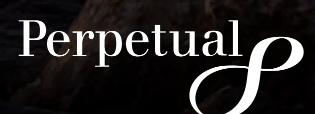
Perpetual Private | Quarterly Market Update

The guard changes

June 2022

Trust is earned.



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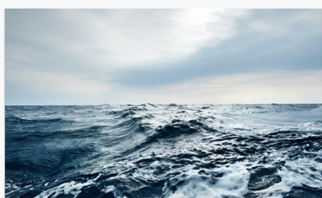

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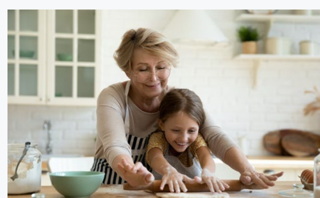

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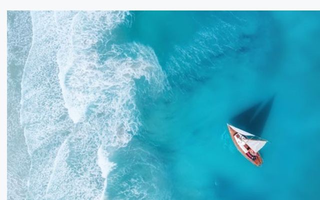

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Snapshot

The beginning of 2022 will most likely be remembered as a moment of transition for financial markets and economies alike.

A period when, after more than a decade of tepid inflation and increasingly easy monetary policy, there was a notable shift in conditions. A shift that is meaningful enough to indicate that the decade ahead is going to be different than the last, with policy makers and investors needing to reach for different tools to those which they have become accustomed.

Despite the importance of acknowledging this 'changing of the guard', it is not as ominous as it may seem. Sure, it means that adjustments will be required to our expectations and our considerations, however it presents opportunities and uncertainty in equal helpings.

We would suggest that, in time, the period following the Global Financial Crisis, through to now, will be recognised as being more the exception than the rule. Moving forward, we anticipate an environment akin to the decades prior to 2007.

Asset class performance – June quarter

Australian equities

Australian shares faced challenging conditions in the final three months of the 2022 financial year. Indeed, having shown relative resilience to conditions affecting international counterparts in the prior quarter, the period saw our local markets fall by 12.2%[1]. Against the major developed markets that we track, this was the second largest drawdown, behind only the technology heavy U.S. Nasdaq index (-15.1%).

As is normal during periods of adjustment, the simple broad market return, obscures significantly contrasting experiences for underlying sectors. On the positive side, the Utilities sector displayed defensive characteristics gaining 1.7%[2], followed closely by the Energy sector[3] (1.2%), buoyed by elevated oil prices. Information Technology[4] on the other hand, sustained significant pressure, consistent with its global counterparts, losing 26.3%.

[1] As represented by the S&P/ASX 300 index
[2] As represented by the S&P/ASX 300 Utilities (Sector) - Total Return
[3] As represented by the S&P/ASX 300 Energy (Sector) - Total Return
[4] As represented by the S&P/ASX 300 Information Technology (Sector) - Total Return

International equities

Global shares extended their drawdown from the previous period, at much the same pace, losing 7.9%[5] (-15.6% in the first 6 months of 2022). Having begun their devaluation earlier than our local markets, international equity markets displayed broad consistency across regions, tightly grouped around the global experience (most indexes delivered between -6% and -9% returns). Notable exceptions to this assertion, were the aforementioned Nasdaq index (more on this in the Global Economic Overview below), the Hong Kong focused Hang Seng index (+9.9%) and the UK FTSE100 (-3.0%). As a result of Chinese authorities delivering "persistent fiscal and monetary stimulus" [6], and the weakness in Pound Sterling performing devaluation by proxy. As with the previous quarter, companies with Value[7] characteristics, significantly outperformed their Growth[8] oriented counterparts. Indeed, despite the challenging environment, Value[9] displayed defensive characteristics, falling only 3.4% in a period where Growth[10] saw a return of -13.9%.

Real estate

Australian Real Estate[11] continued to negatively reprice in the 3 months ending 30th June, alongside its global peers, losing 17.5% and 9.4% respectively. In contrast with the varied fortunes of different sectors in share markets, returns for categories of Real Estate globally, were almost universally negative (the only exception being the 'Specialised' [12] group with a gain of 1.0%). The correlation across sectors, reflecting the influence of interest rates on the asset class. Notably, likely driven by the changing nature of work following remote working practices driven by lockdowns, the Office[13] sector saw the greatest drawdown, losing 18.2% in value over the period. On a regional basis, there were some bright spots, with Hong Kong[14] and Singapore[15] posting positive returns (8.5% and 2.9%) and Japan showing resilience with a loss of only 0.7%. Of course, these regions have different structural and monetary environments to most other regions, driving these outcomes.

Fixed income

As the asset class most immediately proximate to the changed monetary landscape, debt securities were not immune to the downdraft experienced across other asset classes. Global bonds[16], on a currency hedged basis, saw a decline of 4.7% over the quarter, and were down 9.3% over 12 months. Locally, the experience was similar with the broad Australian index down 3.8% and 10.5%, over 3 and 12 months respectively. Floating rate assets in the corporate credit sub-class[17], whilst being directionally consistent with its peers, had a substantially muted reaction, falling by only 0.1% in the quarter. This suggests that the driver of returns in the asset class was primarily the rise in interest rates, with credit spreads only minimally affected for high quality corporates.

Alternatives

Assets across both Growth and Defensive alternative asset classes have displayed their characteristic resilience in the face of investment market turmoil. Indeed, given their lower liquidity profile than that of public markets, we are encouraged that conditions are such that appealing transactions are likely to present, as portfolio decisions by other investors necessitate flexibility in the prices they can command.

[5] As represented by the MSCI AC World Index - Net Return
[6] China Stocks Approach Bull Market as Investors Catch Up on Gains, 27th June 2022, Bloomberg.com
[7] As represented by the MSCI World Index Value - Net Return
[8] As represented by the MSCI World Index Growth - Net Return
[9] As represented by the MSCI World Index Value - Net Return
[10] As represented by the MSCI World Index Growth - Net Return

[11] As represented by the S&P/ASX 300 A-REIT (Sector) - Total Return index
[12] As represented by the MSCI World / Specialized REITs -SUB - Net Return index
[13] As represented by the MSCI World / Office REITs -SUB - Net Return index
[14] As represented by the FTSE EPRA Nareit Hong Kong Net Return index
[15] As represented by the FTSE EPRA Nareit Singapore Net Return index
[16] As represented by the Bloomberg Global Aggregate (AUD Hedged) index
[17] As represented by the Bloomberg AusBond Credit FRN (0+Y)

Cash rate

Forced to respond to stubbornly high levels of inflation, the Reserve Bank of Australia (RBA) has had its hand forced, needing to tighten monetary conditions earlier and faster than it had anticipated only a few months ago. Whilst the Bank has faced criticism for this change in tack, we are somewhat sympathetic. As the Nobel Prize winning economist Paul Samuelson proclaimed "When the facts change, I change my mind. What do you do, sir?" (this quote is regularly but wrongly attributed to another economic heavyweight, John Maynard Keynes). The alleviation of inflationary pressures has failed to appear and the situation in Ukraine has further complicated. Having held its Cash Target Rate at an all-time low of 0.1% for 18 months, its Monetary Policy Committee have felt it necessary to increase rates 3 times in as many months, to where it stands today at 1.35%.

