Perpetual Private | Investment market update

Year-end reflections

December 2022

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Snapshot

With the level of transactions falling across capital markets as many investors pause for the festive period, we have taken the opportunity to reflect on what has been a challenging year for investment returns. As the timing of this note prevents us from being able to examine the year in totality, we have commented on the calendar year through to the market close on 30th November. As such, all references to the 'year' or '2022' refer to this time period.

Tectonic changes occurred in 2022, as a long period of low and stable inflation came to an end. This has led to heightened levels of volatility in the valuations of financial assets, as adjustment to current and expected levels of interest rates filter through the contemplations of market participants.

Heightened levels and persistence of inflation across the global economy have influenced the expectations of economic agents, leading cost pressures to become somewhat embedded. As such, central banks have felt obliged to respond, in force. Institutions from our own RBA, through to the US Federal Reserve, the European Central Bank and the Bank of England, have all increased policy interest rates at a historically rapid pace. In addition, the messaging they have been delivering to further influence economic conditions, has swung rapidly from supportive to foreboding.

These changes represent a paradigm shift from the past decade, causing many intrenched positions and the assumptions of investors to become dislodged. Though this will likely lead to healthier market environments as we move forward, we must endure some turbulence along the way as markets seek a consensus view of the path ahead.

Asset class performance – January 2022 to November 2022

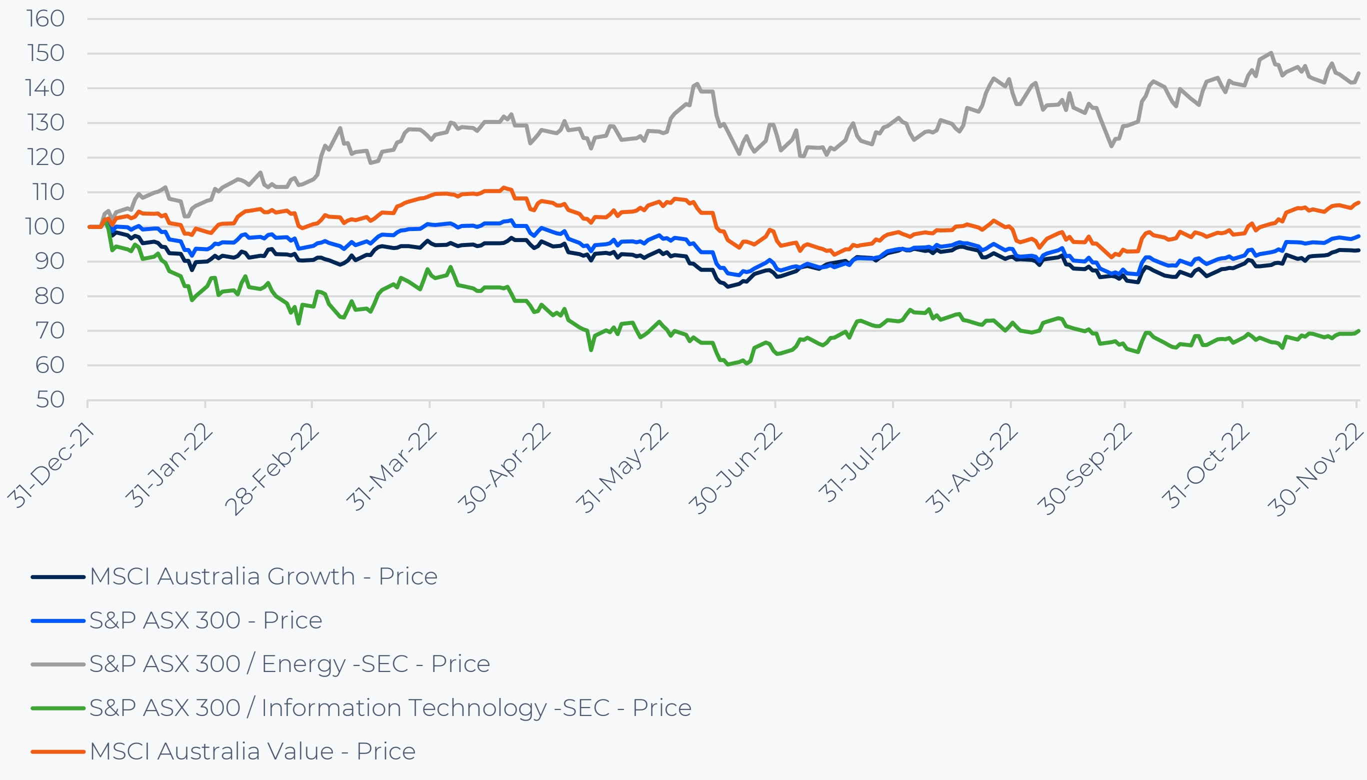
Australian equities

Australian shares have endured a volatile year, as markets and investors adjusted for a tightening monetary environment. Having drawn down as much as 14%[1] by mid-June, they enjoyed an encouraging recovery over the three months to December, closing out 2022 (31st December 2021 to 30th November 2022) with a gain of 1.6%.

Beneath this relatively benign outcome, the divergence between market sectors is notable. Buoyed by recovering global travel, against a backdrop of constrained supply, the Energy sector[2] returned 53.8% in the year to December. In contrast, the Information Technology sector[3] experienced valuation compression, and lost 29.5% over the same period.

