Perpetual Private | Quarterly Market Update

Growth assets continue to perform, but headwinds exist…

January 2022

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Contents

Snapshot

The December quarter of 2021 once again delivered strong equity market returns. In contrast, bond markets delivered negative returns over the quarter as yields ticked upwards, leading bonds to a negative return for the 2021 calendar year.

Despite the latest surge in COVID infections, arising from the more infectious but less dangerous Omicron variant in late November, economic growth across most developed economies appears to be robust.

Markets are now factoring in the prospect of higher interest rates off the back of higher inflation. The US Consumer Price Index (CPI) printed at 7% for the year ending December 2021, which is the highest inflation read since 1982 when Ronald Reagan was in the White House.

Inflation is proving less transitory than many thought, as supply bottlenecks take longer to resolve. The latest COVID surge has caused increased worker absences and exacerbated delivery issues, driving supply shortages.

At the same time, the extraordinary levels of stimulus put in place to combat COVID has 'artificially' boosted the demand for goods over services. It appears the US Fed, along with other central banks, is taking a more hawkish tone and looking to raise rates sooner than previously forecast.

The outlook for the coming year sees continuing moderate to strong economic growth but with lower and more volatile returns across most asset classes. In a rising rate environment, equities should continue to outperform bonds, however it's unlikely that the exceptionally strong market returns of 2021 will be repeated as central banks take action to cool economies.

Asset class performance – December quarter

Australian equities

The Australian equity market moved higher over the quarter, with the S&P/ASX 300 Accumulation Index delivering a 2.2% return for Q4. For calendar year 2021, the S&P/ASX 300 returned 17.5% including dividends. It was a stronger quarter for growth stocks – up 3.4% - versus value stocks at -0.6%. Resource companies in the ASX300 returned 9.9% while Industrials were relatively flat, returning just 0.5%. Despite this last quarter surge, Industrials outperformed Resource stocks in 2021, delivering 19.5% vs 10.2% respectively.

International equities

Global equities advanced in the fourth quarter, topping off an impressive year of gains despite increasing volatility. In AUD terms, the MSCI ACWI delivered 6.0% in Q4, a strengthening Aussie dollar detracting a little over 1% from the local currency return of 7.1%. For AUD investors, unhedged international equities closed out 2021 with a 25.8% annual return. US equities outperformed both their developed and emerging market peers, effectively doubling investors' capital over the trailing three-year period. These are the strongest returns in absolute and relative terms over that horizon since the dot-com era. Ten of the 11 S&P 500 sectors rose in Q4, led by real estate, information technology and materials. Energy and financials rose least, while communication services were flat.

Real estate

In AUD terms, Global Real Estate Investment Trusts (G-REITs) rose 9.5% over the quarter to the end of December 2021 (as measured by the FTSE EPRA/NAREIT Developed Index). They returned 10.2% on a currency hedged basis. In Australia, A-REITs rose 10.1% over the quarter[1]. REITs had a particularly strong year, with the global and domestic benchmarks outperforming their broader equity market counterparts, returning 33.8% and 27.0% respectively.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -1.5% during the December 2021 quarter. At the end of December, the Australian 10-year bond yield was 1.68% versus 1.50% the previous quarter. The Australian 5-year bond yield moved aggressively, jumping to 1.34% versus 0.79% from the previous quarter, contributing to the loss in the index. This came off the back of a strong September inflation print and an improved unemployment rate in November – both of which bring forward a potential rise in official interest rates which are negative for bonds. Indeed bonds had a difficult and volatile year, with Australian bonds returning -2.9% and global bonds returning negative 1.5% for the 2021 calendar year.

Alternatives

Over the course of 2021 Private Equity, Real Estate and Infrastructure markets were buoyant, supported by unprecedented and coordinated fiscal and monetary policy action and the reopening of economies. Debt focused alternatives strategies performed slightly above our expectations for the year, with default rates significantly lower than expected due to COVID-19 monetary stimulus and supportive government programs. Off the back of this support, companies enjoyed improved cash flows which underpinned better performance from the credit instruments they issued.

Cash rate

The Reserve Bank of Australia (RBA) continues to hold its target cash rate at 0.1%. While there has been speculation that the RBA would have to raise rates sooner rather than later, economic slowdowns due to the Omicron surge and a lack of inflation (from a trimmed mean perspective) saw the bank commit to maintain its bond buying program until at least February 2022, with a possible rate rise forecast for 2023.

Aussie dollar

The Australian dollar broadly strengthened against most currencies over the fourth quarter, however it finished 2021 generally down. The Aussie dollar was down 6.1% over the 12 months against the US dollar, buying 72.7 US cents at year's end. The AUD also weakened against the pound, losing 5.2% over the year. It was however stronger against the Euro, appreciating 2.5% over the quarter to finish up 1.4% against Europe's currency for 2021.

[1] Measured by the S&P/ASX 300 A-REIT (Sector) Total Return index

Global economic overview

The last quarter of 2021 began with a strong start for equity markets through October, led by US Equities which rallied almost 7%. While European and Asian markets were positive, they lagged due to concerns around supply bottlenecks affecting exports and rising input prices – especially energy.

