Perpetual Private | Quarterly Market Update

Putting the genie back into the bottle

September 2022

Trust is earned.

Perpetual

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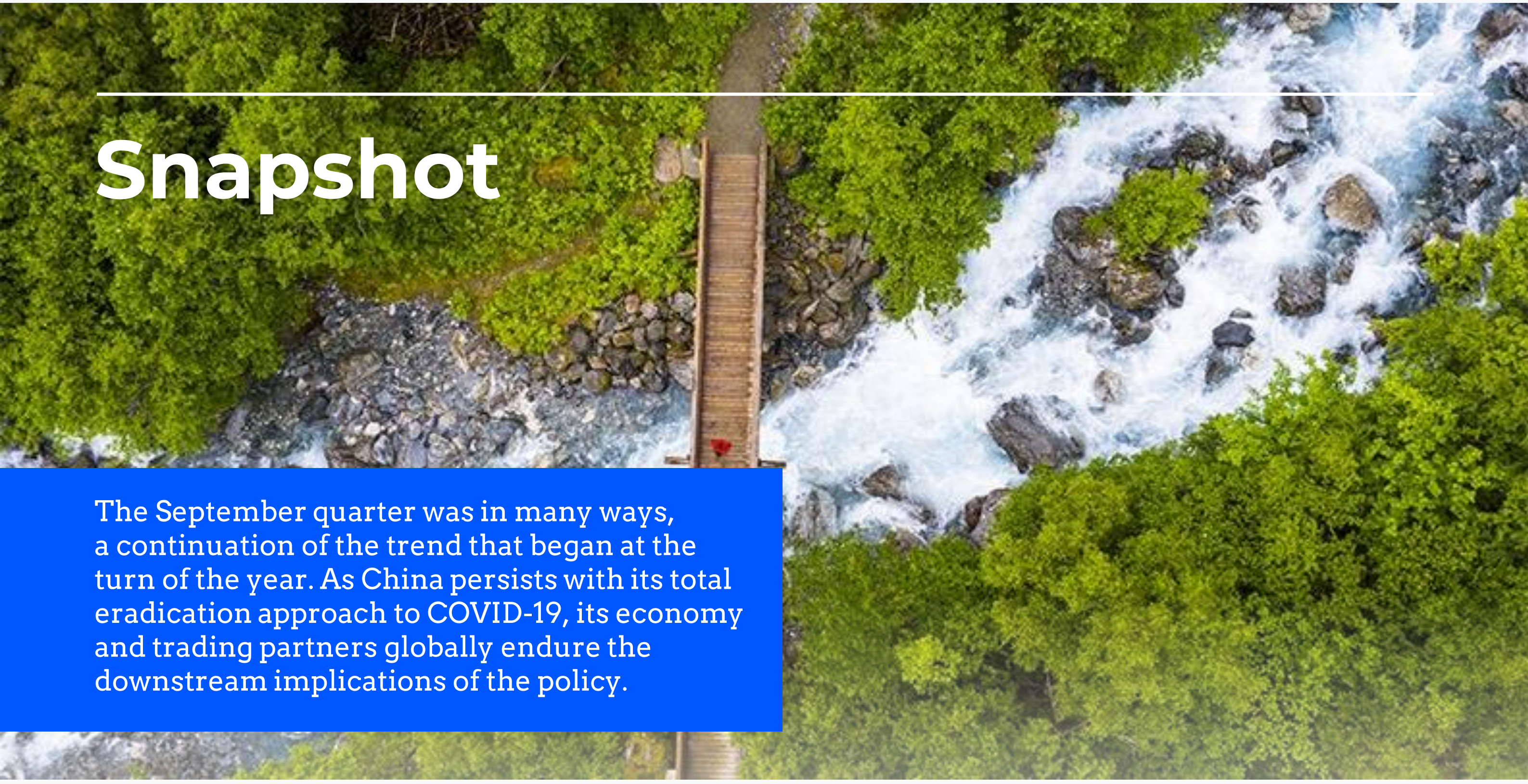


Snapshot

The September quarter was in many ways, a continuation of the trend that began at the turn of the year. As China persists with its total eradication approach to COVID-19, its economy and trading partners globally endure the downstream implications of the policy.

That is, continued disruptions to global supply chains, whilst dealing domestically with rolling economic blackouts as areas and businesses face sudden and enforced isolation, in response to virus outbreaks.

The conflict in Ukraine continues to fill news streams, constrain the supply of important commodities and concern us all with the sombre humanitarian implications. Having found a degree of stability for some months, the situation has again become dynamic as Ukrainian counterattacks regain territory and the mobilisation of Russian citizens reflect increasingly desperate measures in response.

On a purely economic front, the tightened supply environment continues to increase the difficulty for central banks to bring inflation under control, predicating continued policy rate increases.

In the seeming absence of feedback loops which might amplify any of the prevailing adverse conditions, it is most likely that we are working our way through a period of transition. This will certainly drive higher levels of volatility, whilst opening the door to increased levels of opportunities for vigilant investors.

Asset class performance – September quarter

Australian equities

Domestic shares experienced a quarter of 'two halves', gaining 9.1%[1] to the 17th August, before retracing almost that entire amount, delivering a gain of just 0.5%[2] over the three months.

This outcome masks the differing fortunes of underlying industry sectors, with Energy gaining 5.8%[3] in a reflection of high oil and gas prices, whilst the same factors lead Utilities to give up 12.5%[4] as margins were squeezed by higher input costs. It is notable that of the 11 primary industry sectors in Australia, only Energy (oil, gas, coal, etc) and Materials (metals and mining) have delivered positive returns (27.0% and 9.8% respectively) over the 12 months to the end of September.

As would be expected given a more challenging economic environment, smaller companies have struggled. Whilst only losing 0.5%[5] over the quarter, their value fell by 11.2% in September alone and have underperformed their larger counterparts[6] by 14.6% over 12 months.

[1] Measured by the S&P/ASX 300 index
[2] Measured by the S&P/ASX 300 index
[3] Measured by S&P/ASX 300 Energy (Sector) index
[4] Measured by S&P/ASX 300 Utilities (Sector) index
[5] Measured by S&P/ASX Small Ordinaries index
[6] Measured by the S&P/ASX 300 index

International equities

In local currency terms, the major share indices we monitor, all closed the quarter having delivered negative returns. With Japanese markets demonstrating a degree of resilience, having fallen just 1%[7], there is a notable contrast with the Hong Kong equities market, which saw a 20.2%[8] drawdown.

From an Australian dollar point of view the outcome is softened, as exchange rate changes for all but the UK[9] had the effect of counterbalancing the moves. U.S. dollar strength, in particular, resulted in the S&P 500 and Nasdaq indices gaining 1.6% and 2.8% respectively (down 5.0% and 3.9% in USD terms).

Considering global industry sectors, Energy[10] as it was locally, was the leading gainer with a return of 5.3%. Indeed, Energy was also the leading sector on a 12-month basis, gaining 30.6%. At the low end of returns, was Communication Services which fell 8.0%, and is the sector which has declined the most over 12 months, giving up 30.4%. This is a significant reversal of fortunes, as the sector includes Meta (formerly Facebook), Alphabet (formerly Google), Disney and Netflix, who have all enjoyed years of market leading gains.

Despite maintaining a significant lead on a 12-month basis (-1.9%[11] vs -17.9%[12]), Value lagged Growth by 2.3% over the quarter.

Real estate

Global real estate assets continued to experience the effects of a tightening monetary environment, whilst portfolio effects saw flows out of the asset class into other income producing assets.

Here in Australia, listed real estate assets[13] devalued by 6.9%, extending their drawdown over 12 months to 21.1%.