Aussie dollar

Having enjoyed the benefits of strong commodities markets, the Australian dollar (AUD) depreciated in U.S. dollar terms over the quarter by 8.1%, from 75c to 69c. Of course, some of this can be attributed to U.S. dollar (USD) strength, rather than simply being a case of Australian dollar weakness. Indeed, the argument of a strengthening USD is somewhat validated by the relatively stable relationship between the AUD against other major currency pairs. Against the Euro, the Japanese Yen and Pound Sterling, the Australian dollar deviated by less than +/- 2.5%.

Global economic overview

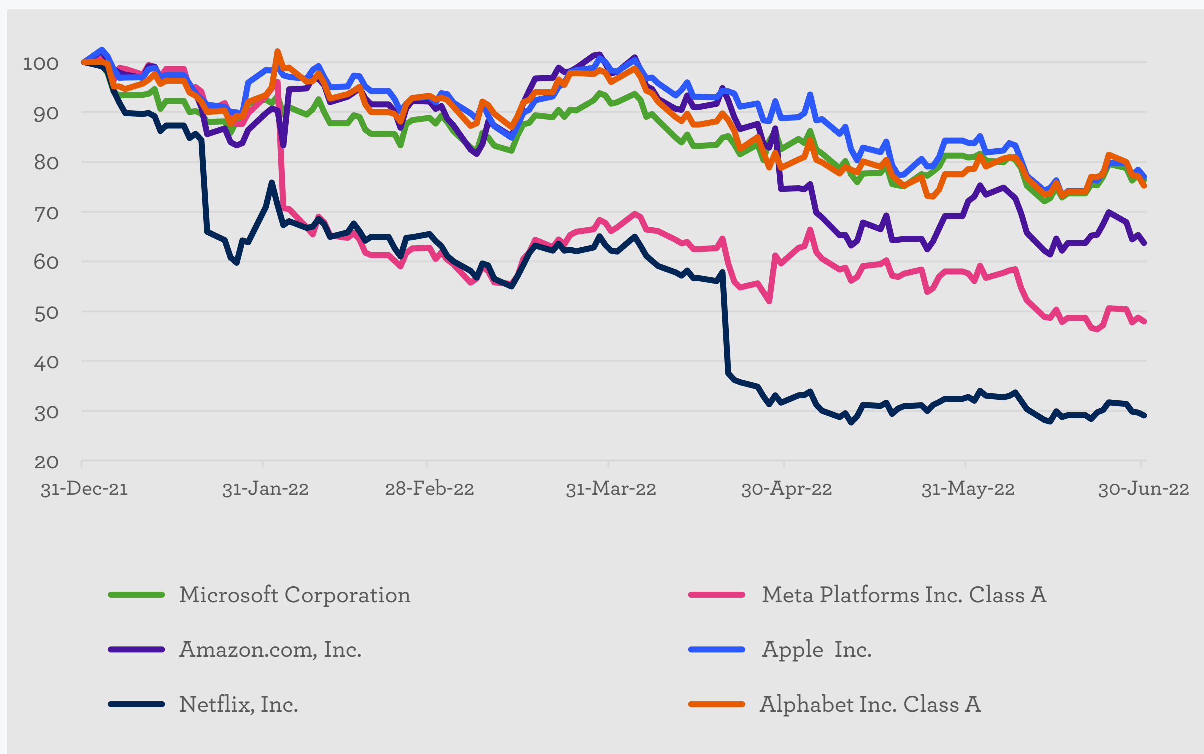
"All is flux, nothing stays still"
– Plato

A Changing of the Guard

Over a period when the world had come to terms with the emergence of the COVID-19 pandemic, financial markets have found themselves confronted by headwinds. Despite overcoming the sudden and dramatic disruption which 'The Great Lockdown' had brought about, financial assets of all types have experienced a phase shift; somewhat ironically, in part, driven by too much economic strength. Unemployment at or near record lows, strong household balance sheets and a resurgence of business activity across both goods and service sectors, have all coincided with real estate, equities and fixed interest assets experiencing meaningful drawdowns.

Having become accustomed to consistent and robust upward momentum in asset values, we now face an environment where returns will be lower and volatility higher. Whilst the impact has been across most asset classes, it is most apparent in the segment which has enjoyed the best fortunes over recent times, Technology. The NASDAQ index, which is known for its bias to technology, has gone from being the best performer, to the worst. In the first six months of 2022, the index has fallen by 25.2%. The "FAANGM" stocks (Facebook, Amazon, Apple, Netflix, Google and Microsoft) have experienced a sudden and meaningful change in sentiment (Figure 1. below). These companies, which have gone from strength to strength, for more than a decade, now find themselves facing shrinking valuation multiples, and no longer enjoy the overwhelming benefit-of-doubt they had been afforded by investors.

Figure 1. FAANGM Stocks – Change of Fortune



Source: FactSet, Perpetual Private

This though, is just the most obvious point of difference. The same drivers that are behind these changes, are being felt across most (if not all) markets, to varying degrees. Australian equities[18] have held up rather well but have still fallen by 10.4% this year. International equities[19], in part but not entirely, due to the higher exposure to technology, are down 15.6% over the same period.

Bond markets, traditionally considered to be defensive in nature, have not been immune. On a global basis[20], they have given up nearly 5% for each of the first two quarters of the year, resulting in a return of -9.4% year-to-date. Similarly, global listed Real Estate[21] has also suffered, losing 9.4% in 2022.

[18] As represented by the S&P/ASX 300 - Total Return index
[19] As represented by the MSCI AC World Index - Net Return
[20] As represented by the Bloomberg Global Aggregate (AUD Hedged)
[21] As represented by the FTSE EPRA Nareit Global Net Return index

The pertinent question we must ask ourselves, is 'what is the common factor here?'. The answer is both simple and complicated. On a simple basis it is interest rates, first and foremost. Why they have changed is less simple, though somewhat intuitive.

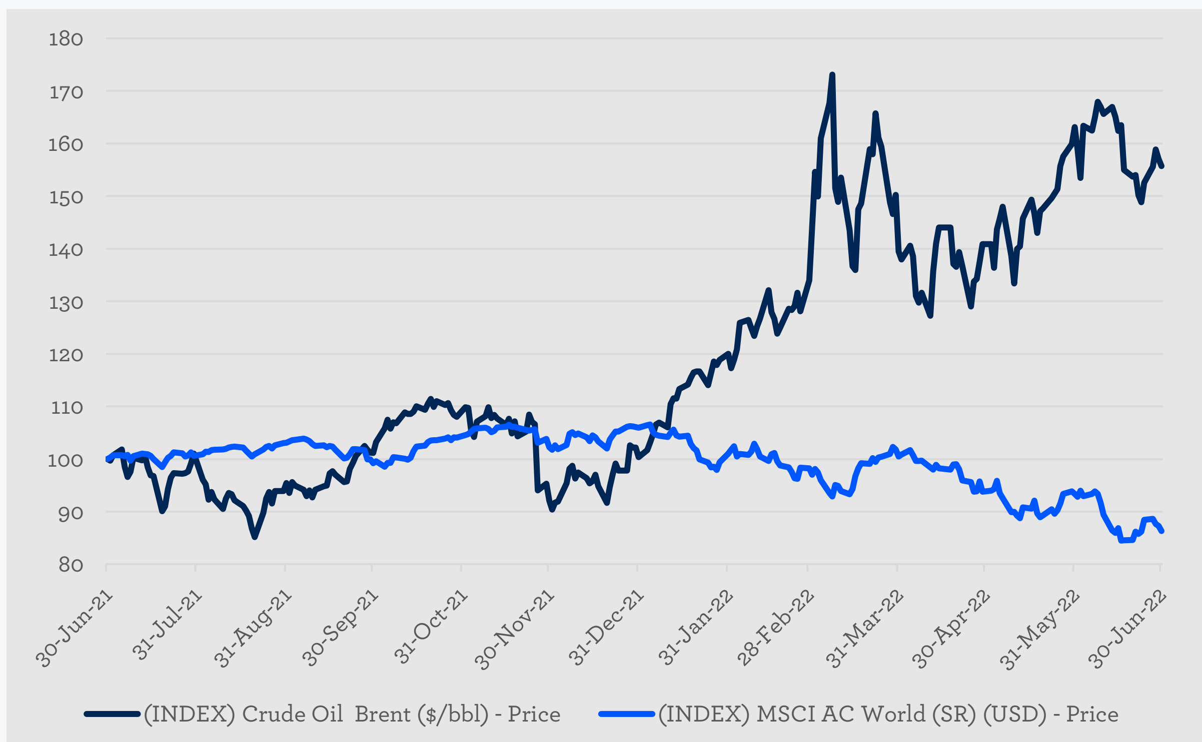
When we consider who drives interest rates, central banks (RBA, ECB, Federal Reserve, Bank of England etc) all share similar mandates of 'price stability'. Another way to say this, is that they are responsible for 'controlling inflation'. So, it doesn't take a leap to realise that it is central banks, true to form, who are working to address the inflationary environment, using their primary tool, monetary policy (in most instances affecting the cost of money in the form of interest rates). Indeed, the primacy of this mandate for these organisations, effectively means that they have little choice but to act in the face of persistent levels of inflation.