A notable feature of the changing market dynamics that we have witnessed this year, is the diverging fortunes of Value and Growth investment styles. Growth, having enjoyed expanding multiples, encouraged by ever lower interest rates is now trailing. Within Australian share markets, Value[4] appreciated by 14.5%, whilst Growth[5] fell by 4.3%. This shift to Value, reflects a degree of risk aversion from investors that is also present in the divergence between large and small companies. Smaller companies (as measured by the S&P/ASX Small Ordinaries index) have receded by 15.2% through the year, an underperformance against the S&P/ASX 300 of 16.7%.

Figure 1: Australian equities – Elevated sector and style dispersion



Source: FactSet, Perpetual Private

[1] Measured by the S&P/ASX 300 index

[2] Measured by the S&P/ASX 300 Energy (Sector) index

[3] Measured by the S&P/ASX 300 Information Technology (Sector) index

[4] Measured by the MSCI Australia Value index

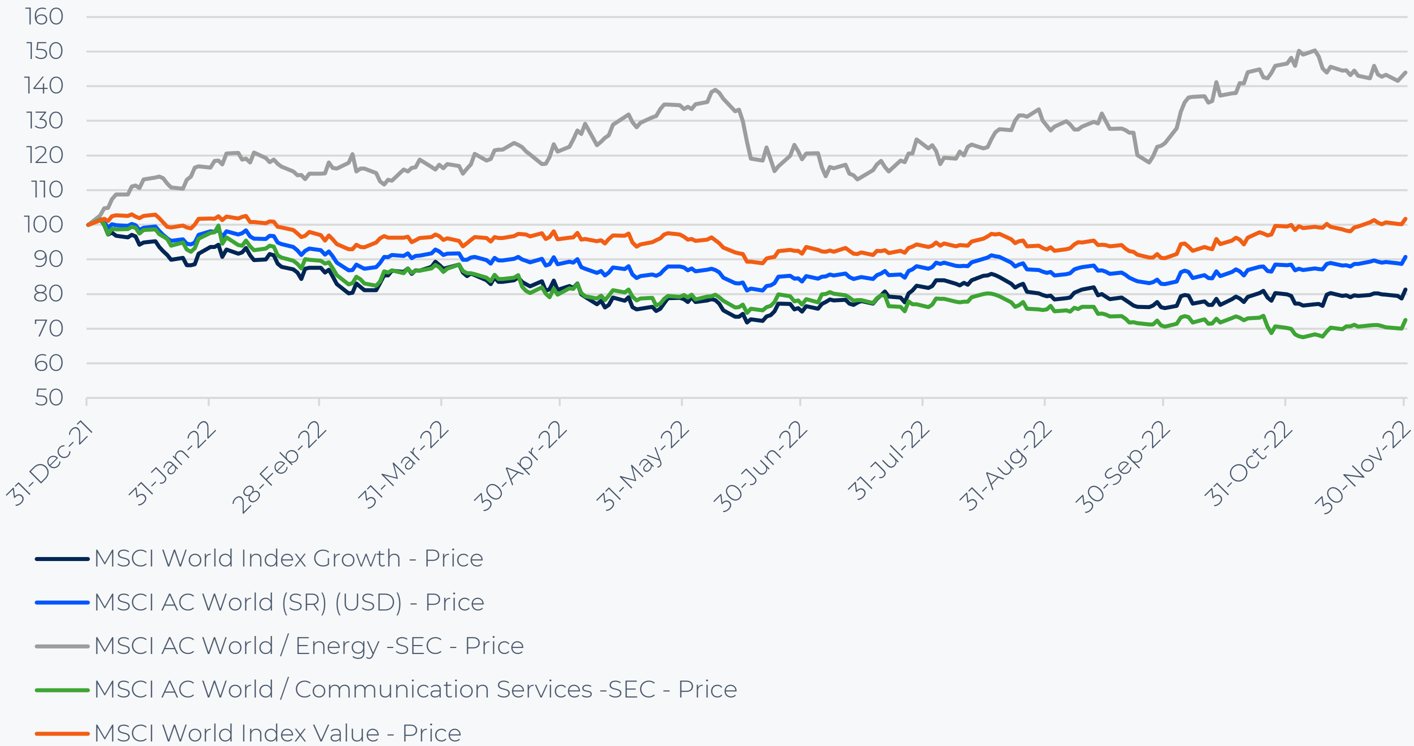
[5] Measured by the MSCI Australia Growth index

International equities

International shares[6] underperformed our local markets, delivering a negative return of 7.7% in AUD terms, primarily weighed down by the U.S. Technology sector, recessionary fears in Europe and the impact of 'zero COVID' policy in China. Indeed, of the major markets we follow outside Australia, it is notable that the UK-based FTSE 100 Index (in Australian dollar terms) has been the only other region to deliver positive returns (+1.4%). Germany[7] and France[8] enjoyed impressive gains of 17.6% and 15.5%, in the three months to December, however this was not enough for them to turn positive in the year, with France down 5.3% and Germany down 10.9% (including 1.4% from a weakening of the Euro).

When considered from a sectoral perspective, the themes that were reflected locally were also present globally. Energy delivered 49.9%[9], whilst Communication Services[10] and Information Technology[11] receded by 26.7% and 18.8% respectively. Additionally, Value gained 4%[12] against Growth's drawdown of 18.2%.