On a global relative basis, Australian property assets have held up reasonably well, when you consider the experience of their European counterparts, losing 16.5%[14] over the quarter and 38.3%[15] over the year. In terms of regions which have retained a measure of stability; Japan, Singapore, Hong Kong and the USA[16] have returned -0.9%, -4.0%, -5.2% and -4.0% respectively. Over 12 months however, only Hong Kong (2.0%) and Singapore (0.1%) gained in value.

Of the global real estate sectors, only Hotel & Resorts delivered positive returns over three and 12 months, gaining 8.9% and 10.2%; this post-pandemic rebound was mirrored by the reversion of Health Care assets, who gave up 13.3% over three months and 16.3% over the year.

Fixed income

With central banks around the globe increasing interest rates, fixed income assets continue to revalue to reflect the new monetary reality. Despite early hope that slight reductions in contributors to inflation may allow for a less hawkish demeanour from monetary authorities, public statements such as that of Federal Reserve Chairman Jerome Powell from the Jackson Hole Symposium at the end of August, quickly put paid to that.

Over the quarter, fixed income assets, as represented by the Bloomberg Global Aggregate index, lost 3.7% of their value. Local indices were somewhat more stable over the period as the RBA's messaging, would appear to have appropriately guided markets. Despite falling by 9.2% over 12 months, local credit assets[17] found support over three months, receding by only 0.1%.

Alternatives

Alternative assets have broadly performed well in the face of more dramatic moves in traditional asset classes. Benefiting both from high degrees of manager skill and in many cases, higher degrees of influence over underlying assets, both our Income and Growth assets have contributed strongly to diversification benefits within our portfolios. Indications are that the current investment environment is producing attractive opportunities at valuations that would have been unobtainable in recent years.

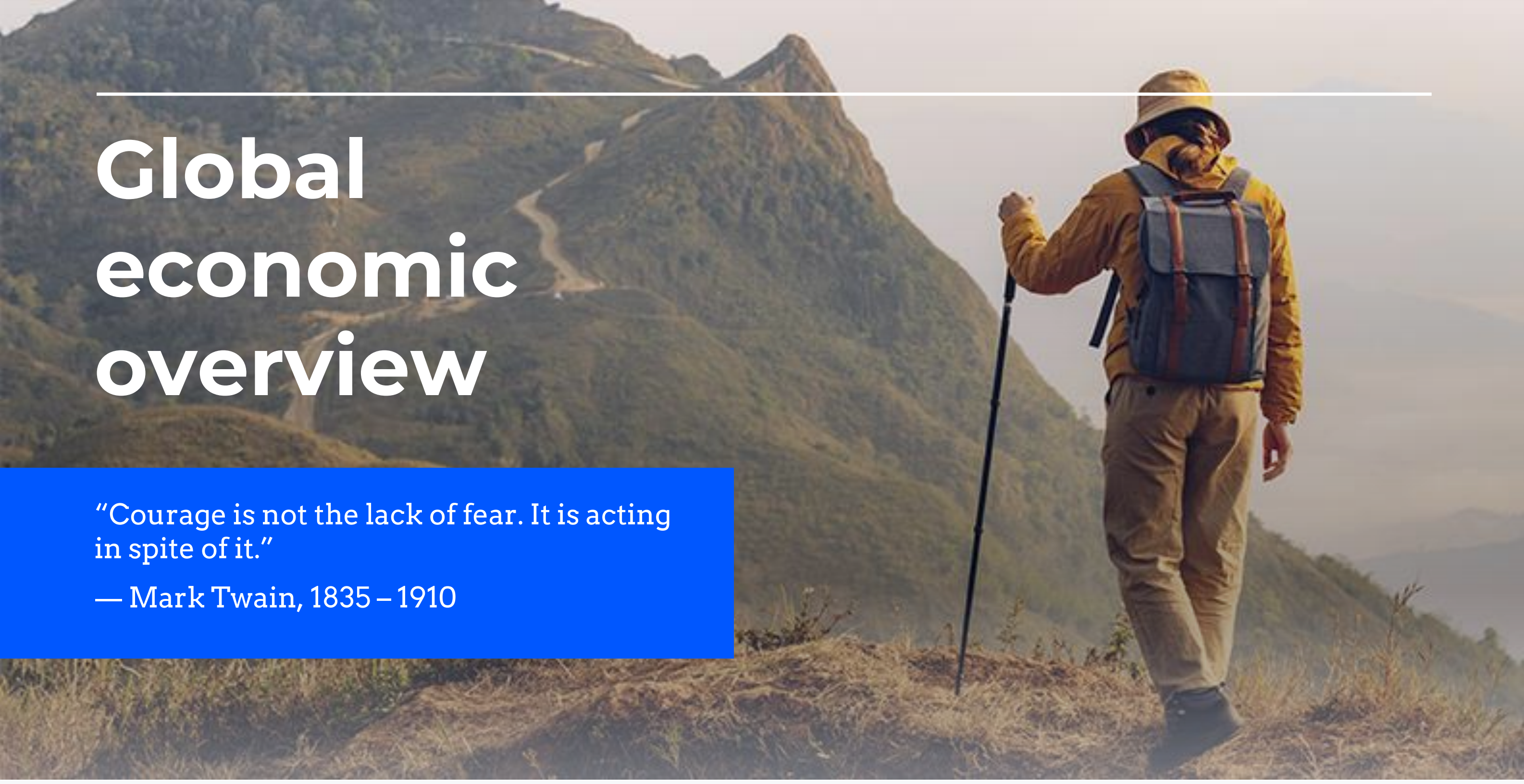
[7] Measured by the Nikkei 225 index
[8] Measured by the Hang Seng index
[9] Measured by the FTSE 100 index
[10] Measured by the MSCI AC World – Energy index
[11] Measured by the MSCI World Index Value index
[12] Measured by the MSCI World Index Growth index
[13] Measured by the S&P/ASX 300 A-REIT (Sector) index
[14] Measured by the FTSE EPRA Nareit Europe index
[15] Measured by the FTSE EPRA Nareit Europe index
[16] Measured by FTSE EPRA Nareit Japan, FTSE EPRA Nareit Singapore, FTSE EPRA Nareit Hong Kong and FTSE EPRA Nareit USA indices
[17] As measured by Bloomberg AusBond Credit (0+Y) index

Cash rate

The third quarter of 2022, saw the Reserve Bank of Australia increase the cash target rate three times, all 0.5% each (followed by a further increase of 0.25% just days into October). Indeed, having been held at a historic low of 0.1% from 4th November 2020 until 4th May 2022, the target rate has now increased to 2.6% in just six months. In a concerted effort to tame inflation before higher long-term expectations are established, these assertive moves seek to address both fundamental and behavioural economic factors.

Australian dollar

The Australian dollar (AUD) lost 7.3% of its value in U.S. dollar (USD) terms over the three months ending 30th September. Whilst this is a significant move in its own right, it obscures the fact that this is not so much a case of AUD weakness, but USD strength. When we consider the trade-weighted dollar over the same period, it has gained 7.1% against its trading partners. This reflects the U.S. dollar's status as a safe-haven currency, a property which has seen it strengthen against most currency pairs. Against the AUD, the British Pound lost 1.1%, whilst the Japanese Yen lost 1.2%, whereas the Euro gained 0.8%.



Global economic overview

"Courage is not the lack of fear. It is acting in spite of it."

— Mark Twain, 1835 – 1910

A period of change and adjustment

Having enjoyed a long period of relative stability, fuelled by exceedingly accommodative monetary policy, allowed by the notable absence of inflationary pressures, we have now entered a new era. Whilst the conditions for this change were variously present throughout 2021, it is the 2022 calendar year when they let themselves be known.