November saw a pullback in markets as concerns around the emerging new Omicron variant took hold and markets factored in the risks to growth. Bonds and safe-haven currencies, such as the USD, rallied through November, before December delivered a strong finish to the year as health concerns eased on lower rates of hospitalisation and serious illness from this latest variant. In addition, hard lockdowns were largely abandoned as a tool to manage the virus, particularly in developed countries where most of the population have been vaccinated and booster programs appear to have some effect on reducing the more serious effects of the virus.

Inflation concerns continued to influence markets through the quarter. The Fed formally removed the word 'transitory' from its inflation narrative, as fears of more sustained inflation on the back of expansive monetary policy settings and the prospect of continued fiscal stimulus had markets factoring in central banks being forced to act sooner rather than later. A US CPI reading of 7%, far exceeded market expectations and combined with tight labour markets, this outweighed any virus concerns, adding fuel to the argument for cooling the US economy.

Commentary from the US Fed became increasingly hawkish over the quarter, as it signalled an end to its ongoing bond purchasing program to make way for the possibility of a rate rise. The release of the Federal Open Market Committee (FOMC) minutes on 8 January, 2022 confirmed that a further acceleration in tapering would occur and a rise in the Fed funds rate could occur as early as the March 2022 meeting. The Bank of England increased rates 0.15% in December while the European Central Bank also signalled plans to scale down its asset purchasing program over the coming year.

In response, bond markets continued to sell-off, with rates increasing across the curve. Most of the pain was felt in shorter maturities, such as 5-year and 2-year bonds, as opposed to 10-year bonds. Inflation linked assets, such as Treasury Inflation-Protected Securities (TIPS), and real assets such as Infrastructure and Real Estate, all rallied off the prospect of higher interest rates.

Emerging markets (EM) declined for a second quarter, which pulled overall performance for EM into the red for the year. In 2021, the gap between developed and emerging markets was almost 25%, which is the widest margin since 2013.

China comprises more than a third of EM Equities, and equity losses there were concentrated in offshore listings, as opposed to the onshore 'A-share' listings. Bucking the global trend, China loosened monetary and fiscal policies over the quarter in response to disappointing retail sales and declining home prices. The Chinese market is dealing with other distinct issues: equity markets were affected by the authorities' crackdown on property developers and specific stocks within certain industries. China is also one of the few countries still pursuing a 'zero-covid' strategy, with the risk of lockdowns potentially putting a handbrake on economic growth.

Closer to home, the September quarter economic contraction caused by Australia's virus induced lockdowns came in at a smaller than expected -1.9%, quarter on quarter. Labour market numbers also exceeded expectations with unemployment dropping to 4.6%, contributing to positive sentiment. While lagging US markets, Australia outperformed other markets in the region, delivering a positive return for the three months to December.

2022 Outlook

Without a doubt, events over the past two years have been exceptional and, in turn, created an extraordinary market environment. Even if investors had been able to predict a global pandemic and the resultant sharp and deep global recession, few would have positioned their portfolios for record amounts of stimulus and support from central banks and governments. Few foresaw the rapid advent of highly efficacious vaccines leading to rapid economic turnaround and some of the strongest equity markets we've seen in decades.

Contrary to expectations, we've seen the continued domination of the US market relative to other developed and emerging markets. We've also seen negative real and nominal returns on bonds. Investors are now facing into the possibility of economies overheating, elevated inflation and a tightening interest rate environment.

Looking towards the year ahead the market needs to deal with the possibility of recurrent surges in COVID cases from new variants, increasing geopolitical tensions between Ukraine, the West and Russia, the increasing trade tensions between China and the US and possible conflict over Taiwan.

Against this backdrop of broad market risks, we have just come off the strongest period of global economic growth in 50 years. The consensus view points towards global growth slowing from these elevated levels. Growth in 2022 is widely predicted to be higher than historic averages, however not as high as we've seen in 2021.

No doubt, as central banks start to address high inflation – a phenomenon we have not seen in over 30 years – there will be a gear change in markets. As we transition from ever falling interest rates to a market where rates are rising, what does this mean for investors?

We've already seen periodic shifts in sentiment over the past 18 months as the high-growth, low or no-profit stocks that have been winners for the past decade have been outstripped by more cyclical businesses that will benefit from a change in the cycle. Profitable businesses that have been discounted due to lower forecast future growth will be more insulated against rising rates as investors start to value today's profits over the promise and uncertainty of aggressive forward-looking profit forecasts.

In other words, as 'income' becomes less risky and bonds start to deliver real returns in a rising rate environment, companies likely to deliver predictable income will be assessed as more valuable than companies previously bought heavily on the 'promise' of higher income long into the future.

Passive investing, based on market-cap weighted indices, has been a successful strategy over recent times, as yesterday's winners have continued to be rewarded by investors, becoming ever-larger parts of the index, in turn having higher weightings and receiving higher flows from passive-based funds.

Eight of the top 10 components of the S&P500 are now tech stocks. The top 10 stocks make up almost 30% of the index and they have enjoyed market dominance relative to the other 490 stocks in the index over recent times. If the market environment has shifted, it's not a question as to whether these businesses will or won't thrive, but whether will they continue to outpace other stocks to the extent that we've seen. In an environment where the gap between other stocks and these top 10 closes, you could expect passively managed funds to underperform those managed by active stock pickers or portfolios that are less aligned to market-cap weighted indices.

