continue to pay close attention to rhetoric from the RBA and central banks globally, as investors look for indications from central banks as to whether interest rate hikes are taming inflation.

There are still risks surrounding the outlook for certain sectors and the pressure on corporate earnings from higher interest rates and a slowing economy has further to play out. Quality industry-leading companies with the pricing power to pass on these higher costs, and strong balance sheets without elevated debt levels, should be relatively well positioned in the current environment. As we look to China, further geopolitical tensions and concerns around the strength of their recovery are a key influence on commodity prices and broader returns from the local resources sector.

We expect volatility in markets to continue for some time, against the backdrop of economic and geopolitical uncertainty. We are in a stock picker's market, and while equity markets may be vulnerable to a near term correction, this should present bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations as markets gyrate. With the various macroeconomic forces in mind, our views are currently biased towards those managers that have a stronger regard for valuations and balance sheet strength as well as those who are focused on investing in business with strong pricing power or thematic tailwinds.

International equities

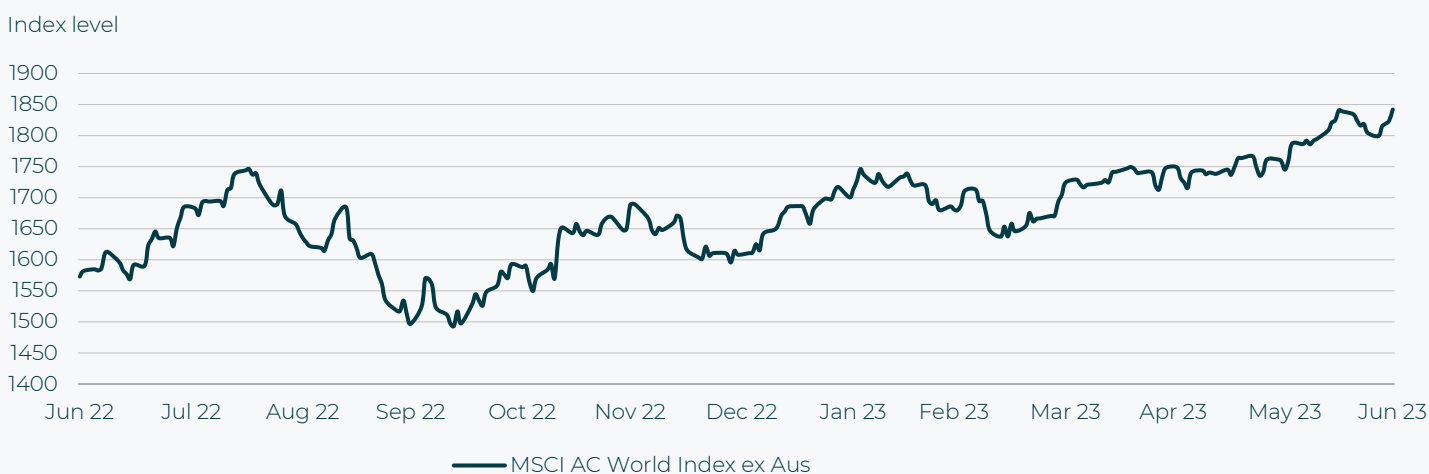
International shares continued to rally through the second quarter of 2023, with the benchmark³⁶ returning 7.3% in Local Currency, and 6.8% in AUD terms. The AUD fell marginally relative to the USD during the quarter helping returns.

After the issues facing the US Regional Banking sector in the first quarter, there was the risk that markets would become shaky as we moved into the second quarter. Pleasingly, after swift regulatory and central bank action, markets calmed. The main thematic during the course of Q2 23 has been the rise of Artificial Intelligence ('AI') and with that most stocks related to this thematic have rallied strongly. With this saw the Information Technology sector rally over 14% (AUD unhedged) during the quarter, outperforming all other sectors by ~5%.

Against the backdrop, Growth stocks, and mega caps continued materially outperform Value stocks. At the sector level Information Technology, Consumer Discretionary and Communication Services were the strongest performers delivering 14.4%, 8.9% and 7.7% respectively. Elsewhere, Materials, Energy and Real Estate were the laggards. Finally, Developed Markets continued to outperform Emerging Markets in Australian dollar terms.

Our international equity managers all performed well over the quarter, buoyed by positive risk sentiment flowing from developments in artificial intelligence and central banks approaching the end of their tightening cycles. Arrowstreet Global was the standout manager, returning +8.4% and benefitting from a sector overweight to Energy. Our Value manager Barrow Hanley, returning +5.7%, struggled on a relative basis given the outperformance of Growth over the quarter.