Equity markets reached - in many cases, all-time - highs in December of 2021 before marking the new year with a somewhat different character. Whilst seemingly defying gravity through the turbulence of challenging economic and geopolitical developments of the past few years, share markets now reflect a more cautious investor sentiment.

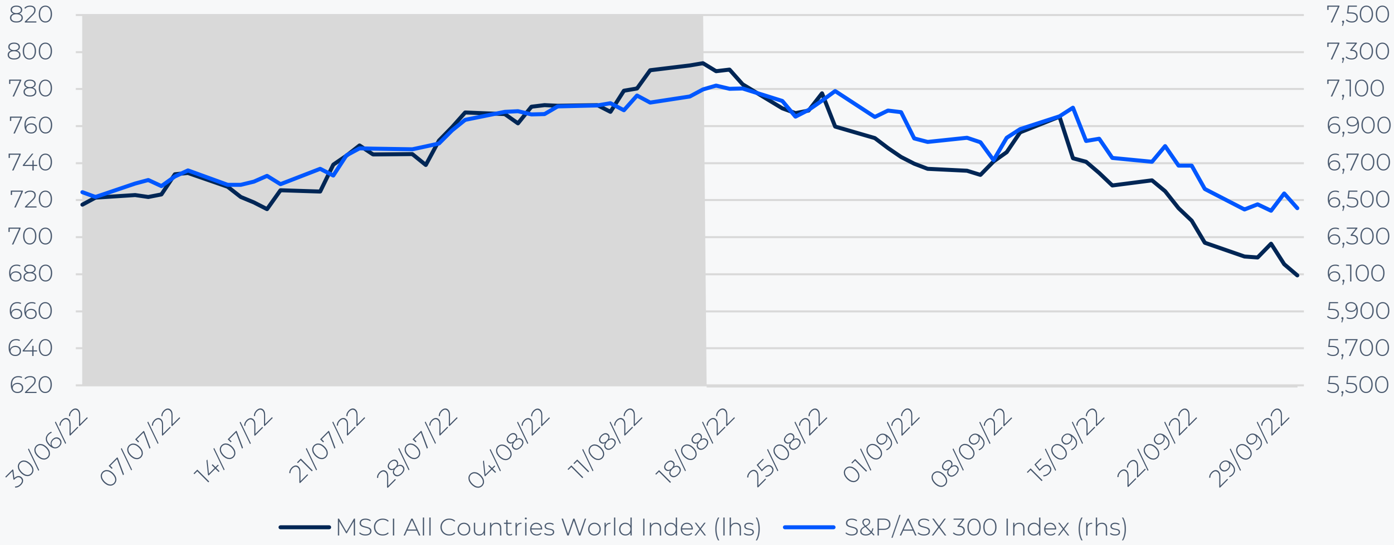
When we contemplate the three months ending 30th September, there was a period of respite from the downward momentum of asset prices, as markets entertained optimistic notions that the tightening monetary landscape may have reached its peak. From the end of June, through to the 16th August, global equities returned 11.0%[18], whilst their Australian counterparts enjoyed gains of 8.6%[19]. In fact, it was a stabilisation of developed government bond yields over the period that allowed optimism to seep into asset valuations. Reflecting on 10-year government bonds as a proxy, U.S. Treasuries remained relatively stable, whilst our domestic equivalents gained 5.7%. This however was not to hold. The second half of the quarter, saw the same U.S. Treasuries return to their prior trend, falling 6.1% through to the end of the quarter.

Over the same period, Australian government bonds fell by a similar amount, 5.5%. These moves betray a growing acceptance by investors that inflation globally will require higher degrees of monetary tightening to return to its targeted ranges.

It will be some time before we can know with confidence if that is the case. Monetary policy is a blunt instrument, with delayed efficacy. As we have described previously, the tailwind that has been at the back of investment assets for more than a decade has now become a headwind. It is by understanding this condition, we are best able to enjoy the emergence of new opportunities as they appear.

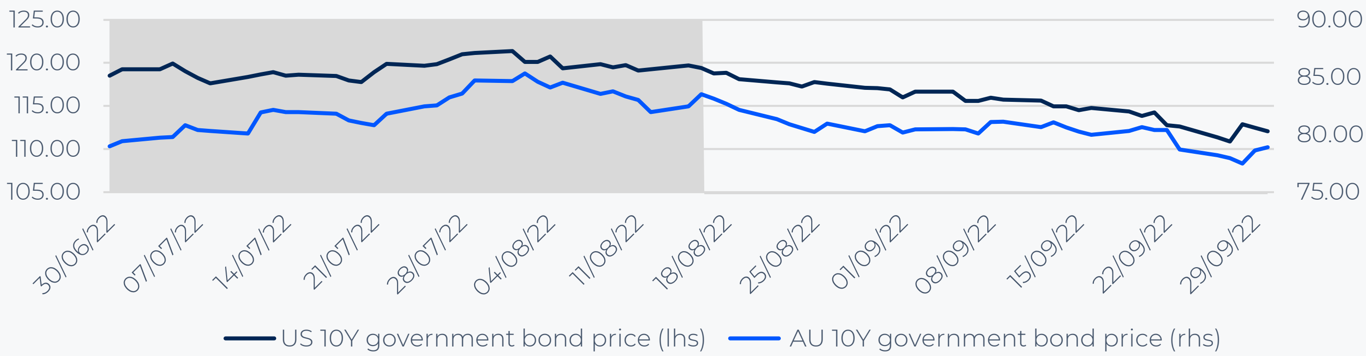
[18] Measured by the MSCI AC World index
[19] Measured by the S&P/ASX 300 index

Figure 1: Equities experienced a quarter of 'two halves'



Source: FactSet, Perpetual Private

Figure 2: Government bonds reflect expectations about monetary policy



Source: FactSet, Perpetual Private

Decision-making in the face of uncertainty

As investors, we must fundamentally accept uncertainty. It is a necessary precondition that we accept risk, so that we may enjoy reward. The dynamic nature of markets effectively prices the required level of return for perceived prevailing levels of risk. If we were able to achieve investment gains without risk, there would be no reason to do anything else. However, life is uncertain, the world is uncertain, and by retaining our sensibility in challenging times, we place ourselves in the best position to benefit once the skies clear.

Having emerged from the dark days of the Global Financial Crisis, economies and markets have enjoyed the backing of benevolent central bankers for over a decade. Policies, such as quantitative easing (or QE), transitioned from being 'extraordinary measures', to being simply ordinary. The names of key central bankers, once the exclusive trivia of bankers and investment managers, have become common knowledge. Such is the intrinsic recognition of their influence, not only on the conditions on 'Wall Street' but on key elements of the fortunes of 'Main Street'.

It is a simple acknowledgement of recent history and the positive effects of low policy rates, that allows our realisation that despite a pandemic-driven halt of the global economy (dare we say 'unprecedented'), unemployment is at all-time lows in many regions and economies continue to show resilience in the face of adversity.

Having enjoyed such conditions, we must now face into efforts to 'put the genie back into the bottle'. As the analogy suggests, it is far easier to deploy monetary easing without triggering immediately negative repercussions, than it is to reverse the process. This is a balancing act which has the dedicated focus of central bankers, as they seek to reverse supportive measures, without disrupting markets or economies. Just as we heard from the Governor of the RBA, Philip Lowe, on 4th October, "...the Board's priority is to return inflation to the two to three per cent range over time. It is seeking to do this while keeping the economy on an even keel. The path to achieving this balance is a narrow one and it is clouded in uncertainty."[20]

[20] Statement by Philip Lowe, Governor: Monetary Policy Decision, 4th October 2022.