High-quality government bonds will struggle to outpace other securities when they are priced for a low or falling interest rate environment. We've seen negative returns on bonds as markets have adjusted, however if rates continue to rise, bonds will struggle to outperform floating-rate securities, such as corporate credit or bank loans. If economic growth continues to support corporates, riskier high-yield parts of the debt market may benefit from that supportive economic cycle. An active approach to fixed income may finally start to outperform. This is a change from the past 20 years, where an environment of ever declining rates meant holding passive government bonds relative to other parts of the fixed income market was a winning strategy.

Alternative assets have recently struggled to outperform equity markets. However an environment of sideways or even just lower returning equities more in line with historic averages could lead to skill-based returns or illiquid assets outpacing equity markets on an after-fee basis (despite fees on alternatives assets being substantially higher).

Finally, with the focus moving away from the pandemic, governments, regulators and investors have started to focus on climate change and embrace environmental technologies and companies acting in a socially responsible manner. Companies that outperform on Environmental, Social and Governance (ESG) criteria will reap the benefit of a lower cost of capital as more institutional and individual investors take a stronger ESG based approach to their portfolios. Another key question for investors in 2022 and beyond is: "Will the overall weight of capital into the ESG sector drive outperformance of these companies relative to other securities?"

Based on our view of the economic outlook today, and the strong investment themes that we currently observe in markets, we can build a portfolio of stocks, funds and assets that focus specifically on these themes and would be well-placed to outperform if everything plays out 'exactly like it's supposed to.'

However, the past 12-24 months has taught investors that unforeseen circumstances can completely unravel the most forward looking investment strategy and a portfolio that is solely based on a very specific set of outcomes occurring could result in significant underperformance or even permanent impairment of capital.

As a result, we continue to invest with a diversified and long-term approach that balances a multitude of risks in the context of the current macro environment and market conditions. While we look forward to a positive year for investors in 2022, our focus remains on building resilient portfolios which we anticipate being able to perform across a range of different market outcomes. It is a case of 'hope for the best, prepare for the worst'.

Australian cash rate and dollar

Australian cash rate

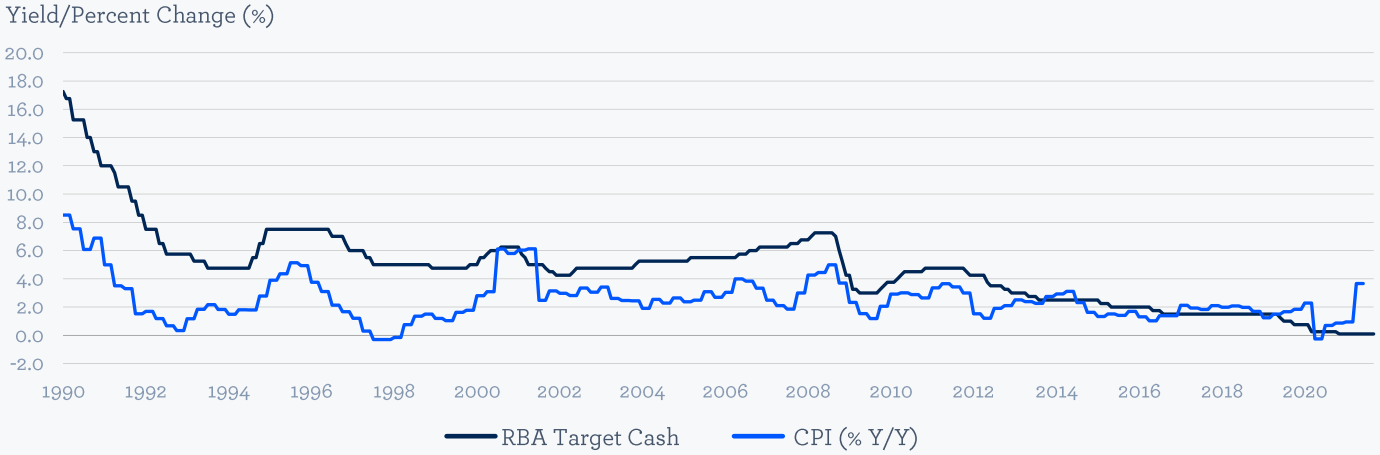
The RBA maintained its cash rate target at 0.1% at its December meeting, after November saw a sharp move lower in the Australian yield curve, off the back of concerns about the Omicron variant. The board noted that the economy continues along its recovery path and, although Omicron poses some uncertainty, it is not expected to derail the recovery.

The RBA officially announced the discontinuation of 'yield curve control,' which is the term it uses for its bond-buying program. However this will continue until at least mid-February when the decision will be reassessed.

The RBA restated its commitment to a low cash rate until inflation is sustainably within their target range of 2-3%, with 2023-24 the expected starting point for rate hikes.