Figure 2: International equities – Consistent themes with our domestic experience



Source: FactSet, Perpetual Private

[6] Measured by the MSCI AC World index

[7] Measured by the DAX index

[8] Measured by the CAC 40 index

[9] Measured by the MSCI AC World - Energy index

[10] Measured by the MSCI AC World - Communication Services index

[11] Measured by the MSCI AC World - Information Technology index

[12] Measured by the MSCI World Index Value index

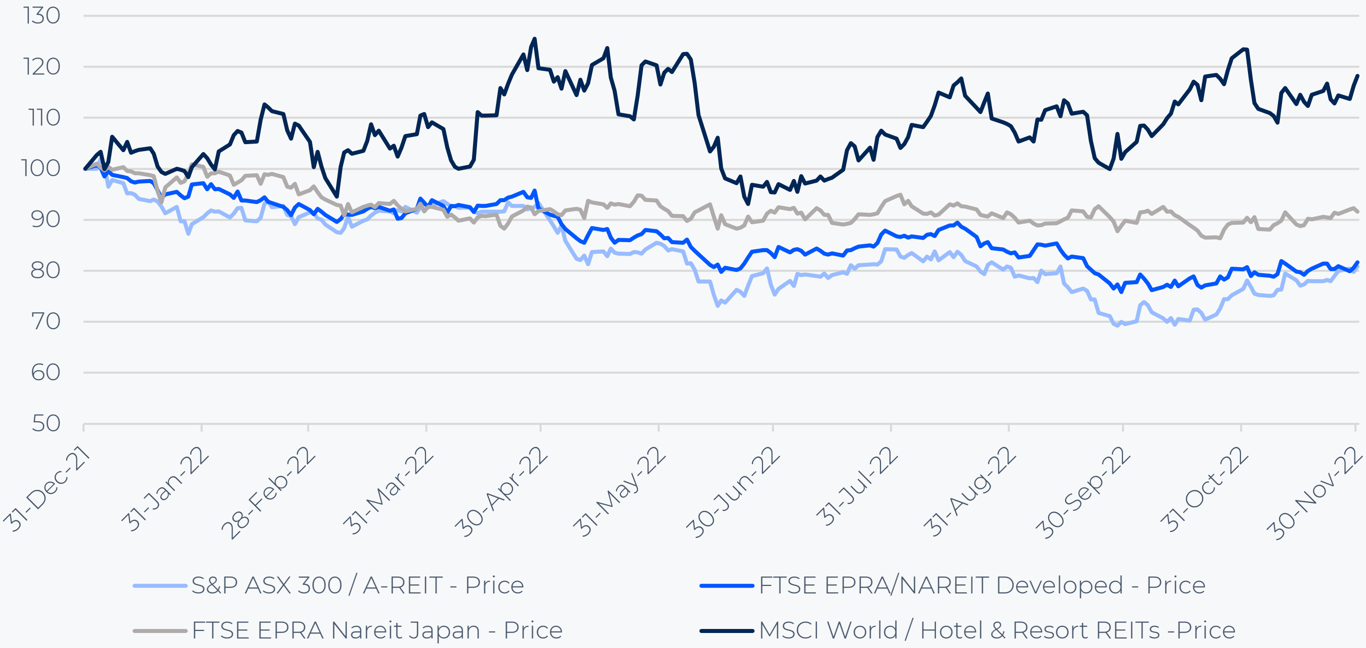
Real estate

With valuation metrics closely tied to the level of interest rates, Real Estate suffered from the tightening monetary environment.

On a global basis, the asset class saw a 14.9%[13] drawdown in its value over the year. This experience was somewhat universal across the developed markets we follow, with only Japan delivering a positive return (+4.8%[14]), measured in Japanese Yen (JPY). This result though, is strongly impacted by the weakening of the JPY, with the same assets falling 6.1% when measured in Australian dollar terms (AUD). Indeed, if we consider all of the regions we monitor in AUD, only Singapore delivered a positive result. At a sector level, we witnessed very little differentiation with all but Hotels & Resorts[15], down more than 10%. Hotels & Resorts gained 9.9% over the period as the global travel industry continues to recover from the pandemic.

In Australia, listed real estate assets were similarly affected by the changed monetary environment, as the S&P/ASX 300 A-REIT index lost 16.7%[16] in value over the year.

Figure 3: Real Estate – Facing into strong headwinds



Source: FactSet, Perpetual Private

[13] Measured by the FTSE EPRA Nareit Developed index
[14] Measured by the FTSE EPRA Nareit Japan index
[15] Measured by the MSCI World / Hotel & Resort REITs index
[16] Measured by the S&P/ASX 300 A-REIT index