What to look out for

Inflation, via the transmission mechanism of interest rates, is the most important driver of investment returns in the immediate future. As such, inflation expectations and therefore the pace and path of changes in interest rates, will continue to dominate the contemplations of market participants. Given such intense scrutiny, trying to predict or anticipate the precise path ahead for these factors provides little benefits. Each new datapoint will be incorporated into models, drive reactions and counter-reactions, whilst markets seek consensus.

Elements which will likely contribute to market volatility, as they alternately recede and intensify will almost certainly include:

Geopolitics

The geopolitical environment has become increasingly fraught over recent years and there are no early signs which might change that any time soon.

- The Russia-Ukraine conflict continues to simmer, with Ukraine's recent successes in taking back territory forcing Putin to command a 'partial' mobilisation of Russian forces (this is a half-step towards admitting a war – something he has been loathe to do). Combine this with the recent bombing of the Kerch Bridge (between Russia and annexed Crimea), and the Kremlin is likely feeling increasingly 'cornered', elevating the chances they might do something substantial to regain the strategic initiative. At present, this remains bound to sabre-rattling, but the risk of escalation has certainly increased. Flashpoints around these developments will likely draw the attention of markets.
- China's relationship with the world has suffered in recent years. Having become increasingly assertive diplomatically has rapidly changed many of their relationships with key Western trading partners, from collaboration to competition. Having potentially 'jumped the gun' with such posturing, as well as coming under increasing economic pressure caused by their zero-COVID policy, there is potential for relations to improve. Despite some supply chain diversification over the past few years, China remains the 'workshop of the world' and so any improvement may help to alleviate supply-side inflationary pressures.

U.S. dollar

As the de facto reserve currency of the world, the U.S. dollar remains integral to the workings of markets. Commodities are priced in it, and most central bank foreign currency holdings are dominated by it. Although its safe-haven designation means that it tends to strengthen in times of economic uncertainty, the magnitude of its appreciation is significant and could drive or indeed exacerbate stress in certain areas of the financial landscape.

Zombie companies

With interest rates having been so low for so long, it is highly likely that some lower quality companies have been in a state of suspended animation (i.e., they would not exist today were it not for such an overwhelmingly supportive economic landscape). As those companies adjust to a more challenging environment, it is quite possible that some may face existential crises. If and when these occur, particularly if they are large companies, markets will likely take fright and drive investors to scrutinise the balance sheet strength of all companies. Our current information suggests that these cases will prove to be isolated, however the impact on market sentiment will be felt as investors digest the development.

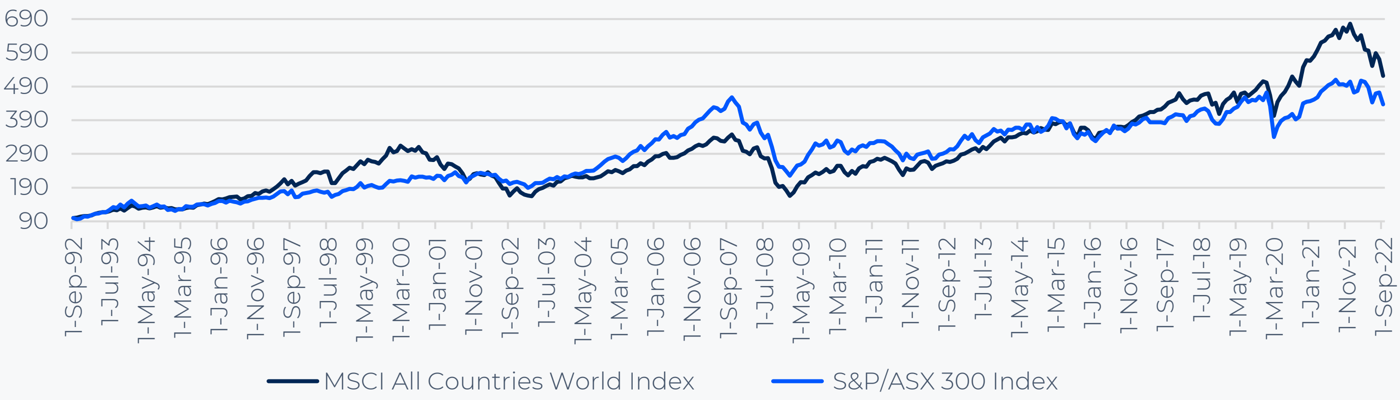
Property markets

Property markets are important for many economies. Following a period of exceedingly low mortgage rates, residential property prices have begun to recede, as borrowers digest higher borrowing costs. Residential property is an important driver of employment and trade, as well as being a meaningful contributor to consumer confidence. Much has been said about the importance of the Wealth Effect, which at its core suggests that as people feel wealthier, their confidence as economic agents increases. Given the penchant for home ownership in most jurisdictions, a reduction of property values can have a meaningful impact on the spending and investing patterns of consumers. Whilst some degree of this will likely aid in reducing inflation, the speed and magnitude of any devaluation could potentially lead to an outsized effect.

Of these factors, most appear to be stable enough that they would not likely derail healthy economic adjustment and recovery. What we will continue to monitor is whether these elements begin to interact, amplifying their impact, or if they trigger self-fulfilling cycles.

The path ahead

Figure 3: Long-term equity market performance



Source: FactSet, Perpetual Private

2022 has been challenging. Having enjoyed a long period (arguably 14 years) of buoyant markets, against the backdrop of a benign inflationary environment, we now face challenges. These challenges are meaningful; however, they are not insurmountable, and they bring with them a measure of positive developments.

One of the pleasant outcomes of the new environment is that certain investment conditions for portfolios have improved. As a direct result of central bank policies, returns (particularly income) from the safest parts of the risk spectrum had been constricted. Moving forward, we can expect lower levels of correlation across asset classes, increasing the benefit from diversification, as well as the production of a more evenly supported level of income.

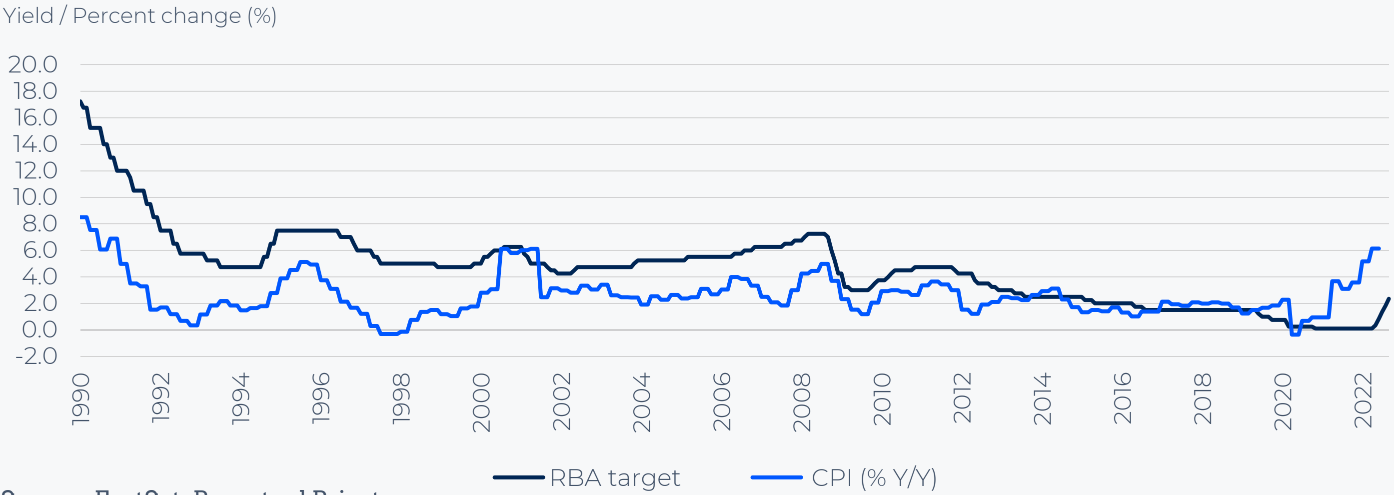
Given the critical importance of interest rates for investment valuations and economies, the path ahead will benefit from greater visibility of and stability in monetary policy. The implied condition being that heightened levels of inflation must be resolved. Supply-side contributors may ease somewhat, as global trade increasingly finds a comfortable, post-pandemic tempo. Other drivers (such as Ukraine-Russia) may provide more persistent complications. To our minds, the demand-side of the equation is the 'path of least resistance', with household cash flows increasingly impacted by elevated costs, and consumer confidence receding as a result of less certain times. As inflation begins to soften, central banks will seek to support economies, bringing investment fundamentals to the fore and providing attractive opportunities to diligent investors.