Figure 1. Australian long-term interest rates

Long-Term Cash Rate VS Inflation



Source: FactSet, Perpetual Private

Australian Dollar

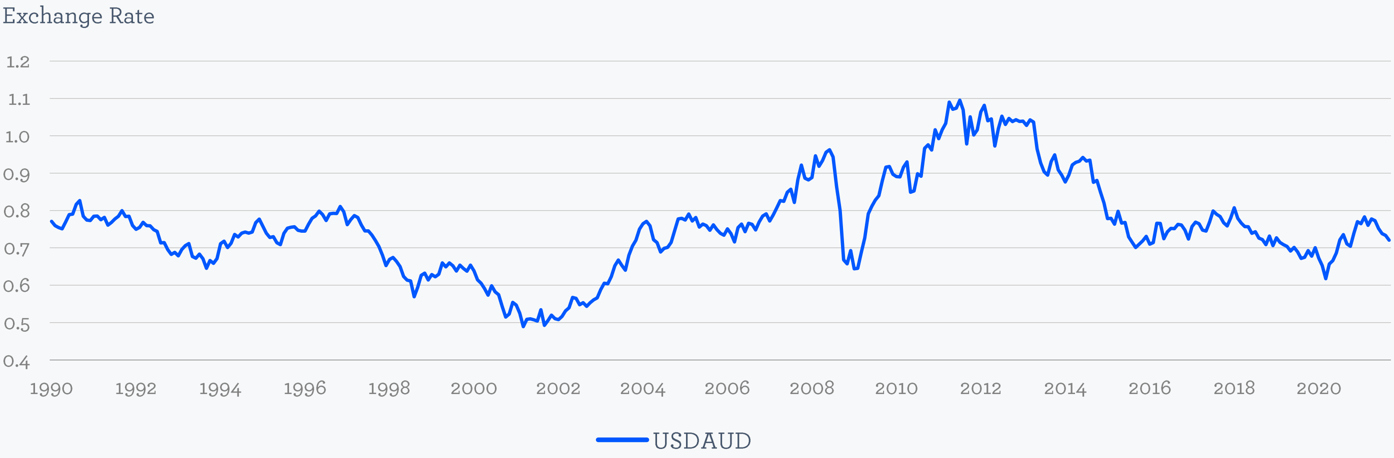
A December rally coinciding with strong equity markets saw the AUD strengthen over the quarter against most major currencies. The AUD ended the year buying 72.7 US cents and 53.6 British pence.

Over the year, the AUD depreciated against major currencies, with the exception of the Euro and the Japanese Yen. The AUD depreciated -5.8% over the year relative to the US dollar, which contributed to higher returns on US assets for Australian investors held in USD.

Australian Dollar outlook

Against a backdrop of continuing economic growth and positive equity markets the outlook for the AUD is broadly positive, particularly in a scenario of higher commodity prices and interest rates, which are generally positive influences on demand for the AUD. At current levels, the AUD is in line with long-term averages against most major currencies.

Figure 2. Australian Dollar U.S. Dollar (Daily) Long Term
USD Per AUD Long-Term Exchange Rate



Source: FactSet, Perpetual Private

Australian and international equities

Australian equities

The Australian equity market continued higher over the quarter, however it lagged global equities, with the S&P/ASX 300 Accumulation Index delivering a 2.2% return for Q4 in AUD terms. It was a stronger quarter for growth stocks - up 3.4% - versus value stocks at -0.6%. However there was a strong recovery in value stocks at the back end of the quarter, up 4.6% over the month of December.

Domestic headlines were dominated by the new wave of Omicron cases, vaccination rates, rising inflation concerns, ongoing supply constraints, interest rate expectations and China's growth profile. The Australian equity market has been well supported by loose monetary and fiscal policy. The Australian share market also continues to benefit from good employment numbers and a strong corporate earnings outlook off the back of sustained low rates, rising Chinese demand for iron ore and the release of pent-up demand from households as they draw down on excess savings and spend more on travel as borders are re-opened.

Investors broadly have been more willing to look past the recent acceleration of Omicron cases, particularly given most of the population are now fully vaccinated and the Omicron variant is displaying milder symptoms and lower mortality rates than previous variants.

The best performing sector for the quarter was Materials (12.7%), led by a recovery in iron ore stocks on news that China may be easing its stance towards the real estate sector. It was closely followed by strong performances from the more defensive Utilities (11.4%) and A-REITs (10.1%) sectors, which are relatively well positioned for an inflationary environment. It was a more difficult quarter for the Energy sector (-7.5%) amidst falling oil prices and concerns demand may be subdued because of surging Omicron cases. The Information Technology sector (-4.6%) also struggled as valuations were hit by rising inflationary pressures.

Figure 3. Australian Shares
Australian Shares – Large Companies

Source: FactSet, Perpetual Private

Australian equities outlook

While the emergence of the Omicron strain is a new source of uncertainty, leading to higher market volatility as the cases roll in, it is not expected to derail the recovery. This recovery is underpinned by higher vaccination rates, sustained low interest rates and continued fiscal support from governments, combined with a spending rebound as households draw down on accumulated savings and travel more as borders are re-opened.

The outlook for inflation and any interest rates remains the focus. Central bank tapering, rising inflation and subsequent interest rate hikes are likely to spark higher bond yields which could weigh on equity valuations. This is particularly relevant for more rate-sensitive growth stocks which are typically priced on forecasts of higher future income streams.

Rising costs, higher rates and fiscal policy withdrawal may weigh on earnings growth. Global central banks have started to either increase interest rates or are forecasting rate hikes over the coming 12 months, although, in Australia RBA Governor Philip Lowe has indicated rates are not expected to increase next year with inflation still below the target range. He reaffirmed a focus on how quickly labour markets tighten as the economy recovers from lockdowns and when and by how much this leads to wage rises that feed expectations of further inflation.