For most of 2021, as inflation began to rise, central bankers from around the world chose to 'look through' what they deemed to be transitory inflation, pointing to the disruption of global supply chains brought about by the pandemic as the driving force. Without the benefit of hindsight, the contention is entirely reasonable. With borders closed, lack of staff levels due to isolation requirements and differing medical mandates across the globe, supply disruption was not an imaginative construction.

As countries and businesses adapted to the reality brought about by COVID-19, supply chains have improved. What was not anticipated, was China's dedication to their 'COVID Zero' approach. As arguably the most important country for component parts of global trade, the ongoing constraint placed on their economy as a result of this policy has prevented much of the anticipated easing of this source of inflationary pressure.

Complicating matters (to put it mildly) is the conflict in Ukraine. Leaving aside the humanitarian devastation that the fighting has created, the impact on the global economy is inconvenient to say the least. With both Russia and Ukraine being significant producers of commodities, their inability to deliver exports as a result of sanctions and blockades respectively, has tightened markets for everything from fertiliser to oil, to grain (such as sunflower seeds and wheat). Mapping the rise of oil prices, against global share markets as we have done below (Figure 2. below), draws back the veil on the relationship between these factors. As is immediately apparent, the rise in oil prices at the start of the year almost directly coincided with a reduction in equity prices.

Figure 2. Oil vs Equities



Source: FactSet, Perpetual Private

A Drop in Pressure?

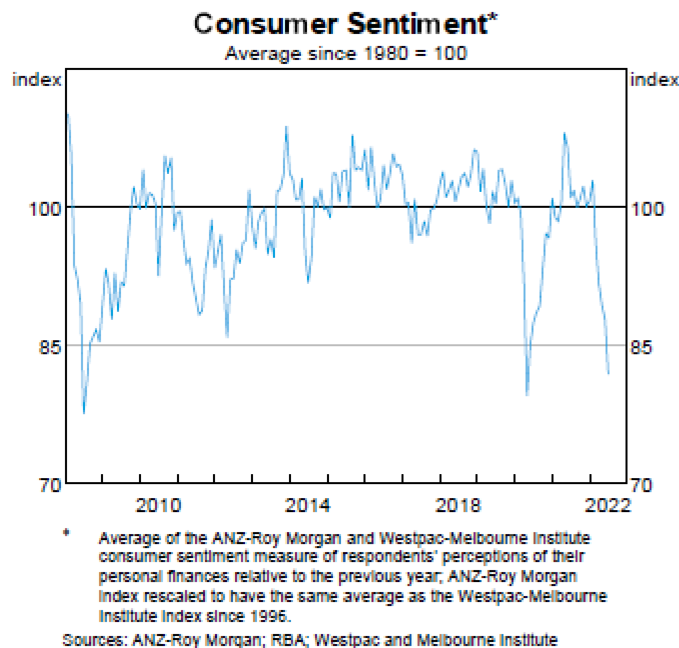
With the symbiotic relationship between inflation and interest rates, the headwinds which asset prices are currently facing, will remain until inflationary pressures reduce. For that to happen, one or both of COVID Zero and the invasion of Ukraine, need to improve.

Following communications from the Chinese Communist Party (CCP), we feel confident that they will remain committed to their policy. What is less certain, is how they seek to address it. For those who have followed the rise of the Chinese economy over the past few decades, a recognition of the ability of the Party to adapt to adversity is almost universal. Whilst we would never expect an admission of fault, we have witnessed adjustment and withdrawal of economic policies which have proven damaging or ineffective, almost without fail. As such, it seems a comfortable assumption that the policy will certainly remain in name, but its implementation will change and adjustments will be made to minimise the impact on the country's output, as much as possible. As such, we look optimistically at this area for the alleviation of some of the pricing pressure that trouble central banks.

On the Ukraine/Russia front, the path ahead is less clear. Despite assertions from the Russian state to the contrary, they will not be able to claim victory anytime soon, especially on any terms that they would have deemed acceptable just a few months ago. From an economic point of view, the fact that fighting, and indeed Russian ambitions, have become largely focused on the east and south of the country, provides some element of stability. Loss of life will certainly continue; however, some degree of economic normality may be able to return. At the point of writing, Ukraine's traditional shipping routes remain under blockade by the Russian navy, but the United Nations amongst others are attempting to negotiate 'humanitarian corridors' to allow shipments of grain to return to global markets. Questionable as the appropriation of Ukrainian produce in areas occupied by Russian separatists, it would help loosen market conditions for agricultural commodities. Though this avenue of hope is more challenged, its potential benefit can be described as 'non-zero'.

As a learned friend wisely reminded us, inflation involves the interaction of both supply and demand. Whilst in the current environment the supply factors are more identifiable and therefore more significant, demand is no less important. As a direct side-effect of the stimulatory policies of recent years, spending behaviour has remained robust in the face of adversity. With prices increasing and interest rates adding to the burden of debt for economic participants, perhaps 'demand destruction' will prove to be the path of least resistance. It is too early to determine if this will be the case but a fall in consumer sentiment (Figure 3. below) may be an early sign that this factor is already in play.

Figure 3. Consumer Sentiment



Source: RBA Chart Pack June 2022

Adversity Creates the Conditions for Opportunity

This analysis may appear to be overcast with negativity but that is not the case, or at least not the intention. When we consider the economic environment, we focus on the risks, knowing that the returns will 'take care of themselves'. Headwinds are not ideal but are not the end of the world either. Indeed, it is in bearing risk that we are able to expect reward. In a hypothetical scenario where all investments carry zero risk, we would expect them to attract identical and low levels of return. Navigating markets and investing wisely, requires the acceptance of a deviation from this scenario.