Australian cash rate and dollar

Australian cash rate

The Reserve Bank of Australia, continued to increase rates throughout (and even immediately after) the quarter. Having increased the cash rate target six times in just six months (moving from 0.1% to 2.6%), markets found cause for optimism from the 4th October change being 0.25%; below the anticipated 0.50%. Consistent with comments from the Board over recent meetings, this more nuanced approach was welcomed by risk assets. The Governor's statement following the October meeting sums up the Board's position on the matter clearly; "The size and timing of future interest rate increases will continue to be determined by the incoming data and the Board's assessment of the outlook for inflation and the labour market. The Board remains resolute in its determination to return inflation to target and will do what is necessary to achieve that."[21]

Figure 4: Australian long-term cash rate vs inflation



Source: FactSet, Perpetual Private

[21] Statement by Philip Lowe, Governor: Monetary Policy Decision, Reserve Bank of Australia, 4th October 2022.

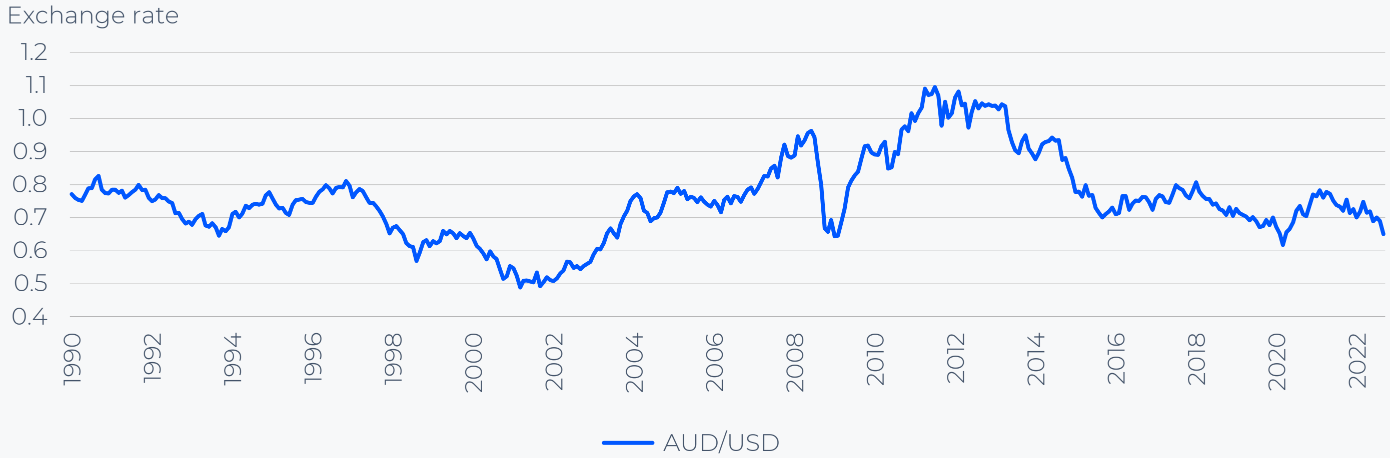
Australian dollar

The Australian dollar (AUD) has been comparatively weak, when evaluated aginst the sustained significant strengthening of the U.S. dollar. Just as interest rates are dominating the landscape for investment valuations, the rise of USD has dominated currency markets. Despite losing 7.3% of its value in U.S. dollar terms, the Australian dollar has remained relatively stable when compared to other peers. Against the British Pound, the Japanese Yen and the Euro, the AUD did not appreciate or depreciate by more than 1.2% over the quarter. Against the ever-important Chinese Yuan, AUD was similarly stable however declined by 1.5%, to the marginal benefit of our Chinese-facing exporters.

Australian dollar outlook

Given the tectonic changes occurring with monetary policy, it is challenging to anticipate what changes may occur to exchange rates. At present, our dollar is below its long-term average in USD terms. As currencies tend to be mean reverting in most environments, that is our ongoing base case. However, during times of significant economic adjustment as we currently face, these relationships can be delayed in re-asserting themselves. Given the tendency of currencies to 'trend' and the recent downward momentum that the AUD/USD cross has developed, near-term expectations lean towards further weakness.

Figure 5: AUD/USD long-term exchange rate



Source: FactSet, Perpetual Private

Australian and international equities

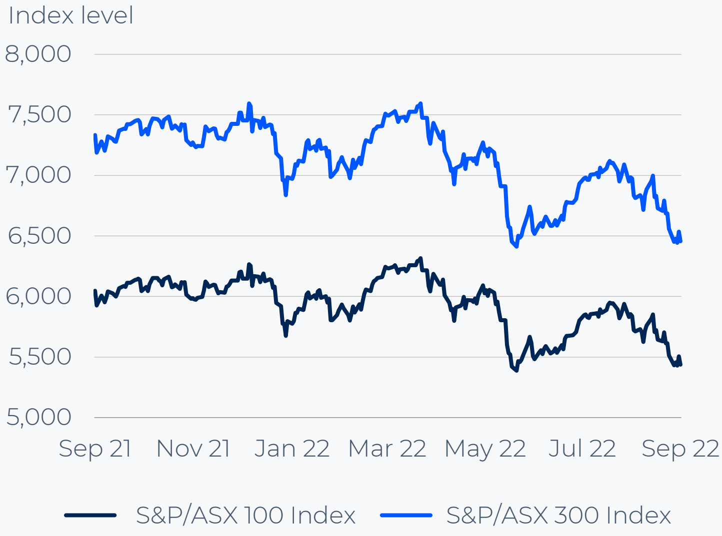
Australian equities

The Australian equity market finished the quarter in positive territory, with the S&P/ASX 300 Accumulation Index increasing by 0.5%. Australian equities outperformed global equities, with the MSCI All Country World Index (local currency) falling 4.9% over the same period.

Whilst returns on Australian equities were relatively flat over this period, it was quite a volatile quarter. We saw a sudden revival of positive market sentiment over July as many companies released better than expected earnings results. Indications from central banks that they may ratchet down the pace of rate hikes, led to a brief recovery in share markets over July, particularly from Growth stocks. This was followed by a market sell-off in late August through September, as central banks reasserted their conviction in raising rates to tame inflation, which then had a negative impact on longer-duration Growth stocks.