Figure 11: International shares (local currency terms)



Source: FactSet, Perpetual Private.

³⁶ As measured by the MSCI All Country World Index

International equities outlook

Equity markets continue to be driven by macroeconomic forces – specifically inflation data and forecasts, as well as the path and pace of interest rates. While uncertainty remains around the outlook for economies globally, we expect volatility (to both upside and downside) to continue.

Our main areas of focus include:

- Central banks and the path and pace of interest rates – Investors are acutely focused on the rhetoric from central banks with regards to proposed and future rate hikes needed to stem inflation. We believe that inflation has peaked for the time being, which subsequently contributed to the continued strong recovery in equity markets on the presumption that central banks are successfully taming inflation and could therefore slow the pace and size of further rate hikes in the near future. That said however, any further tightening through higher rates is likely to limit the upside for equities as markets begin to reassess appropriate forward-looking valuations.
- The earnings outlook for corporates – It is our view that the ‘real economy’ is facing the combined pressure of inflation and rising interest rates, which together will likely weigh on consumer spending, and subsequently future corporate earnings. That said, many corporates were able to expand their margins through the COVID-19 period, and as such there is room for some margin contraction – this likely only buys time, rather than changes the outcome.

- Valuations across most markets and sectors are near or around their post GFC averages. At this point in time we do not see a strong valuation signal to drive an overweight position to equities across portfolios. Any volatility should present our bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations.

We expect the macroeconomic outlook to continue driving equity markets over the near term, with higher volatility expected to continue. The coming earnings season should provide a guide as to how corporates are coping with this dynamic.

Over the remainder of 2023, we expect inflation to fall, however do not believe that the path will be linear, and its impact will continue to be felt across the corporates. As such, we expect financial markets to focus on fundamentals later this year, specifically, earnings growth, margin sustainability, cost control, free cash flow conversation and balance sheet strength. Managing investment portfolios in this environment poses multiple challenges for investors, however we believe that focusing on Quality (as defined in the previous sentence) and valuation will provide investors with right levers to navigate the environment successfully.

A-REITs and G-REITs (listed property securities)



Real estate markets responded positively to the resolution of banking failures in the US and Europe. However, as the quarter progressed, bond yields rose leading real estate to give up some of the early period gains. Australian Real Estate Investment Trusts (A-REITs), represented by the S&P/ASX 300 A-REIT sector rose 3.2% over the quarter against the backdrop of Australian Shares gaining 1.0%³⁷. Global Real Estate Investment Trusts (G-REITs) as measured by the FTSE EPRA/NAREIT Developed Index (Unhedged) rose 0.9% in AUD terms compared to 7.5% for International Shares³⁸.

REIT markets are trading at discounts to net-asset-value, reflecting lower valuations as a result of rising cap rates. A recession may result in further declines as earnings growth slows. Uncertainty remains due to light transaction levels, though the quarter saw some office sales in Sydney and Melbourne at discounts of 10-20% and re-valuations from some large super fund investors of similar magnitude.

We expect this will provide some clarity for investors, particularly when interest rates are believed to have peaked.

Retail was the worst performing sector over the quarter with interest rates starting to impact consumer spending. On a regional basis, Japan outperformed and the UK was weakest in local currencies.

The Martin Currie Real Income Fund, returning +3.8%, was the strongest returning fund for the Real Estate asset class, benefitting from exposures to the Industrials and Utilities sectors. The Magellan Infrastructure Fund was the laggard, detracting -0.8%, although this was in-line with the broader infrastructure benchmark which struggled over the quarter.