Whilst inflation and interest rates are under close watch, the corporate earnings outlook for 2022 at this stage remains positive. Cheap money and excess liquidity continue to drive high valuations and support for corporate activity. The pandemic has presented many companies with the opportunity to shore up their balance sheets and raise capital where required to weather the storm. There are growing cost pressures for businesses but healthy consumer and business demand means businesses that are industry leaders with the pricing power to pass on these costs are better positioned to weather any inflationary pressures. Managers are also targeting reopening themes in share markets, including technology and a pick-up in travel given pent-up demand.

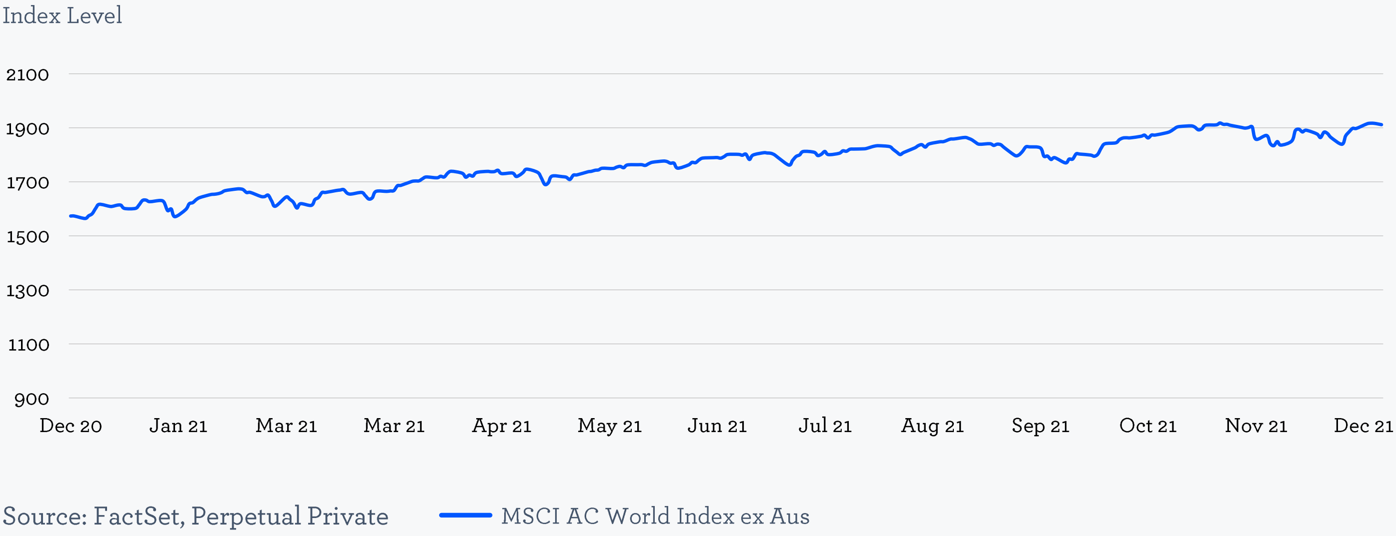
International equities

Global equities advanced in the fourth quarter, topping off an impressive year of gains despite market volatility. In AUD terms, the MSCI ACWI delivered 6.0% in Q4, closing out 2021 with a 25.8% return. US equities beat out their developed and emerging market peers, in local currency terms with the MSCI US returning 10.0% over the quarter and 26.5% for the 2021 year. US stocks have effectively doubled over the past three-years, delivering their strongest returns in absolute and relative terms over that time-period since the dot-com era. Ten of the 11 S&P 500 sectors gained in Q4, led by real estate, information technology, and materials. Energy and financials rose least, while communication services were flat. For a third consecutive quarter, growth companies and large caps topped their value and small-cap counterparts.

European equities were positive during the quarter, with the MSCI EAFE returning 3.9%. The region topped off a good year, returning 18.7% for 2021. European shares bested UK stocks in Q4, though the strength of the UK currency narrowed that outperformance in major currency terms.

Emerging markets equities trailed developed stocks, declining for a second consecutive quarter and delivering a negative calendar year result. Emerging Asia and Latin America trailed the broader index, whereas emerging Europe, the Middle East & Africa gained. China stocks turned negative in the fourth quarter for the first time since the start of the pandemic, while economic data there was disappointing. Chinese retail sales decelerated, fixed asset and property investment moderated and home prices fell for a third consecutive month in November.
Property developers Evergrande and Kaisa defaulted on debt obligations.

Figure 4. International Shares
(Local Currency Terms)



Source: FactSet, Perpetual Private

International equities outlook

Though inflation continued to accelerate in 2021, central banks and bond yields have been slow to respond amidst the global economic recovery post the COVID-19 crisis. We expect the big change in 2022 will be central bank withdrawal of monetary support. The US Federal Reserve accelerated its asset purchase tapering schedule and forecast three rate hikes in 2022, the Bank of England (BOE) hiked rates by 15 basis points (bps) in December, and the European Central Bank (ECB) announced plans to scale down pandemic-era asset purchases in 2022. Economies are also still grappling with the uncertain economic impacts of new Covid variants. Potential limits on activity, coupled with the tightening policy environment, prompted pundits to moderately downgrade 2022 global economic growth forecasts, and we expect more modest equities returns as a result this year.