Over this period, large cap stocks outperformed smaller companies, whilst Value stocks slightly outperformed Growth stocks. We continue to see strong returns from the Energy sector (+5.8% for the quarter), which has also been the strongest performing sector for the past 12 months (+27% YTD). Also benefiting largely from the July market rally were Healthcare (+3.2%) and Information Technology (+2.7%) stocks. The worst-performing sectors were Utilities (-12.5%), closely followed by A-REITs (-7.0%), which were impacted by a weakening housing market amid higher loan rates and a perceived deterioration in economic conditions for commercial property.

Figure 6: Australian shares - large companies



Source: FactSet, Perpetual Private

Australian equities outlook

We expect movements in the Australian equity market will continue to be influenced primarily 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 monetary authorities as to whether interest rate hikes are proving effective at taming inflation, which should dictate future rate hikes.

We saw this play out over the quarter with early hopes of a slowdown in monetary tightening adding fuel to equity markets, followed closely by disappointing inflation figures, which led central banks to reassert their conviction in continuing to raise rates to tame inflation. The Australian equity market gyrated up and back down through this period. Of note, just after quarter-end the RBA increased rates a further 25 basis points, which was half the amount most forecasters had predicted and subsequently the Australian equity market rallied 3.8% higher, for their best day in more than two years. We expect the market will continue to behave in a similar fashion as further rate announcements are released by the RBA and central banks abroad.

With inflation data and the path of interest rates largely dictating equity markets, we expect volatility to continue, which should present bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations. With these macroeconomic forces in mind, the Australian Shares Implemented Portfolio is currently biased towards those managers who have a stronger regard for valuations and our managers are focused on investing in businesses with strong pricing power or thematic tailwinds.

Despite downward pressures on equity prices, to date we have seen relatively strong corporate earnings results. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which together will weigh on consumer spending and should become more pronounced as consumers roll off fixed rate mortgages and are faced with substantially higher minimum repayments. As such we anticipate a lagged effect on the corporate earnings outlook and continue to monitor this with great interest.

International equities

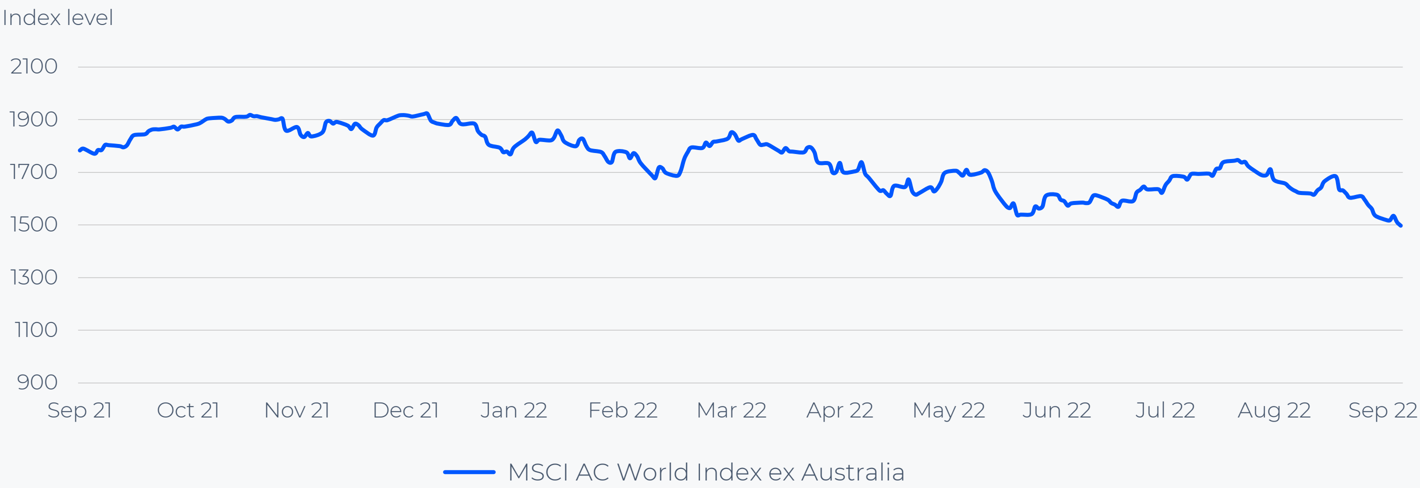
Global equities continued their downward trajectory over the September quarter, with the MSCI All Countries World Index falling 4.9% in local currency terms (-0.3% in AUD terms).

Whilst returns on international equities were down slightly over this period, it was a volatile quarter. We saw a sudden revival in market sentiment over July as many companies released better-than-expected earnings results and there were some indications from central banks that they may ratchet down the rate hikes, which led to a quick recovery in share markets over late July and early August, particularly from Growth stocks. This was soon followed by a market sell-off in late August and into September as central banks reasserted their conviction in raising rates to tame inflation, which had an outsized impact on longer-duration Growth stocks.

Over this period, emerging markets underperformed developed markets, whilst Growth stocks marginally outperformed Value stocks. Of note, China saw double-digit negative returns over the period, with the Hang Seng (Hong Kong) Index down 14.7% in AUD terms. This was driven by slowing global growth hitting export demand, the downturn in China's housing market and further disruptions due to their zero-COVID policy.

In local currency terms, the only positive sector for the quarter was the Energy sector (+1.3% for the quarter), which has also been the strongest performing sector for the past 12 months (+25.1% YTD). While the worst performing sectors were Communication Services (-12.8%) and Real Estate (-11.2%).

Figure 7: International shares (local currency terms)



Source: FactSet, Perpetual Private

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. As uncertainty remains for the outlook of economies globally, we expect volatility 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. Inflation has continued to surprise to the upside in most countries. U.S. inflation for instance in August was a major driver of negative market sentiment – even as CPI continued to decline from its previous peak, core inflation gained pace, suggesting that forces of inflation remain strong across all sectors. Investors have interpreted this as a sign that monetary tightening is likely to continue over the near term. With further tightening likely to limit the near-term upside for equities, markets continue 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 results from corporates. However, it is the earnings expectations or outlook that has declined amid weakening business conditions.

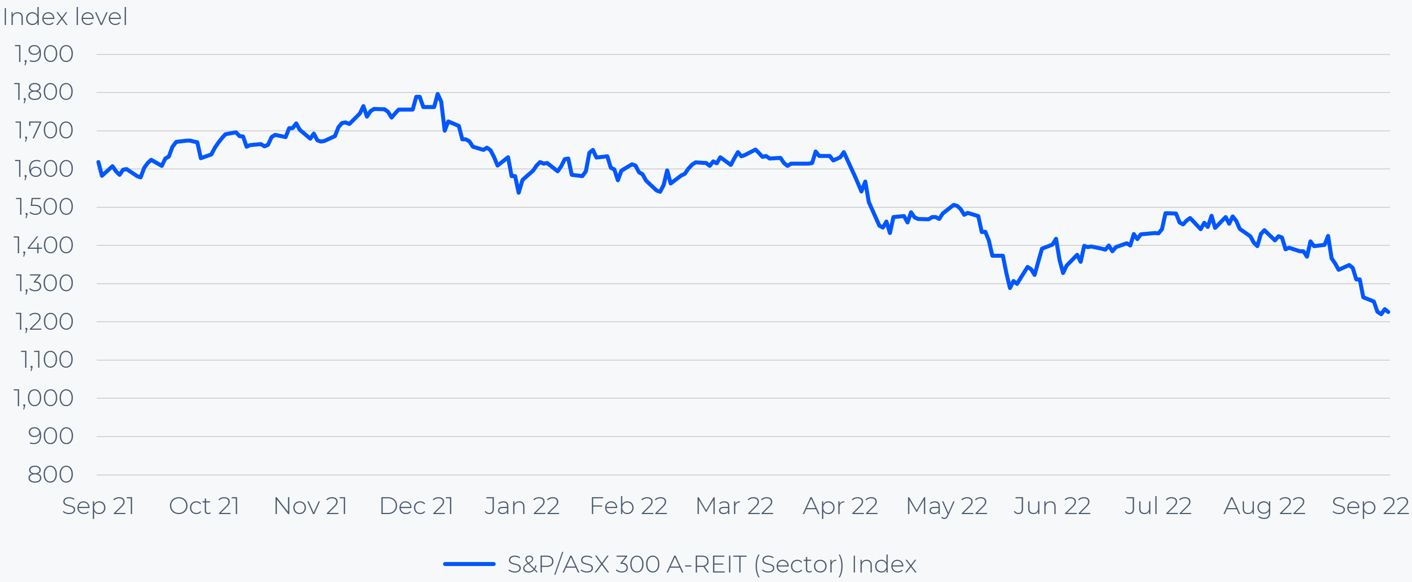
We expect the macroeconomic outlook to continue driving equity markets over the near term. With higher volatility expected to continue, we believe this should present bottom-up fundamental active managers with opportunities to deploy capital to Quality and possibly oversold companies at more attractive valuations. With these macroeconomic forces in mind, the Implemented International Shares Portfolio is also biased towards those managers who have a stronger regard for valuations and our managers are focused on investing in businesses with strong pricing power and/or thematic tailwinds.