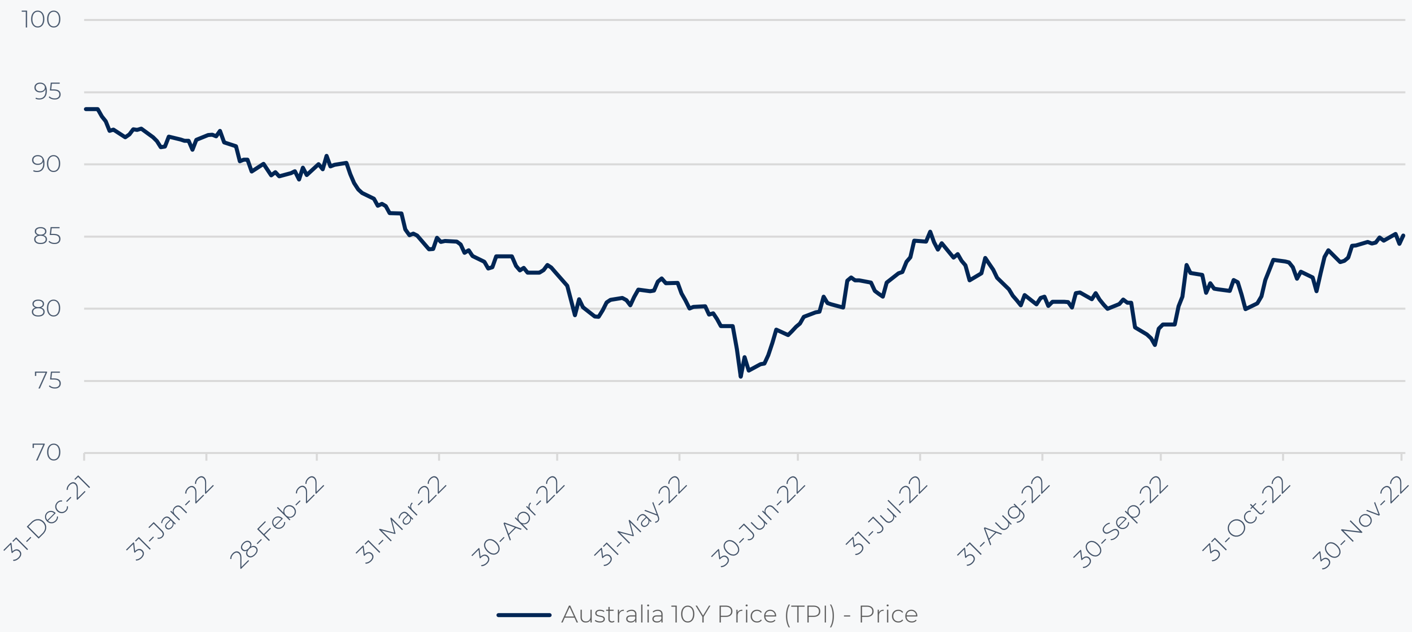
Fixed Income

In much the same way as real estate, debt instruments are inherently priced off interest rates. As such, with central bankers determined to address inflation, fixed income securities have suffered.

Locally, the value of Australian government bonds with a 10-year maturity, fell 9.3%[17] over the period. The change being almost entirely due to the change in interest rates. Credit, being predominantly floating rate did better, giving up only 6.2%[18]. Meanwhile, cash-like bank bills, were able to produce a 1%[19] return.

Internationally, the environment was more challenging. When hedged back into Australian dollars, global corporate bonds lost 14.8%[20]. As a consequence of their reduced interest rate sensitivity ('duration'), traditionally risky high yield (aka "junk bonds") performed better (-12.5%[21]) than their investment grade peers, as the impact to their credit risk was relatively muted, with business conditions remaining healthy.

Figure 4: Fixed income – Adjusting to the new monetary landscape



Source: FactSet, Perpetual Private

[17] Measured by Factset Australia 10y Price (TPI)

[18] Measured by the Bloomberg AusBond Credit (0+Y) index

[19] Measured by the Bloomberg Austbond Bank Bill index

[20] Measured by the ICE BofA Global Corporate (AUD Hedged) index

[21] Measured by Bloomberg Global High Yield (AUD Hedged) index

Alternatives

Alternative assets have performed well through 2022, despite volatility in traditional asset classes. Within Private Equity, Real Estate and Infrastructure, asset values have broadly remained flat or moved up on the back of the ability to pass through inflation to consumers (Private Equity and Inflation) and contractual rental increases (Real Estate). Hedge funds have been more varied in performance with the notable performers in the complex being Trend Following and Global Macro strategies. Within Private Credit markets, defaults have remained subdued. Of note, transaction volumes and realisations have slowed materially across all alternative asset classes. As we look forward into 2023, we are optimistic about the prospects for hedge funds who can take advantage of opportunities in public markets. Elsewhere in private markets, we have reason to believe that a rebasing is occurring which should result in an investment environment that produces attractive opportunities at valuations that would have been unobtainable in recent years.

Cash rate

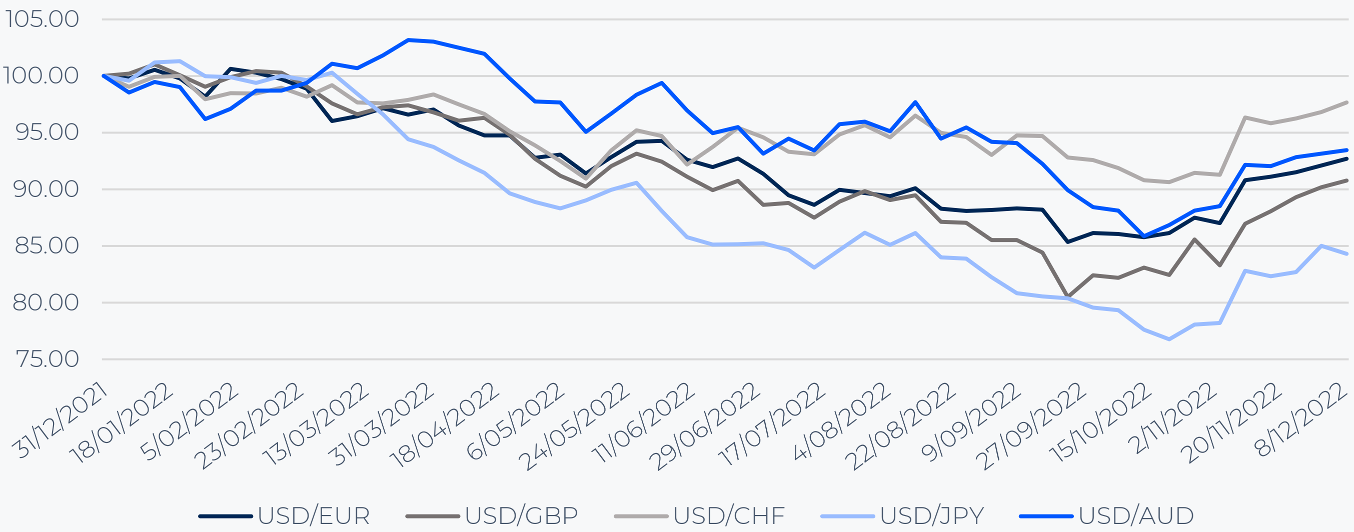
In its final meeting for 2022, the Reserve Bank of Australia increased the cash rate target by a further 0.25%, its eighth consecutive increase. Having only reduced or held rates since November 2010, we believe this represents a meaningful change to the overall investment environment.