A-REITS and G-REITS (Listed property securities)

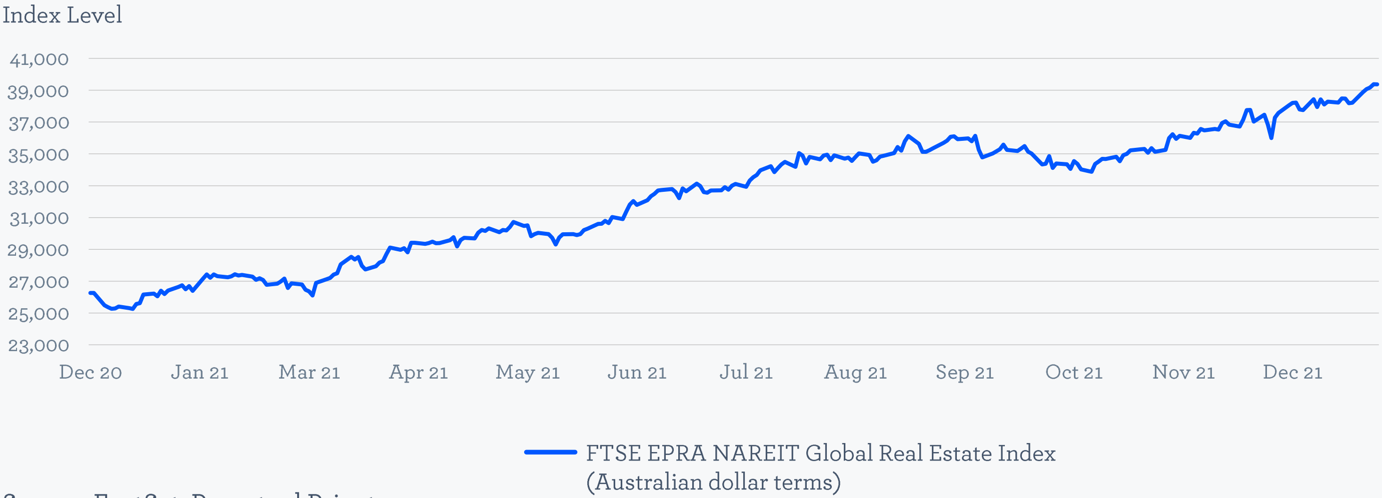
In AUD terms, Global Real Estate Investment Trusts (G-REITs) rose 9.5% over the quarter to the end of December 2021 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index rose by 10.2%, the higher return reflecting a stronger Australian dollar. In Australia, A-REITs rose 10.1% over the quarter. REITs overall had a particularly strong year, with both global and domestic benchmarks outperforming their broader equity market counterparts. Within the domestic market, the main themes were: i) pressure on retail REITs following the advent of the Omicron COVID variant and ii) increasing asset valuations, particularly in niche sectors such as childcare, neighbourhood shopping centres and self-storage. Globally, there were several 'take privates' in niche sectors, such as datacentres and self-storage. This is a trend we expect to continue.

Figure 5. Australian Real Estate Investment Trusts (A-REITs)
Property

Source: FactSet, Perpetual Private

Figure 6. Global Real Estate Investment Trusts (G-REITs)

Property



Source: FactSet, Perpetual Private

REITs outlook

The quarter saw the Omicron variant of COVID-19 establish itself as a driver of markets, however as we move into 2022 and the Omicron wave peaks, we expect markets to focus on the outlook for inflation and the path of interest rates, especially in the US. Despite this, COVID-19 continues to cause significant disruption; many corporates are still 'working from home', retail foot traffic remains below pre-COVID-19 levels and hotel vacancy rates, while improving, also remain below pre-COVID-19 levels.

Operating conditions have changed meaningfully for sectors like Hotels, Retail and Office. The themes we outlined across real estate markets remain intact:

- 'Right sizing' of shopfront real estate. We are now beginning to see 'private capital vehicles' being raised to acquire distressed retail assets, most notably in the US.
- Many corporates have embraced 'working from home' for their staff, and this will lead to a shift in thinking around office space requirements (right sizing, collaborative space, etc.). We expect strong demand for CBD real estate, while fringe and suburban office assets may suffer from lower demand.
- For hotels, while domestic travel may pick up in some regions, those hotels heavily reliant on business or international leisure travel will remain under pressure for the near future.

The market is now beginning to incorporate a scenario where central bank interest rates rise over the next 12 – 24 months. This may cause some volatility in markets. Those REITs with the ability to grow rental earnings or maintain development margins will be best placed to weather any rate rise. Debt will be an issue - we expect securities with more highly leveraged capital structures and poor interest coverage ratios to underperform. As always in property, sector and geographic allocation remain important with valuations and growth prospects differing across markets and segments.

We remain of the view that 'quality' real estate with access to capital markets remain the most attractive investments. The outlook for REITs varies meaningfully by sector and investors should consider the reliability of short-term earnings underpinning current sector level valuations and the valuations ascribed to individual assets. We expect returns more in line with our capital market assumptions for 2022.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -1.5% during the December 2021 quarter. At the end of December, the Australian 10-year bond yield was 1.68% versus 1.50% the previous quarter. The Australian 5-year bond yield moved aggressively, jumping to 1.34% versus 0.79% from the previous quarter, contributing to the loss in the index. This came off the back of a strong September inflation print and an improved unemployment rate in November.