The 'change of guard' in economic conditions, is a change, but that is all. The tailwind that has been at the back of investments for more than 10 years, has become a headwind. That does not predicate a negative environment for investments, just one that is more nuanced. The common parlance of a 'risk-on' (or risk-off) environment has changed into 'which risk and when'.

Looking forward, the buoyant times of past can no longer be relied upon. That said, for a diversified portfolio, the sources of return can be expected to be more varied, with 'defensive' assets likely to again provide defensive attributes. We welcome this change, as it allows us greater opportunity to deliver attractive investment returns, whilst duly respecting that the level of jeopardy has increased. The path ahead is challenging but the returns that can be expected are appealing and commensurate.

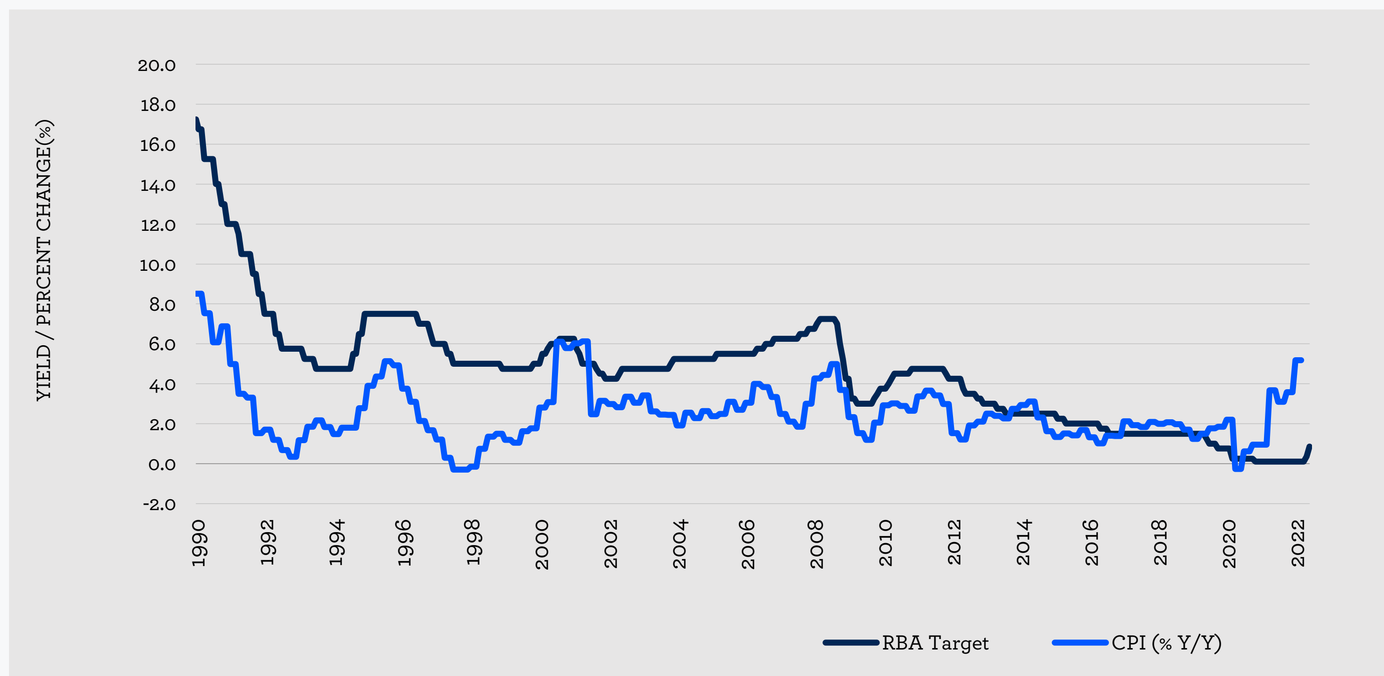
We encourage investors to work with their advisers to drive alignment between their circumstances and their strategy and avoid damaging knee-jerk reactions in emotive conditions.

Australian cash rate and dollar

Australian Cash Rate

The RBA has been forced by growing inflation expectations, to taking a hawkish approach to monetary policy. Having resisted for as long as it could it is now, alongside many of its foreign peers, taking a 'hard and fast' approach to increasing its Cash Target Rate. In apparent similarity to the way interest rates were reduced in the face of the pandemic, they are now being increased with comparable vigour. With the Target Rate at only 0.1% in April, we have now witnessed 3 increases in as many months, bringing the rate to 1.35%

In recognition of the imperative to tame inflation, whilst doing minimum damage to the economy, we believe it likely that the central bank 'communication policy' tool is being engaged. The implication of this is that forceful words are being deployed to tame 'animal instincts' in consumer behaviour, so that inflation expectations can be brought under control. Should inflationary pressures begin to meaningfully subside, we find it likely that the messaging and actions of central banks will be tempered. It is too early to have confident expectations as the how this will play out, so we will continue to monitor the situation closely.