³⁷ As measured by the S&P/ASX 300 index

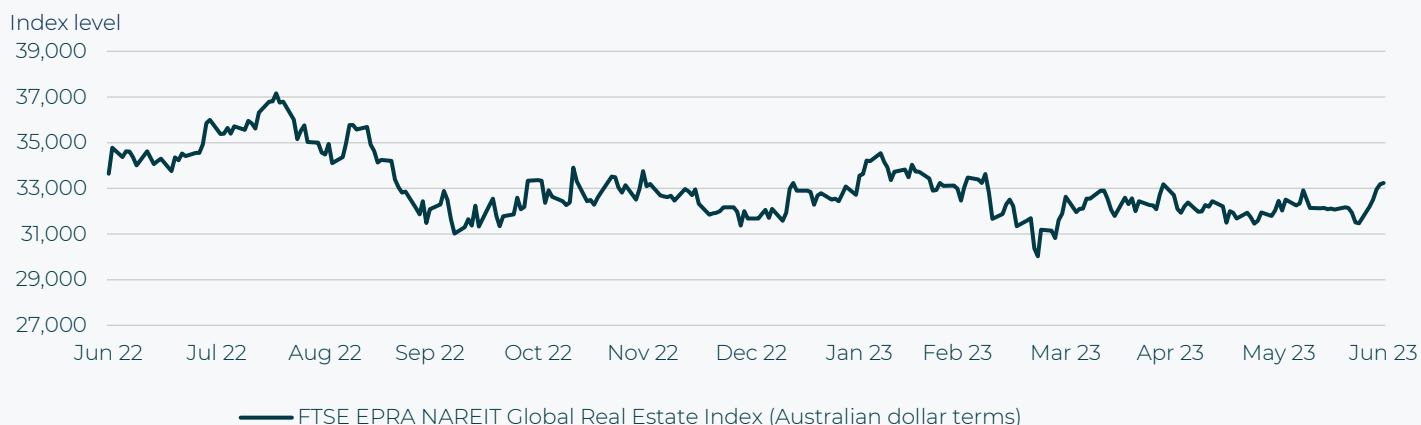
³⁸ As measured by the MSCI All Country World index

Figure 12: Australian Real Estate Investment Trusts (A-REITs)



Source: FactSet, Perpetual Private.

Figure 13: Global Real Estate Investment Trusts (G-REITs)



Source: FactSet, Perpetual Private.

REITs outlook

We expect both domestic and global REITs to experience ongoing volatility, with the path of inflation and interest rates driving market direction.

Valuations across REIT markets are at multi-year lows, trading at considerable discounts to fair value, however dispersion between sectors is extreme. We have seen a small resumption of transaction activity and recognition from some asset owners that prices have declined. Sector and geographic allocation remain important with valuations and growth prospects differing across markets and segments.

The outlook for REITs varies meaningfully by sector and investors should be circumspect on the robustness of short-term earnings underpinning current sector level valuations and the valuations ascribed to individual assets. Our active managers are focused on those assets with strong and/or improving balance sheets and improving earnings prospects. We remain of the view that 'Quality' real estate with access to capital markets remains the most attractive investments.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -3.0% during the June 2023 quarter. Australian 10-year bond yields rose sharply during the period off the back of strong CPI numbers, “unexpected” RBA rate rises in May and June and strong employment numbers. At the end of June, the Australian 10-year bond yield rose from 3.30% to 4.02% over the quarter.

After pausing in April, the RBA made two consecutive 25bp rate hikes in May and June. The RBA decided to pause again, leaving the target cash rate at 4.10% in July. In the statement from RBA Governor, he said that inflation in Australia has passed its peak but is still too high. The RBA explained that further tightening monetary policy may be required if inflation stays high.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned -0.3%. Credit performed in line with the general market, with the ICE Bank of America Global Corporate Index (Hedged) also returning -0.3% over the quarter. High yield debt as measured by the Bloomberg Global High Yield Index

(Hedged) strongly outperformed investment grade credit, returning 1.6% for the period.

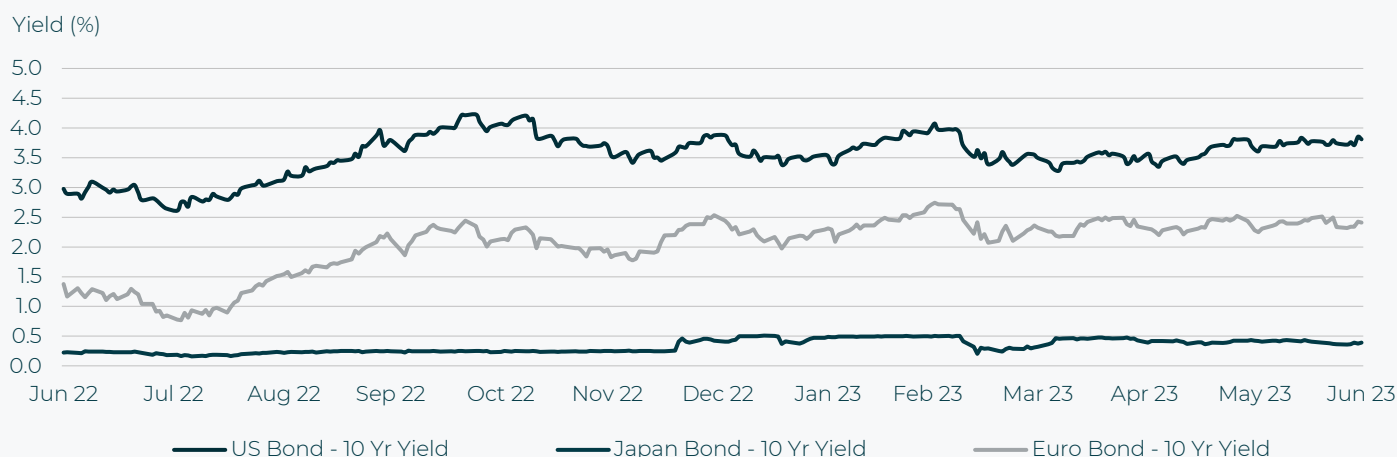
AUD/USD was flat for the quarter, finishing a 0.67 at the of June after climbing to 0.69 in the middle of that month. In June, the US Federal Reserve held its target range at 5.00% to 5.25%, taking a pause after 10 rate hikes. The pause gives the Federal Reserve the opportunity to observe the impacts of their tightening policy. The Federal Reserve Chair explained that stretching out rate rises is appropriate to allow to make that judgement. The US 10yr yield rose to 3.81% from 3.49% over the quarter as the market priced in the possibility of further rate rises.