In November 2021, Australian unemployment was 4.6%, down from 5.2%. The September CPI reading was high, rising 3.0% for the 12-months ending September 2021 and was pushed upwards by a 10.4% increase in Transport and a 6% rise in Furnishings, Household Equipment and Services. The trimmed mean - the preferred inflation measure for the RBA – was up 2.1% for the year ending December. That remains within the 2%-3% inflation target.

The RBA held their target cash rate at a historical low of 0.10%. In Philip Lowe's December statement, the RBA noted that leading indicators point to a strong recovery in the labour market and that inflation was still low (from a trimmed mean perspective). The RBA will continue its bond buying program, purchasing $4 billion of bonds a week until at least mid-February 2022.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) was flat for the period. Credit fared just as well, with the ICE Bank of America Global Corporate Index (Hedged) returning 0.0% over the quarter. High yield debt as measured by the ICE Bank of America High Yield Index (Hedged) fell slightly, returning -0.5% for the period.

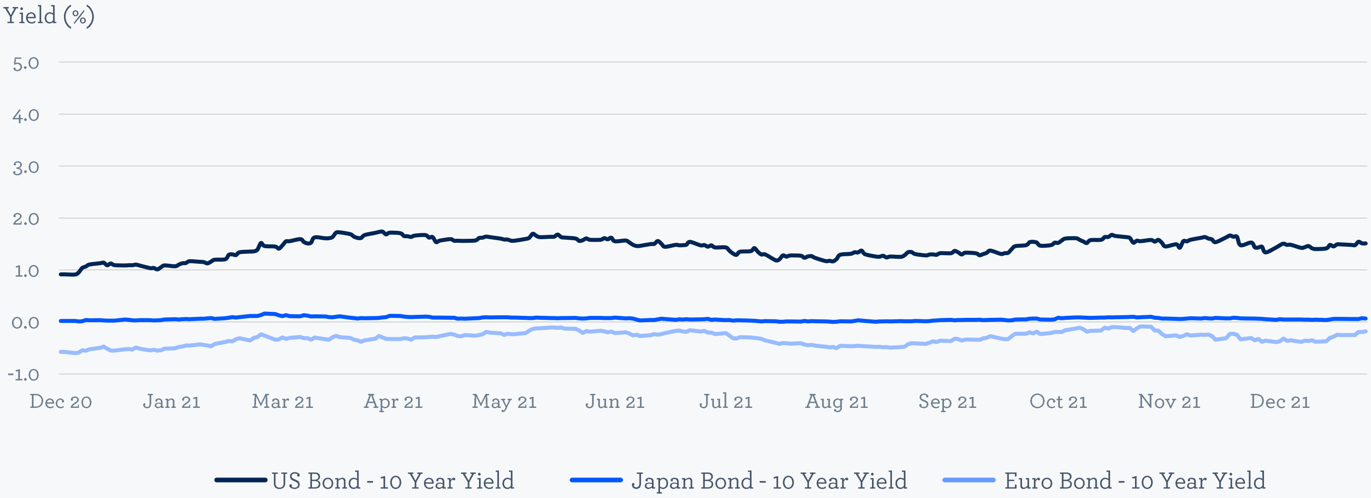
US inflation has been running hot for the past few months with CPI up 7% for 2021. The Personal Consumption Expenditures Price Index (PCE) - the Federal Reserve's preferred inflation gauge - was up 5.7% to November 2021, up from 4.4% in September. This led to the Federal Reserve pivoting late last year to focus on inflation and to "taper" its asset purchases. At the current rate of taper, asset purchases should finish in March 2022, opening the possibility of rate rises.

In the January 2022 testimony, Federal Reserve Chairman, Jerome Powell said that the economy is growing at its fastest pace in many years and that the labour market is strong. He also reiterated the Fed's dual mandate of maximum employment and price stability. The statement pointed out that the poor suffer more from price rises due to inflation and that the Federal Reserve will use its tools to stop inflation from becoming entrenched.
The Fed added that recent increases in inflation are due to transitory factors.

Figure 7. Australian Government Bonds

Source: FactSet, Perpetual Private * Note: Bond prices are inversely correlated with bond yields

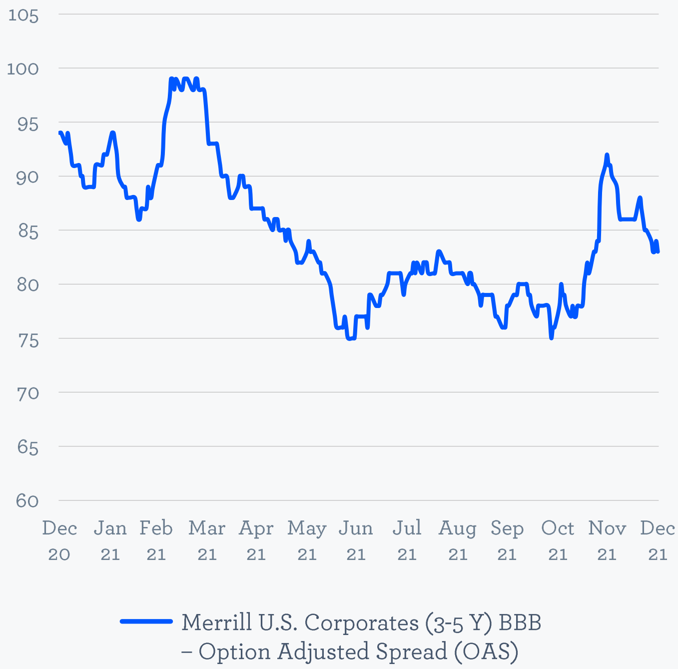
Figure 8. Global Government Bonds



Source: FactSet, Perpetual Private * Note: Bond prices are inversely correlated with bond yields