Source: FactSet, Perpetual Private

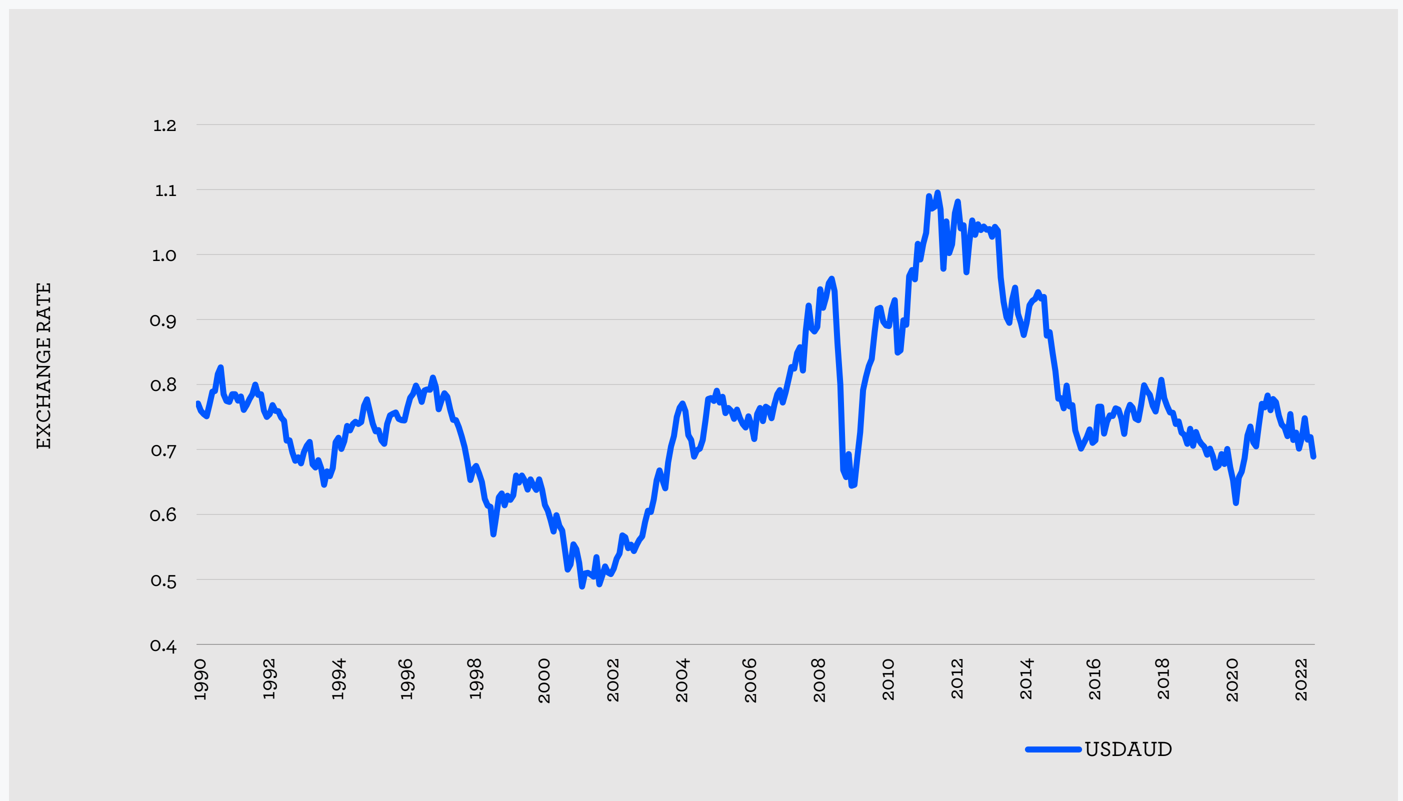
Australian Dollar

Having enjoyed some strength as a result of robust commodities markets, the status of the Australian dollar has paled in contrast to the U.S. dollar (USD). Over the period, the buoyant USD has benefited from both its status as a 'safe haven' and the anticipated trajectory of interest rate increases delivered by the Federal Reserve. This strength does not detract from the relative positives which can be attributed to AUD, it simply reflects the short-term factors which happen to be present in the current moment. Most other major currencies have experienced a similar depreciation in USD terms, whilst the AUD has remained relatively proximate. Over the quarter, it fell by 0.7% against the British Pound, 2.5% against the Euro, whilst gaining by 2.5% against the Japanese Yen.

Australian Dollar outlook

Despite large deviations over time, the Australian dollar (in U.S. dollar terms) does tend to be mean reverting over the long term. Having spent a significant amount of time trading above its 30 year average (75c) recent conditions leave it trading at an approximate 8% discount to this level. Looking forward, the trajectory of our currency will remain heavily dependent on the inflationary environment, and the contrasting strategies of central banks.

Figure 5: Australian Dollar U.S. Dollar (Daily)
Long Term



Source: FactSet, Perpetual Private

Australian and international equities

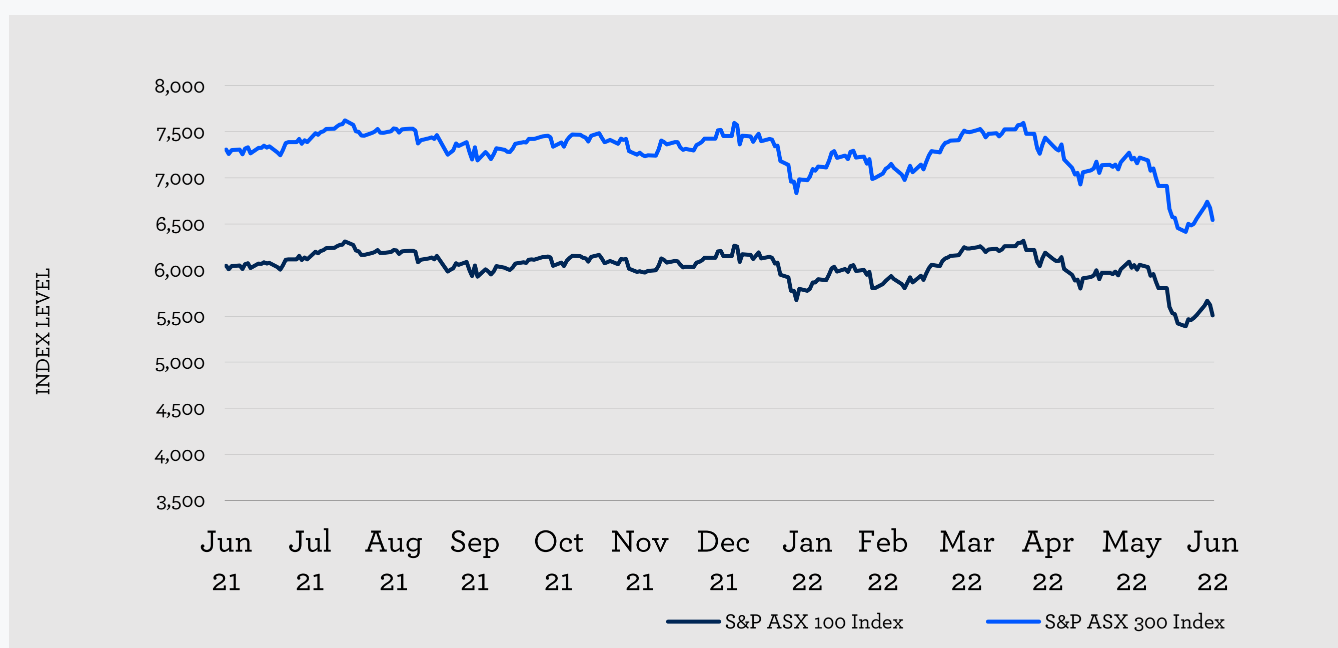
Australian equities

The Australian equity market reversed the modest gains made over the previous quarter, with the S&P/ASX 300 Accumulation Index falling 12.2%. This however, was in line to International Equities, with the MSCI All Country World Index (local currency) falling 14.2% over the same period. The relatively strong performance from our local market over the quarter has been largely driven by 3 key sectors; Energy (+29.8% year-to-date), Materials (-2.1% year-to-date) and Utilities (+16.1% year-to-date).

After significant disparity in returns between Growth stocks and Value stocks in Q1, the two styles delivered similar performance during Q2 with the difference between the two styles less than 2% (as measured by the MSCI Australia Growth and Value indices).

One of the most notable underperforming sectors in the market were 'Buy Now, Pay Later' stocks, with most falling significantly more than the broader market on concerns about the health of the consumer, as well as increasing regulatory risk across the sector.

Figure 6. Australian Shares
Large Companies



Source: FactSet, Perpetual Private

Australian equities outlook

Equity markets continue to focus on the many macroeconomic issues outlined above. While uncertainty remains around the outlook for economies globally, we expect volatility to continue. It is likely that macroeconomic issues will continue to drive equity markets for the foreseeable future. Our main areas of focus include:

- Central banks and the path and pace of interest rates – The rhetoric from the RBA indicates that despite softening macroeconomic data it is more likely, than not, for interest rates to continue increasing. Near-term this is likely to limit the upside of equities as markets begin to reassess appropriate forward-looking valuations. Furthermore, due to the structure of the Australian housing market, where consumers are more impacted by changes in short term moves in interest rates, we expect the Australian consumers to be sensitive to changes in rates.

- Potential weakness in the AUD – there tends to be two main drivers of the Australian Dollar relative to other major currencies; i) price of commodities and ii) interest rate differentials. Despite commodity prices remaining high relative to history (supporting the AUD), we are of the view that the RBA will not seek to keep pace the US Federal Reserve, and as such we expect some modest weakness in the exchange rate our currency will attract.

- The earnings outlook for corporates – despite falling equity prices, at the time of writing we have seen very little weakness in 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 corporate earnings.

Bringing these points together, we feel relatively more comfortable with those exposures that have a larger component of offshore / U.S. dollar earnings and expect greater variance in the performance of different sectors, for example, commodities may continue to do relatively better than Consumer Discretionary.