There was wide dispersion between the performance of our Fixed Income managers over the quarter. Janus Henderson Tactical Income was the top performer, contributing +1.2%, as credit investments continue to perform well amid rising interest rates. The UBS Diversified Fixed Income Fund detracted from performance, returning -3.0%. The fund remains biased to long duration exposures across the portfolio and is positioned to benefit from a decline in interest rates.

Figure 14: Australian government bonds



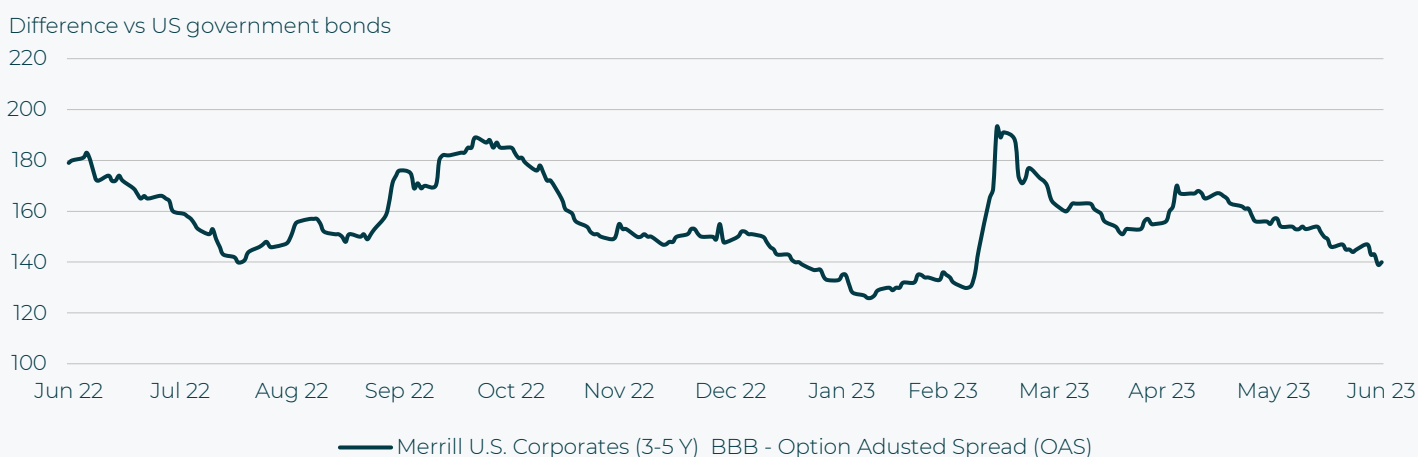
Figure 15: Global government bonds



Source: FactSet, Perpetual Private.

Note: Bond prices are inversely correlated with bond yields.

Figure 16: Global credit markets



Source: FactSet, Perpetual Private.

Note: Bond prices are inversely correlated with bond yields.

Fixed income outlook

The market appears to have gotten past the turmoil caused by the fall of Silicon Valley Bank (SVB) and Credit Suisse. 10-year bond yields in both the US and Australia fell in March after the potential crisis, only to rise to much higher levels during the quarter. The response to the potential banking crisis was quick and effective enough to contain the crisis, at least for now. It is clear that inflation is a more pertinent problem.

The supply side of the inflation bogey is probably behind us. It is getting much easier to get cars and electronics. Furthermore, energy costs have fallen from their early 2022 highs when Russia began their invasion of Ukraine. Unfortunately, inflation is proving to be much stickier because of higher labour costs and higher rental/housing costs.

Our view is that inflation will remain higher for longer. We may have been a few months early with our move to duration, but we are still confident that yields represent good value.