Having moved from 0.1% in May 2022, we will end the year with the target rate at 3.1%. That the pace of increases has abated following the level reaching 2.35%, demonstrates the Board's desire to avoid undue negative impacts to the economy. For the foreseeable future, it would now appear that the Bank will take an evidence-driven approach, knowing that many elements of the tightened monetary environment will operate with a lag.

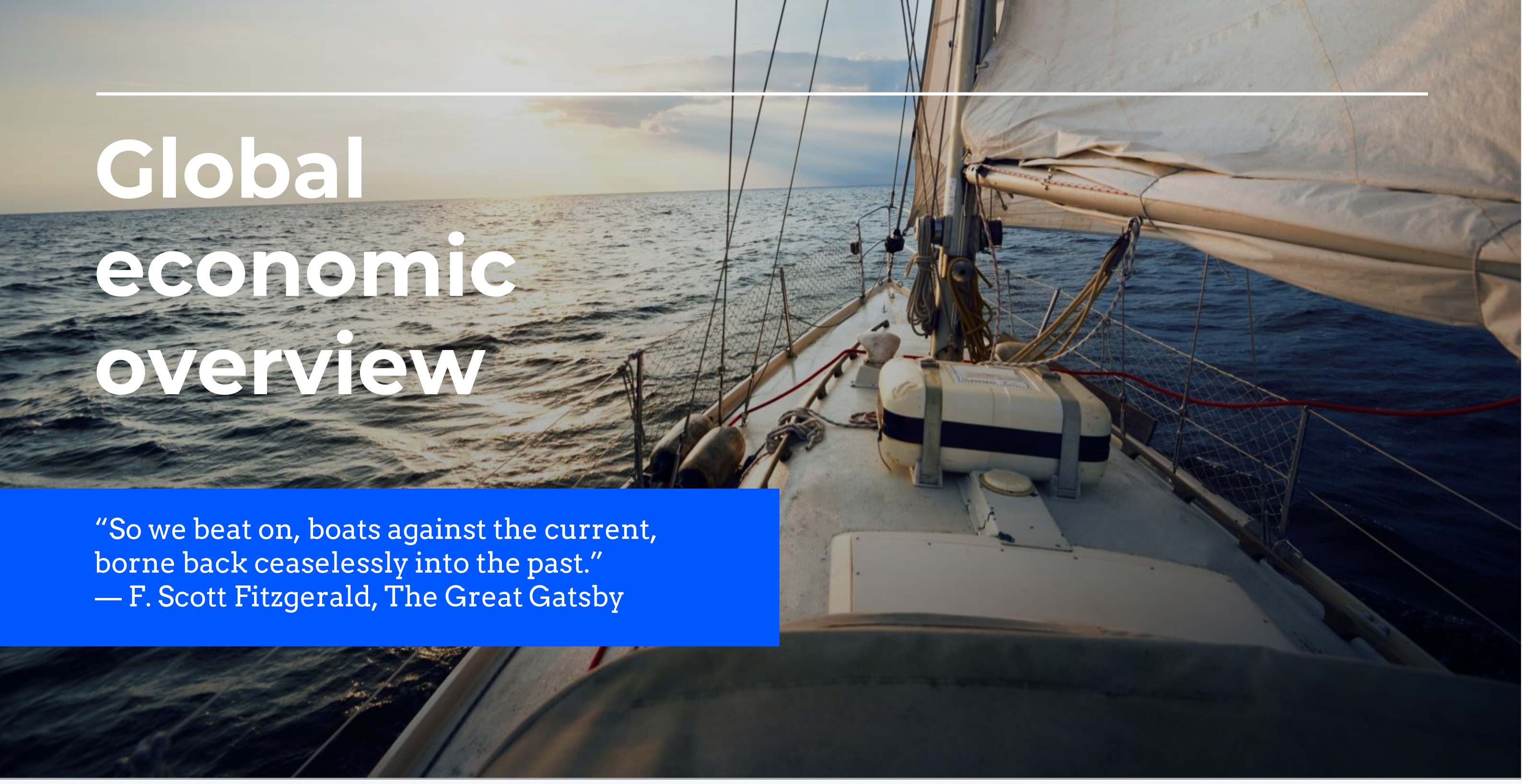
Australian dollar

The Australian dollar (AUD) has behaved as a relative passenger in 2022, along with many other major currency pairs. This is due to the de facto reserve currency of the world, the U.S. dollar (USD), appreciating strongly as investors sought out its 'safe haven' qualities. In AUD terms the USD strengthened by 6.7%. Having suffered from the traumatic 50-day prime ministerial stint of Liz Truss, the Pound Sterling depreciated relative to USD, losing 12.3% of its value, though this is a significant recovery from its -26.7% year-to-date performance in mid-September. The Euro held up better, though is still impacted by the negative implications and externalities arising from the war in Ukraine, fading by 9.3% in USD terms. The Japanese Yen, traditionally itself a safe haven has derated significantly over the year, losing 20% in USD terms, as their continuation of low interest rate policy contrasted negatively with that of its peers. Of the main currencies we monitor, only the Swiss Franc held within normal ranges against the U.S. dollar, retreating only 3.8% over the year.