International equities

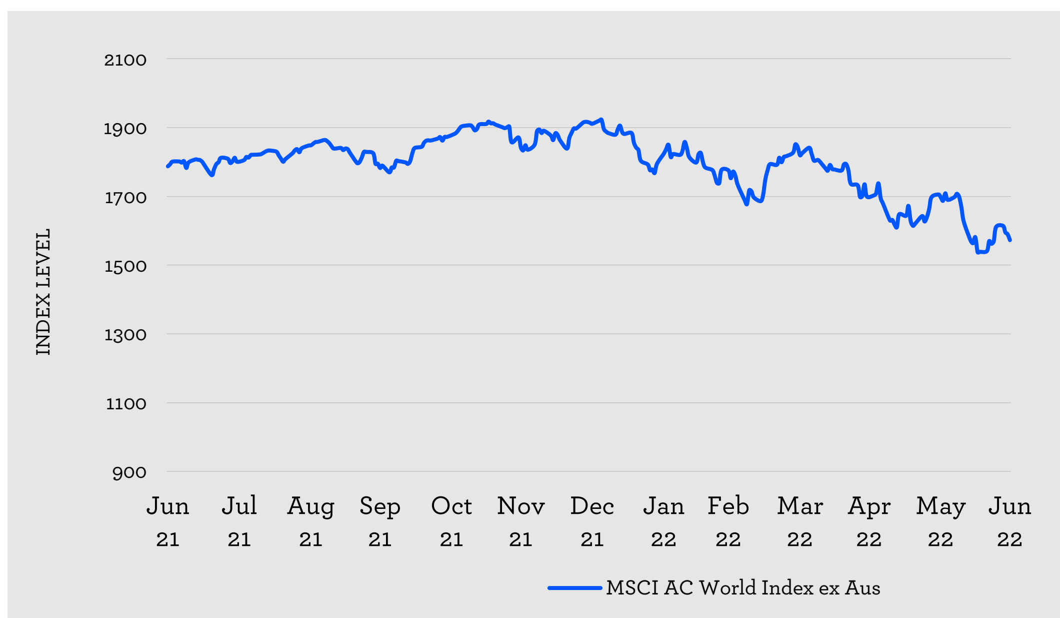
Global equities continued their downward trajectory in the second quarter of 2022, returning -7.9%[22]. Markets continue to be focused on the macroeconomic issues of inflation, interest rates, and more recently the threat of a recession which is coupled with China's 'Zero COVID' policy to some extent.

Across the market, sector performance varied widely, with Consumer Discretionary, Information Technology, and Communication Services significantly underperforming the broader benchmark. The best performing sectors; Energy and Utilities delivering small positive returns.

In local currency terms, Emerging Markets fared marginally better than Developed Markets. Small Caps and Technology stocks are now comfortably in bear market territory after reversing gains delivered late in the first quarter.

[22] As represented by the MSCI AC World Index - Net Return

Figure 7: International Shares
(Local Currency Terms)



Source: FactSet, Perpetual Private

International equities outlook

Equity markets continue to focus on the many macroeconomic issues outlined above. While uncertainty remains around the outlook for economies globally, we expect volatility to continue. It's likely that macroeconomic issues will continue to drive equity markets for the foreseeable future. Our main areas of focus include:

- Central banks and the path and pace of interest rates – The rhetoric from several central bank indicates that despite softening macroeconomic data it is more likely than not that interest rates will continue to rise. Near-term this is likely to limit the upside of equities as markets begin to reassess appropriate forward-looking valuations.

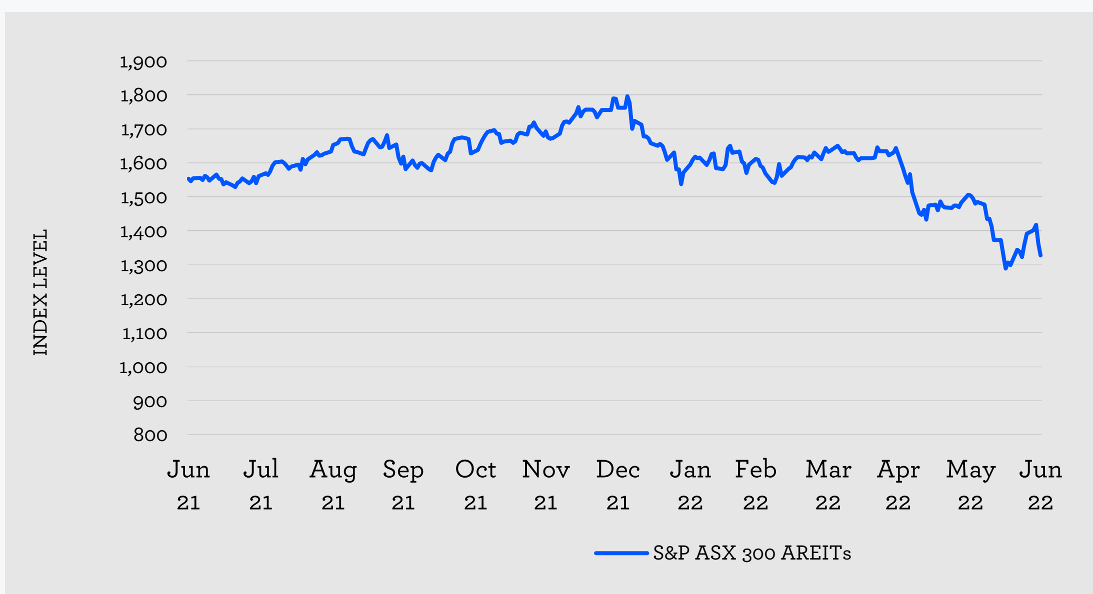
- The earnings outlook for corporates – Despite falling equity prices, at the time of writing we have seen very little weakness in the earnings outlook for corporates. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which together will likely weigh on consumer spending, and subsequently corporate earnings.

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

In Australian dollar terms, Global Real Estate Investment Trusts (G-REITs) fell 9.9% over the quarter to the end of June 2022 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency-hedged basis, the FTSE EPRA/NAREIT Developed Index fell by 15.6%. In Australia, A-REITs fell 17.5% over the quarter. Driven by increasing real yields in bond markets. Those REITs with conservative balance sheets, long weighted average lease expiry (WALE) in less cyclical, sectors generally outperformed.

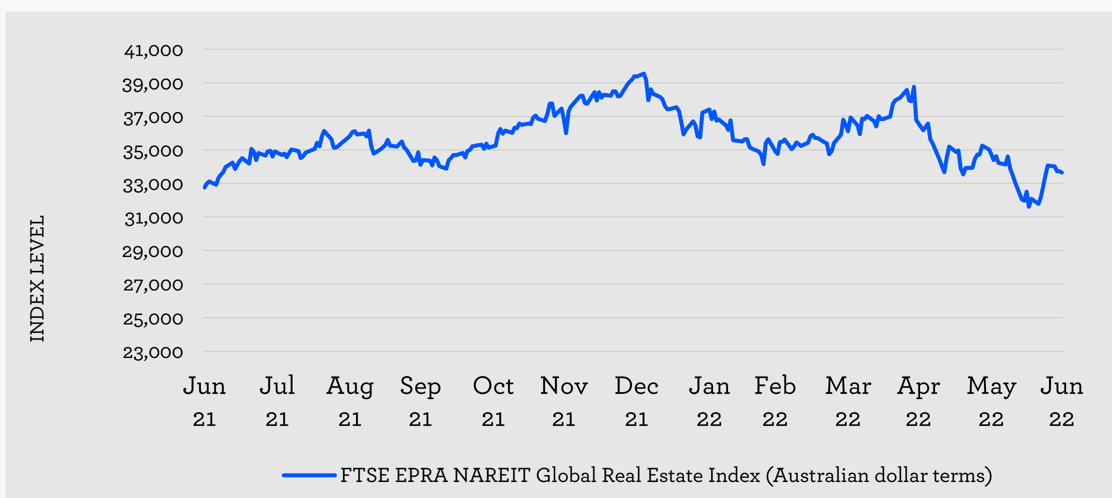
Capital raising activity slowed materially during the quarter, and transaction volumes were softer as a result of uncertainty around the cost of debt. Despite the volatility in markets, we did see asset level valuations increase as at 30th June 2022, although most increases were relatively modest.