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

In AUD terms, Global Real Estate Investment Trusts (G-REITs) fell 5.4% over the quarter to the end of September 2022. On a currency-hedged basis, the same index fell by 10.5%, continuing the negative trend from prior quarters. In Australia, A-REITs (Australian Real Estate Investment Trusts) similarly declined 6.7% over the quarter.

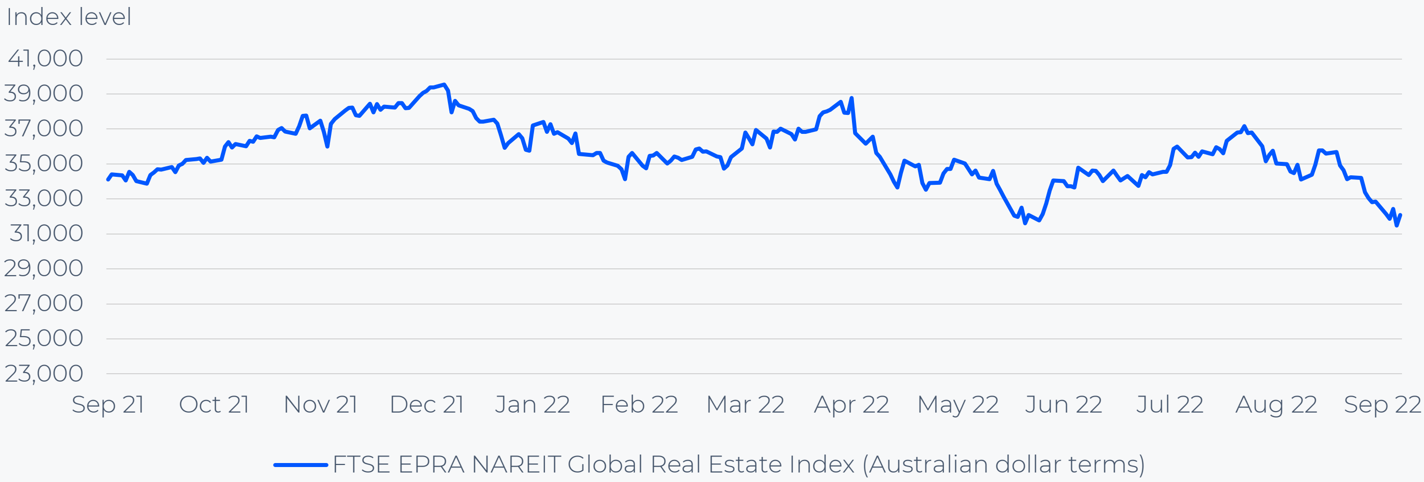
Weaker performance from REITs has been driven by rising bond yields and the subsequent impact to property valuations. Those REITs with more conservative balance sheets, generally outperformed. Capital-raising activity continues to slow with softer transaction volumes, as a result of uncertainty regarding the cost of debt. Despite volatility in markets and a steep share price decline in REITs driven by higher interest rates, valuations are now at multi-year lows, and we are starting to note the emergence of more attractive investment opportunities – with a number of REITs now trading at considerable discounts to our interpretation of fair value.

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



Source: FactSet, Perpetual Private

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



Source: FactSet, Perpetual Private

REITs outlook

Both domestic and global REITs should continue to experience heightened volatility, as underlying asset valuations are closely tied to the fortunes of bond yields – a function of higher inflation and subsequently higher interest rates. With central banks adding further rate hikes over the quarter, this continues 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 also remain important with valuations and growth prospects differing across markets and segments.

Operating conditions continue to change meaningfully for sectors like Hotels, Retail and Office, with uncertainty around the earnings environment. The following themes that we have outlined previously on real estate markets remain intact:

- ‘Right sizing’ of ‘shop front’ real estate. We have seen ‘private capital vehicles’ being raised to acquire ‘distressed’ retail assets, most notably in the U.S. (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 (‘footprint’ optimisation, 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, whilst 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.

Our investment managers are focused on 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 investment in the asset class. 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.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -0.6% during the September 2022 quarter. The Australian yield curve was in a holding pattern over the period. At the end of September, the Australian 10-year bond yield was 3.6%, only slightly off the previous quarter's 3.7%. The Australian 5-year bond didn't change significantly either, ending the period at 3.32% versus 3.34% from the previous quarter.

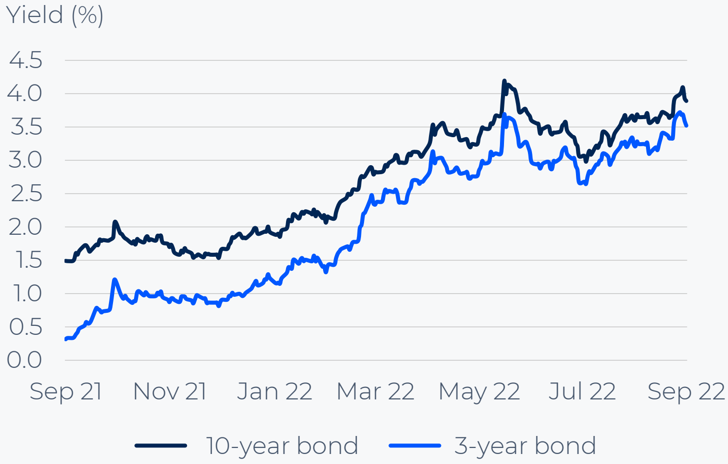
In July 2022, the Australian unemployment rate was 3.5%, down from the previous 3.9%. The trimmed mean, the preferred inflation measure for the RBA, was 4.9% at the end of June, up from 3.7%. This is much higher than the 2%-3% RBA inflation target.

This year, the RBA has embarked on its most aggressive tightening for decades after keeping rates at historical lows during the COVID crisis. More recently, the RBA increased the cash rate target by 25 basis points to 2.60% during its October meeting. In the RBA's most recent statement, they explained that the cash rate had already been increased substantially and that higher inflation and higher interest rates are putting pressure on household budgets.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned -3.8%. Credit underperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning -5.0% over the quarter. High yield debt as measured by the Bloomberg Global High Yield Index (Hedged) did relatively well, returning -1.9% for the period.