Figure 5: FX – Dollar strength weighing on entire currency complex



Source: FactSet, Perpetual Private



Global economic overview

"So we beat on, boats against the current,
borne back ceaselessly into the past."
— F. Scott Fitzgerald, The Great Gatsby

Looking back over the year

2022 has been a rough year for investors. Considering the year in hindsight, one might retain a certain sense of irony in the way markets have performed. With the pandemic having been diffused to a manageable level and lockdowns ending in many countries, we could have hoped to enjoy easier times. So-called "transient inflation" should have subsided and there was hope amongst investors that economies would return to some form of 'normality'.

Looking back to expectations in February, announcing the RBA's Monetary Policy Decision at the time, Governor Lowe stated, "The central forecast is for underlying inflation to increase further in coming quarters to around 3¼ per cent, before declining to around 2¾ per cent over 2023 as the supply-side problems are resolved and consumption patterns normalise"[22]. Of course, the Board weren't to know that Russia would invade Ukraine a short three weeks later. Regardless, with underlying inflation coming in at 6.1% in October, this forecast now seems quaint.

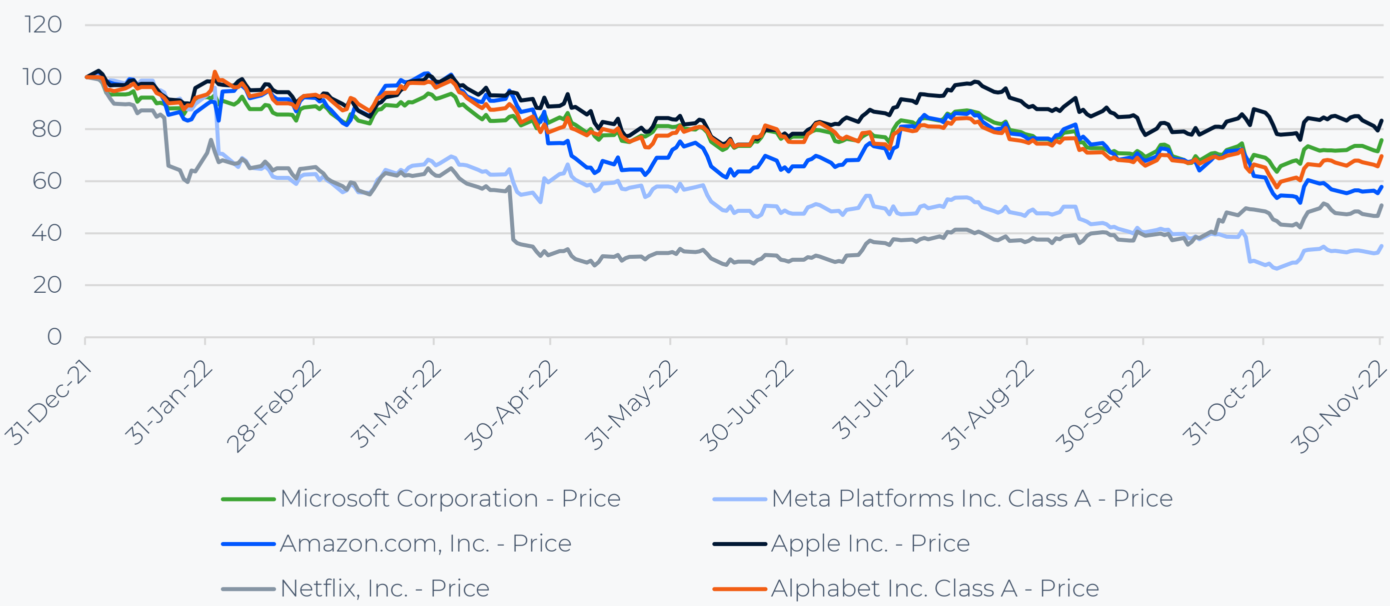
Indeed, this year shares some degree of similarity with 2020. With the US and China having signed the "Phase One" trade deal on 15th January of that year, then the UK completing their withdrawal from the EU two weeks later, the path ahead appeared clear through to the U.S. presidential elections in November. Despite COVID-19 quietly spreading across the world, the minutes from the Reserve Bank's Board meeting on 4th February are as understated as their comments on inflation this year, stating "Members discussed the coronavirus outbreak, noting that it was a new source of uncertainty for the global economy. With the situation still evolving, members observed that it was too early to determine the extent to which growth in China would be affected or the nature of the international spill overs"[23]. As we now know, markets began to sell off from 20th February, only to accelerate when the World Health Organisation declared COVID-19 a global pandemic on 11th March.

As 2022 progressed through the months of February and March, we experienced a similar escalation in volatility. This time, it wasn't pandemic-led lockdowns that were the catalyst, it was inflation.

With central bankers becoming increasingly hawkish, financial assets increasingly reflected the impact of higher interest rates in their valuations. Equity markets fell, here and abroad. The Technology sector in particular, was affected.