Figure 8: Australian Real Estate Investment Trusts (A-REITs)
Property



Source: FactSet, Perpetual Private

Figure 9: Global Real Estate Investment Trusts (G-REITs)
Investment Trusts



Source: FactSet, Perpetual Private

REITs outlook

The previously flagged shift in focus towards inflation and monetary policy continued, with a greater emphasis on the 'pace and path' of central bank interest rates. We expect this to be a focus, over the remainder of 2022, with the added element of the recent inversion of the US yield curve (recession indicator) keeping investors on their toes.

Operating conditions have changed meaningfully for sectors like Hotels, Retail and Office, with the operating and earnings environment remaining uncertain. The themes we outlined across real estate markets remain intact:

- 'Right sizing' of 'shop front' real estate. We are now beginning to see 'private capital vehicles' being raised to acquire 'distressed' retail assets, most notably in the US (although fundraising has slowed materially).
- 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 Premium and A-Grade CBD real estate as corporates use the amenities to encourage staff back to the office.
- For Hotels, while domestic travel may pick up in some regions, those hotels which are heavily reliant on business or international leisure travel will likely remain under pressure for the foreseeable future.

The market is now beginning to incorporate a scenario where central banks lift interest rates faster than previously anticipated. This is beginning to have an impact on the cost of debt for refinancing and acquisitions. Those REITs with near term debt expiry are likely to face higher ongoing servicing costs resulting in a drag on earnings. We expect those securities with more highly leveraged capital structures, and poor interest coverage ratios to underperform. Sector and geographic allocation remain important with valuations and growth prospects differing across markets and segments.

Our 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 remain the most attractive investments. 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. Despite the recent drawdown in markets, in our view, REITs are only trading marginally below fair value.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -3.8% during the June 2022 quarter. Australian government bond yields increased aggressively in the last quarter and the yield curve flattened on expectations of a committed RBA tightening cycle. At the end of June, the Australian 10-year bond yield was 3.7% versus 2.8% the previous quarter. The Australian 5-year bond yield experienced a strong move, jumping to 3.3% versus 2.5% from the previous quarter.

In May 2022, the Australian unemployment rate was 3.9%, unchanged from the month prior. The March reading for CPI was high, having risen to 5.1% for the 12-months ending March 2022, due to strong demand combined with supply disruptions. The Trimmed Mean, the RBA's preferred inflation measure was 3.7% for the year ending March, much higher than the 2%-3% RBA inflation target.

The RBA has embarked on a path of significant monetary tightening, for the first time in decades, having kept rates at historical lows during the COVID crisis. In May, rates were increased by 25bp. Then in June, added another 50bp, bringing the target cash rate to 0.85% for the quarter. Past the end of the period, in early July, the RBA added yet another 50bp, bringing the target cash to 1.35%.

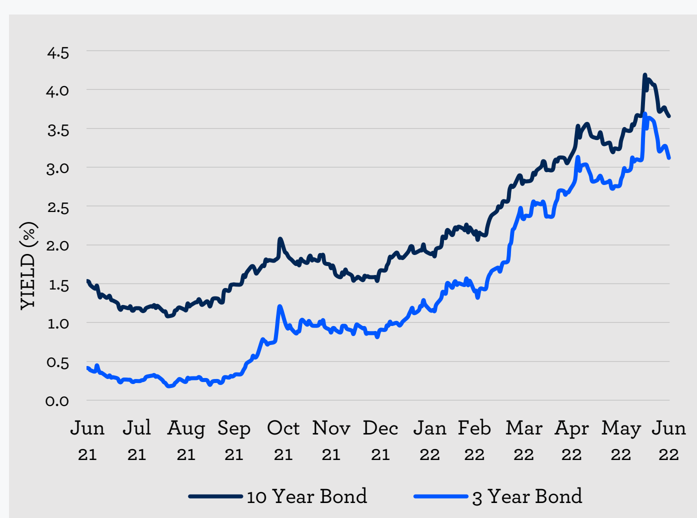
On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned -4.7%. Credit underperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning -6.9% over the quarter. High yield debt as measured by the Bloomberg Global High Yield Index (Hedged) did very poorly, returning -11.2% for the period.

US yields increased over the quarter while the yield curve flattened. The US 2yr yield rising to 2.9% from 2.3% 3 months prior and the US 10yr rose to 3.0% from 2.3% over the same period. US inflation has been running hot for the last few months with CPI up 8.6% for the 12 months to the end of May 2022. The Personal Consumption Index (PCE), the Federal Reserve's preferred inflation gauge was 6.3% over the same period after reaching a high of 6.6% in March.

The US Federal Reserve began tightening in March 2022 by increasing its target rate by 0.25%, followed by a 0.50% move in May. In June 2022, they became more aggressive, adding 0.75%, with the target rate finishing the quarter at 1.50% to 1.75%.

Figure 10. Australian Government Bonds

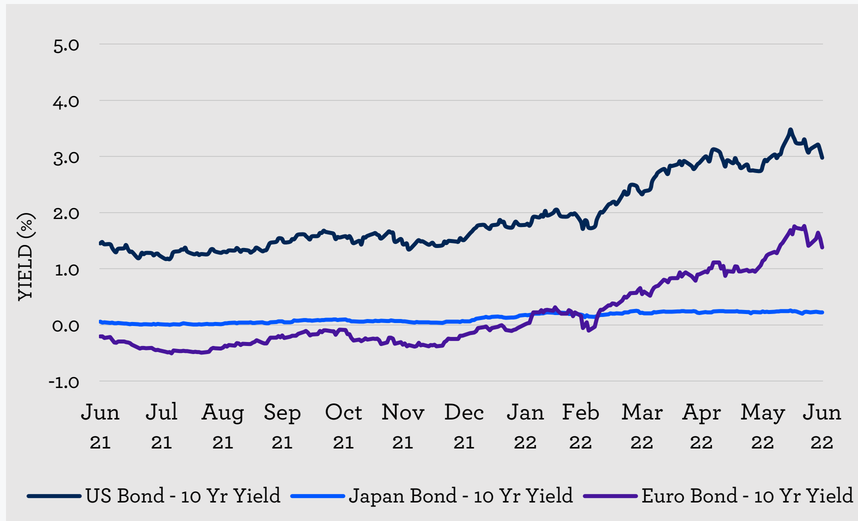
Yield (%)