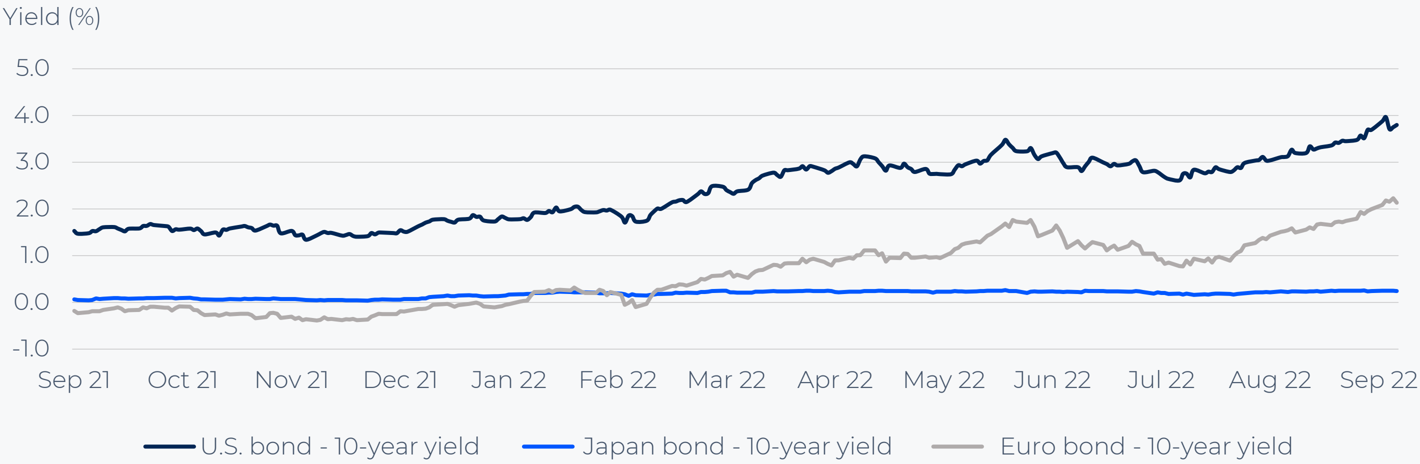
U.S. yields rose during the period, contributing to the strong USD. The U.S. 10Y increased to 3.1% from to 3.0% in the previous quarter. The U.S. Federal Reserve began tightening aggressively in March 2022. At its September meeting, they determined to increase rates by 75 basis points, bringing their target range to 3%-3.25%.

Figure 10: Australian government bonds



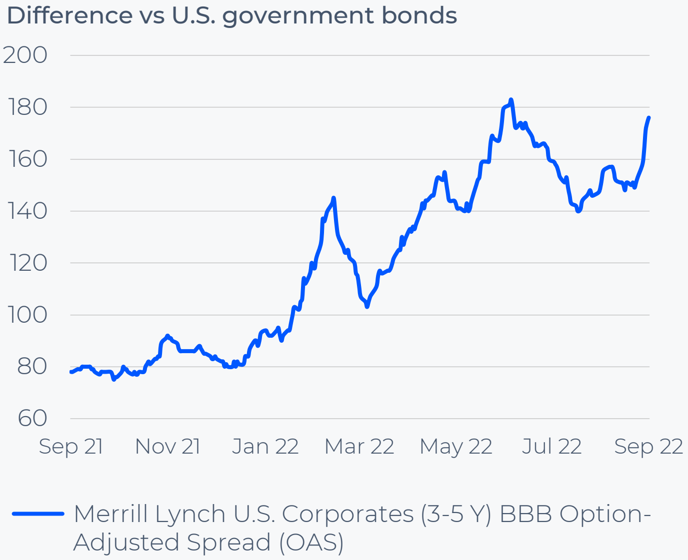
Source: FactSet, Perpetual Private
* Note: Bond prices are inversely correlated with bond yields.

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

The Implemented Fixed Income Portfolio continues to operate with duration a little over half that of fixed interest markets, as measured by the Bloomberg Global Aggregate Index. This has helped it minimise the impact wrought by rising rates. It's a small comfort, but the portfolio has delivered a less negative return than traditional fixed interest markets over the last three years.

We are still waiting for the opportunity to normalise the duration of the portfolio but remain sceptical about timing the market. Fixed interest looked "cheap" a year ago and even "cheaper" at the start of 2022, only for it to get even more "cheap". Given the high level of volatility in the market, we are more likely to wait for the data, rather than attempt to anticipate it.

Inflation in the U.S. remains high and we are continuing to monitor U.S. inflation prints to look for signs of it normalising. 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 low when compared to the U.S.

Alternatives

Growth alternatives

Whilst Private Equity (PE) does, by its very nature, tend to have valuations that are sympathetic of listed markets relative to Infrastructure and Real Estate, pleasingly our PE investments have held up well, with only modest 'mark downs' year-to-date. Most of the underlying businesses have reasonable cost control or 'sticky customers' allowing for better margin control. Cost pressure (mainly wages) is though impacting the 'COGS' line of P&Ls. As our investment programme is broadly under-committed, we anticipate 2023 to be a good 'vintage year' for PE and we are well-positioned to take advantage. 'Sponsor-to-sponsor' transactions have and are expected to continue to slow in light of the current environment. There is though, still a reasonable level of transaction activity by strategic and listed market buyers, who generally have a lower cost of capital or are able to generate more material 'synergies' from their acquisitions.

When we consider Infrastructure, we are comfortable with current valuations, and see only limited downside. Generally, the discount rate used by valuers has been 'mid-cycle' and is unlikely to impact valuations near-term, short of a certain 'regime shift' (to a sustained higher interest rate environment). Our exposure is 'barbelled' between regulated/CPI-linked and volume-risk assets. Some softness in revenues may be on the horizon if economic conditions deteriorate further. There are regulated and unregulated opportunities for our portfolio's assets, and we expect to commit future capital to these opportunities. Pockets of upside from 'energy transition' related assets could add to the near-term return outlook.

From a Real Estate perspective, U.S. multi-family dwellings located in growth markets should enjoy future rental income. Domestically, our exposure is predominantly in high-quality CBD office markets. We face limited near-term Lease Expiry or Debt Expiry concerns in our largest exposures.

The presence of a high level of sector and stock level dispersion across credit and equity markets bodes well for excess returns being generated by our Hedge Fund exposure. Our current focus is on market-neutral equity and long/short credit opportunities (equity markets for alpha, and credit markets for alpha and attractive carry returns). We are actively avoiding hedge funds which have large swathes of 'private investments' (debt and equity) made through the turmoil of the pandemic in 2021-22.

Income alternatives

Non-investment grade credit, High Yield and Leveraged Loan markets, printed negative returns for the quarter. However, both managed to outperform global fixed interest markets. High Yield spreads started the quarter at near-term highs but recovered toward the end of September. Loans haven't suffered the same volatility as High Yield and have outperformed comparatively during the 2022 calendar year.

We expect most private debt to have lower prices because of the higher comparable spreads in the broadly syndicated market. The Fund's exposure to CLO equity posted a loss for the quarter but did 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, syndicated loans, CLOs and private debt market valuations over the next six to 12 months.

The Income Opportunities Fund has been retaining higher levels of cash over the past few months to cover for capital calls and currency losses. With the weakening of the AUD versus the USD, the Fund has paid out some hedging losses over the period.

Over time, we expect the Fund to reduce its exposure to first lien unlevered private debt, in favour of more liquid securities. This will help the Fund meet its hedging and distribution requirements. Potential investments may include convertibles, Investment Grade structured product, High Yield or more broadly syndicated loans.

We continue to monitor interesting private strategies that can 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 it attractive over the coming months.

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