[22] Statement by Philip Lowe, Governor: Monetary Policy Decision, Reserve Bank of Australia, 1st February 2022.
[23] Minutes of the Monetary Policy Meeting of the Reserve Bank Board, Reserve Bank of Australia, 4th February 2020.

Figure 6: Technology sector stocks – Falling stars



Source: FactSet, Perpetual Private

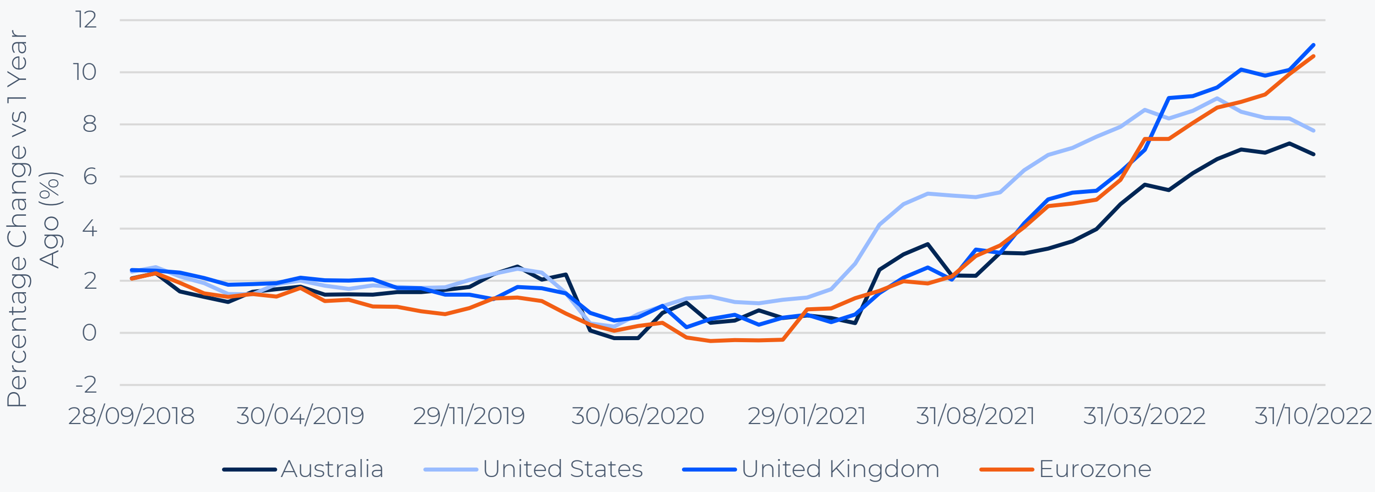
Indeed, property prices - a clear beneficiary of years of increasingly low interest rates - also experienced significant drawdowns globally.

Providing very little to investors in the way of safe harbour, even traditionally defensive bond prices fell. Indeed, our investigations suggest that this is the only time in history that U.S. Treasuries have fallen in value during an equity bear market.

The agents of change

Given the expansive and consistent reduction in value across markets, it should be of no surprise that there was a common thread. As you will already be aware, this common thread was the arrival of meaningful and persistent inflation.

Figure 7: Consumer price inflation – The 'common thread'



Source: FactSet, Perpetual Private

As we have discussed throughout the year, inflation impacts asset prices primarily but not exclusively, via monetary policy. Simply put, for most central banks, targeting inflation is a primary objective. As a result, it is naturally expected that under such conditions, it is necessary for interest rates to be increased in an attempt to discourage spending, effectively reducing demand in the economy.

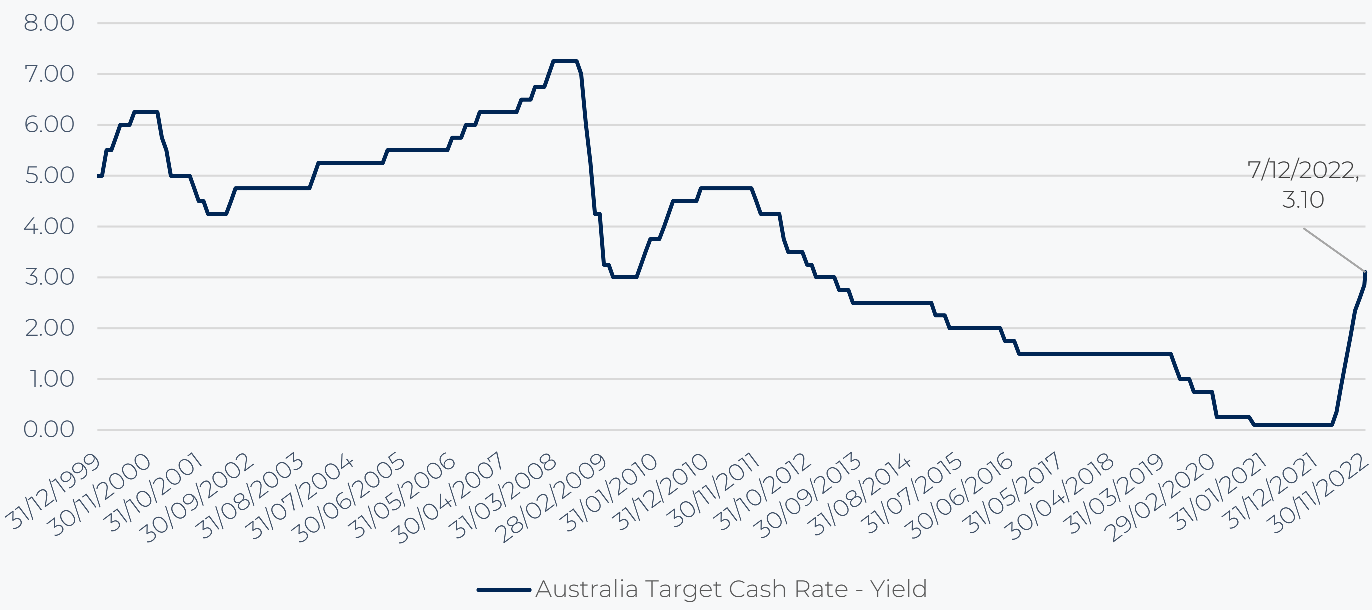
Considering again the conditions in 2020 - as concern for the health of economies under the constraint of lockdowns came to bear, enabled by a lack of inflation, monetary authorities were able to reduce interest rates in support. It was, in fact, this environment and these actions which brought about the end of a decade-long trend of increasingly low interest rates.