The high cost of debt has led to higher defaults, albeit from a low base. We do expect defaults to increase with the severity of the defaults dependent on how deep a recession will be. While defaults are low, we are worried that recovery rates may also be low, undermining the value of highly ranked securities like 1st lien debt. We remain neutral on our outlook for credit as base rates are high and spreads are reasonable.

Alternatives



Growth alternatives

Traditional asset classes rallied strongly through Q2 2023, while unlisted asset classes continued to exhibit more modest movements. Transaction volumes across all asset classes (private equity, real estate and infrastructure) remain soft in light of uncertainty around the cost of debt and the macroeconomic outlook. More recently talk has shifted to the outlook for Real Estate, specifically Office and we have witnessed some modest valuation declines.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. The regulated assets within the portfolio are positioned well to deliver returns through the current inflationary environment with the ability to pass inflation-linked cashflows through to investors. A number of the energy transmission assets are well positioned to benefit from the 'energy transition' as renewables connect into the grid. Despite higher long bond rates, our portfolio appears to be well insulated with most external valuations carried out on a 'through the cycle' basis resulting in limited movements in valuation assumptions. Late in quarter we saw some media speculation around the state of capital structures across the UK's water utility sector. We expect this to continue over coming months as investors consider the optimal structures for these companies in a higher interest rate environment.

Within Private Equity (PE), Leveraged Buy Out (LBO) transaction volumes have slowed, reducing the pace of deployment and realisations in Q2 23. We have observed Private Equity managers are beginning to look to smaller sized deals (bolt-ons) which can be funded by existing debt facilities or free cash flow, rather than having to take on more debt for bigger acquisitions which have a negative impact on balance sheet strength and cash flow metrics.

Despite the changing market dynamics, we remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. We are optimistic that 2023 will be a fruitful investing environment and expect to deploy in line with our plan through this CY and into 2024.

Sector and geographical dispersion has increased within Real Estate markets. The most notable dynamics over the past quarter is: i) the anticipation that US Multi-family rental growth rates will begin to soften; and ii) the Office valuations becoming an increased area of concern, although downside risk varies significantly on a market by market basis. Domestically, the cost of debt combined with the uncertainty about the outlook for rental growth has stymied several transactions. Our focus remains on the nexus between availability of capital and valuations. Of note, we are seeing the cost of debt rise in the US which is slowing transaction volumes, and dampening prices. Finally, we have seen cap rates begin to widen in the Industrial sector, an area we have avoided. Looking forward, we are focused on whether there are opportunities in markets which were earlier to suffer from 're-pricing' (e.g. Western Europe).

Changing market dynamics (inflation, path and pace of interest rates, weakening economic environment) warrants continued reassessment of our thinking and outlook. For now, our focus remains on central bank policy decisions, and on the health of the 'real economy'. We are responding to what we expect to a market environment more akin to that of the environment prior to the GFC (interest rate cycles, and greater focus on fundamentals) by favouring hedge fund strategies with a focus on security selection within equities and credit. Where we engage Private Equity, we are particularly focused on operational capability (as opposed to balance sheet optimisation).

Income alternatives

Both High Yield and Leveraged Loans printed a positive return for the quarter, with Leveraged Loans outpacing High Yield. Returns came from a combination of higher yields and spread tightening. The Bloomberg Global High Yield index posted a 1.5% return and the Morningstar LSTA US Leveraged Loan 100 Index returned 3.3% in local currency terms. Our view has long been unfavourable towards High Yield, preferring Leveraged Loans and Private Debt.

We expect an increased number of downgrades by ratings agencies and higher defaults. This will weigh mostly on the value of some of the market linked assets such as High Yield, Leveraged Loans and CLOs. Private Debt is somewhat shielded from the mark-to-market because of its illiquidity but it is not immune from delinquencies and defaults.

Most of our preferred assets are related to 1st lien unlevered private debt. For the most part, these are 1st lien senior secured loans diversified across Europe, North America, and Australia. These investments are expected to underperform more recent vintages of private debt but are more seasoned and are expected to mature within the next few years.

Over time, our preference is to gradually reduce our engagement with 1st lien unlevered private debt in favour of more liquid securities. The liquid investments also provide some optionality of reinvesting in private assets, such as more private debt or insurance linked strategies should they present appealing opportunities.



Andrew Garrett, CFA CAIA

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Andrew Garrett provides investment research, portfolio construction and bespoke investment advice for Perpetual Private's clients. He works closely with advisers by providing specialist investment knowledge on Perpetual's investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally. Andrew is a holder of the Chartered Alternative Investment Analyst and the Chartered Financial Analyst designations.

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