Source: FactSet, Perpetual Private

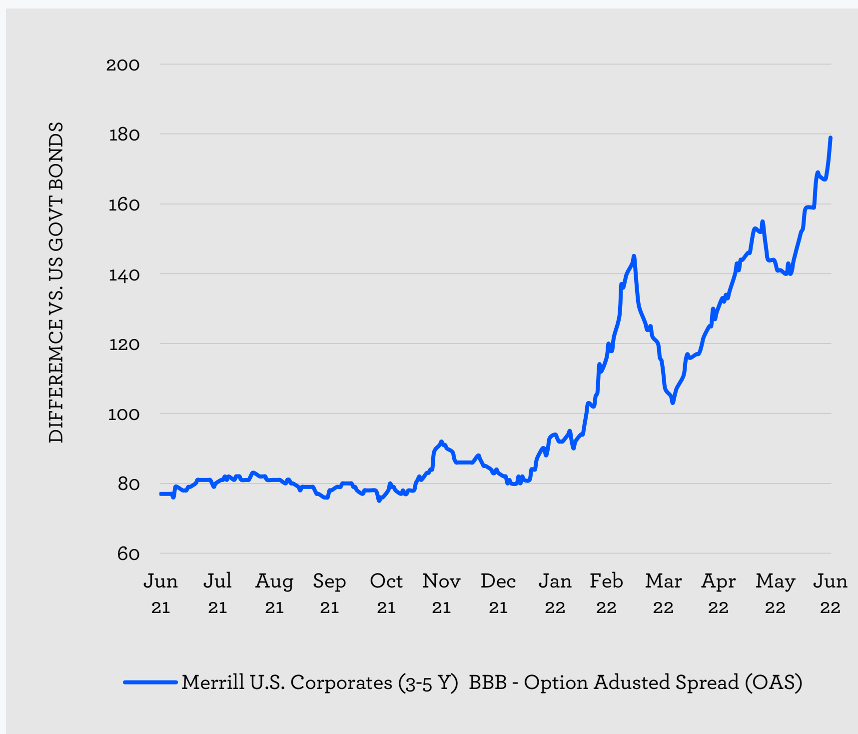
* Note: Bond prices are inversely correlated with bond yields

Figure 11. Global Government Bonds



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

Figure 12. Global Credit Markets



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

Fixed Income Outlook

Fixed interest looked "cheap" a year ago and even "cheaper" at the start of 2022, only for it to get even more "cheap" by mid-June. Given the high volatility in the market we are more likely to wait for the data rather than pre-empt it.

Inflation in the US remains high but is lower than the quarter prior. While one quarter does not make a trend, we are continuing to monitor US inflation prints to look for signs of it normalising. Supply is still constrained as evidenced by higher fuel and food prices. This is exacerbated by strong US wages growth, with the average annual earnings for all private industries increasing 5.3% for the 12 months to May 2022. There are signs that US wages growth is slowing but again, we wait for the data.

Australian inflation is also high and there are signs that it will continue to rise given the fall in the AUD and tightening supply of demand-inelastic items such as food and petrol. Wages growth in Australia is rising but its rate of growth is tame when compared to the US. The Australian Wage Price Index rose 2.4% for the year ending March 2022. Wages growth and very high household debt may prevent the RBA from hiking rates as aggressively as the Federal Reserve.

After outpacing the Government Bond market, credit markets have finally had their comeuppance, with the ICE BofA Global Corporate and Bloomberg Global High Yield indices strongly underperforming government bonds for the year. Things could get worse from here if downgrades accelerate and we see higher defaults due to a recession. We do believe that outside of some pockets of weakness (eg. retail, low margin tech), most US corporate balance sheets are in reasonable positions which may present attractive buying opportunities in the future.

Perpetual's alternatives funds

Growth alternatives

Despite continued market volatility in listed and tradable markets during Q2 2022, private markets have carried on with limited fanfare. Transaction volumes across all asset classes (Private Equity, Real Estate and Infrastructure) continued to soften over the quarter on the back of market volatility, rising and high inflation, and rising cost of debt. Despite the drawdown in listed markets, valuations across private real estate and infrastructure are broadly unchanged (short of any company specific issues coming to the fore). We expect to see some valuation weakness within private equity, and specifically seasoned venture capital.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. 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. Despite recent upward moves in the long bond rates, our exposures appear to be well insulated with most external valuations carried out on a 'through the cycle' basis resulting in limited movements in valuation assumptions.

Within Private Equity, LBO transaction volumes have slowed, reducing the pace of realisations in the quarter. We expect the pace to continue to moderate through the year, as a result of a clear upward shift in borrowing costs for private equity sponsored transactions. Given the current macroeconomic uncertainty, we do not expect this trend to reverse near term. Consequently, those transactions which are occurring, are doing so at softer valuations. Holding values are also beginning to retreat, with the largest expected pockets of weakness likely to be in seasoned Venture Capital (VC). The longer the interest rate tightening cycle is, the deeper the expected reversal in VC valuations is likely to be.

Sector dispersion remains wide within Real Estate markets. Office assets in Australia remain well bid, particularly by foreign investors. Dynamics continue to support east coast markets, with CBD office being the most attractive on a relative value basis. We are beginning to see large, high quality retail centres transact. However, office assets in markets where labour is more mobile has not fared as well. 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.

Market dynamics have changed meaningfully during the quarter (inflation, path and pace of interest rates, weakening economic environment), which in our mind warrants a shift in thinking and outlook. We continue to focus on policy decisions made by central banks but have incorporated a deeper focus on the health of the 'real economy'. We are responding to what we expect to be a market environment more akin to that of the environment prior to the GFC (interest rate cycles, and greater focus on fundamentals) by adding hedge fund strategies with a focus on security selection, and income producing real estate and infrastructure.

Income alternatives

Non-investment grade credit performed poorly for the quarter with the High Yield and Leveraged Loan markets producing negative returns. After beating both government bonds and investment grade bonds to March 2022, High Yield lived up to its name and provided a high yield at the end of June as investors priced in the chance of higher defaults. High Yield spreads reached 10-year lows at the start of 2022, with the ICE BofA US High Yield Index option adjusted spread hitting 3.1%. By the end of June, the same measure had increased to 5.9%.

Broadly, syndicated loans priced lower at the end of the quarter due to higher volatility in yields and a fall in CLO issuance, leading to a loss of demand. According to the S&P/LSTA leveraged loan index, the market suffered its biggest loss since the COVID crisis.

We expect most private debt to have lower marks because of the higher comparable spreads in the broadly syndicated market. Whilst CLO equity posted a loss for the quarter, it performed well over the year.

Going forward, an increased number of downgrades by ratings agencies and the possibility of higher defaults will weigh on High Yield, broadly syndicated loans, CLOs and private debt market valuations over the next 6-12 months.

Our Income Opportunities Fund, has been holding high levels of cash over recent months. Coming into 2022, it held a little over 25% in cash, in anticipation of its first direct property investment. Post that investment, cash levels fell to approximately 10% of the fund. The higher levels of cash have worked to moderate some of the losses from non-Investment Grade markets.

Over time, the Fund expects to reduce its exposure to 1st lien unlevered private debt in favour of more liquid securities. This will help in meeting its hedging and distribution requirements. Potential new investments may include Convertibles, Investment Grade structured products, High Yield or more broadly syndicated loans.

We maintain our search for interesting private strategies that are able to produce a source of income with a low correlation to corporate debt. Potential private strategies include Insurance and Asset Backed Debt. A repricing of corporate private debt may make this category attractive in the immediate future.

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