Figure 9. Global Credit Markets

Difference VS. US Govt Bonds



Source: FactSet, Perpetual Private. * Note: Bond prices are inversely correlated with bond yields

Fixed interest outlook

Inflation was the word of the year for 2021. After some very good economic news, strong fiscal support by most developed market governments and a sluggish recovery in supply chains, inflation expectations remained high for most of the year. Concern about policy overshoot and rate hiking at a quicker pace led to long bond yields jumping in early 2021. As long-term inflation/growth expectations stabilised and tapering became a reality, near-term bond yields rose in the US and Australia. As a result, 2021 was not a good year for bond markets. We expect headline inflation to remain high but moderate over time. We also expect continued volatility in bond markets.

In relative terms, strong GDP growth helped investment grade credit outperform government bonds. However, in absolute terms investment grade credit was hurt by the jump in the near-term bond yields and globally, investment grade credit lost value for the year. The Bloomberg Global High Yield Index, which is a rough measure of the high yield market, posted a 2.2% return for the year. That's a relatively strong showing for non-investment grade corporate bonds but much lower than its historical average. We remain positive on credit versus government bonds but acknowledge that at some point, higher government bond yields will make them more attractive than corporate bonds.

Perpetual's alternatives funds

Growth alternatives

Through the course of 2021 Private Equity, Real Estate and Infrastructure markets were buoyant, supported by unprecedented and coordinated fiscal and monetary policy action and the reopening of economies. Perpetual's Growth Alternatives programme continued to deliver strong performance throughout the latter part of 2021.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows and more recently, on infrastructure's inflation-hedging properties. Regulated and contracted assets remain well bid. Our decision to increase exposure to volume-linked infrastructure sectors through 2020 and 2021 is proving profitable as transactions in public and private markets support valuations, ultimately contributing to portfolio performance.

Within Private Equity, Leveraged Buy Out (LBO) returns were strong through 2021, with 'mega funds' outperforming mid-market funds. Pleasingly, we saw an increase in the pace of realisations (sales and other forms of profit taking) through the course of 2021, which will allow us to continue the repositioning of the Private Equity allocation towards equity-focused strategies. Near term, we expect to add to LBO and Co-Investment strategies with our preferred managers. With economies and borrowing costs remaining low (for now), we are optimistic that the transaction environment will remain stable, resulting in realisations across our existing holdings.

Sector dispersion remains wide within Real Estate markets, with Industrial and Logistics assets continuing to be well bid, while valuations for Retail and Hotel/Hospitality assets remain uncertain. During 2021, Office assets in Australia were well bid, particularly by foreign investors. Market dynamics continue to support East Coast markets, with CBD office being the most attractive on a relative value basis. However, office assets in markets where labour is more mobile have not fared as well. As with Private Equity, capital is beginning to flow more freely with economies reopening and this supports acquisition activity.

However, the nexus between availability of capital and valuations remains our focus. Our recent investments in income producing assets across major sectors (multi-family, industrial) in secondary cities in the US are showing early promise. During the quarter we finalised the sale of some legacy real estate debt positions, to facilitate the repositioning into exposures with higher expected returns.

Looking forward, we are focused on policy decisions made by central banks, especially the US Federal Reserve which we expect to have a large influence on markets through the course of 2022. We are responding to a market environment more akin to that prior to the GFC by adding Hedge Fund strategies which can navigate such environments. Our near-term focus is on credit focused strategies with limited interest rate duration and a strong emphasis on security selection.

Income alternatives

Debt focused alternatives strategies have performed slightly above our expectations for the year. Defaults post the COVID-19 recession have been limited and companies are experiencing improved cash flows. Those sectors where issues are prevalent are concentrated in Retail, Hospitality and Energy sectors.

We continue to look for opportunities and yield across sub-investment grade, private markets and structured product. Yields in investment grade and high yield markets are tight, pushed by the global appetite for yield. Leveraged Loans and Collateralised Loan Obligations (CLOs) offer a better return relative to risk. Ratings upgrades and lower expectations of default have helped Leveraged Loans and CLOs produce strong risk adjusted returns over the past few years. They've also benefitted from their floating rate structure in an environment where interest rates are expected to rise.

Our private debt deployment was relatively slow at the start of 2021 but came back to form by the end of the year. Deal flow in the market was good but our managers did not deploy capital at the same rate. The improved market conditions should help with liquidity and we hope to see the pace of realisations/refinancing in Private Debt markets pick up. Infrastructure debt remains challenging from an expected return perspective with demand from European financial institutions pushing pricing to a point where we do not see value.

More Information

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