In a sense, that the trend had been in place for such an extended period, is precisely why its 'end' has had such a significant impact to both economic and investment conditions. Whilst there had been notable concerns and indeed protestations about the use of cheap money in response to the Global Financial Crisis in 2009, the feared spike in the prices of goods never arrived. With each successive year that passed, the prognostication of negative side effects from low interest rates, looked increasingly wrong.

This created an environment where those steeped in economic orthodoxy, looked out of touch with reality. Over time, a growing cohort of younger investors had entered markets with little or no experience of inflationary environments. "This time is different," one of the most dangerous phrases in investing, began to become a mantra as tech giants dominated, 'special purpose acquisition companies' also known as 'SPACs' emerged (known as 'cash shells' in previous cycles) and curiosities such as crypto currencies and NFTs attracted billions of dollars of investment.

Ultimately it wasn't to last and an adjustment to the 'old normal' is now underway.

Figure 8: Australia target cash rate – The end of the trend



Source: FactSet, Perpetual Private

Considerations for the year ahead

That the risk of inflation was increasingly ignored by market participants, is precisely what made it become the eventual 'Achilles' heel' of market structure. On the plus side, that most of the challenges we face today are related to inflation and interest rates, makes the situation more manageable. That's not to say easy but the proximate drivers of these conditions are relatively well known and are now under intense scrutiny by monetary authorities.

Outside of this central channel of risk, there are several other, presently identifiable factors, which may drive investment outcomes over the coming months.

Ukraine conflict

Whilst the conflict in Ukraine continues to produce significant levels of human suffering, from the perspective of an Australian investor it has been in a relatively stable equilibrium for some months now. Though the effect of constraining supplies of important commodities will continue to influence inflation, the situation does look likely to remain restricted to this one factor. So regular has the implicit (and indeed explicit though veiled) threat of the use of nuclear weapons by Russia become that now, it barely even counts as news. This isn't to say there is no risk. As we witnessed when a missile from the conflict landed in Poland, a NATO member, there is the potential for the situation to escalate. This is a concern but would not likely benefit anyone involved, thereby making it more unlikely. As Russia has struggled to sufficiently address battleground requirements against a much smaller adversary, to draw NATO into the situation directly, effectively opening a new front would not appear to be to their benefit. Equally, for those countries supporting Ukraine, the billions of dollars being spent in support is likely already more than they'd like to be exposed. As such, the path-of-least-resistance is for a depressing continuation to what has become a regionally focused war of attrition. Whilst we do not seek to go into depth on growing tensions surrounding Taiwan, we do think that this conflict has likely discouraged a forceful re-unification of the country in the short term. Here there is also room for an escalation but as this will likely be disadvantageous to all those involved, we also suspect its present state to also be a somewhat stable equilibrium.

Policy error

As we saw under the ill-judged and short leadership of Liz Truss as British Prime Minister, this environment is far less forgiving than we have become used to in recent years. Additionally, in many countries, governments have taken on a notably populist tinge. This leads to the increased risk of well-intentioned policies, including those seeking to address cost of living pressures, disrupting important economic balances. As should be apparent to students of history, when you force changes on a dynamic system, you don't only change the parts you want. There are invariably downstream impacts from all such changes.

We like to conceptualise this as removing a single thread from a piece of fabric; sure, you changed the precise component that you hoped, but you also affected every other thread that it touched. Whilst we don't expect policy errors to become pervasive, we do note the heightened risk of such things occurring and so anticipate their sporadic occurrence.

Inflation could fall faster than expected

Of greater risk but of the same risk category as policy error, relates to the precision with which monetary policy is deployed. Tighten too little and inflation becomes increasingly imbedded. Tighten too much and we face the threat of a painful recession. Present actions are geared towards aggressively curtailing inflationary pressures. If inflation were to fall faster than expected, it is likely that this bias would lead to monetary policy remaining tighter than necessary for longer than necessary. This would logically reduce economic activity at precisely the time it should be increased. Such conditions could lead us to permanently lose a certain degree of economic growth as economic momentum stalls. The counterbalancing factor for this issue, is that it is under intense scrutiny and is thus present in the consideration of all monetary policy decision. This does not irradicate it as a risk but does work to meaningfully mitigate it. This is certainly a primary focus for investors as we move through 2023.

Opportunity ahead

Our base case is that the global economic environment will continue to return towards the 'old normal' with target cash rates of between 3% and 5% across developed countries. As this increasingly becomes the consensus view of market participants, it will continue to be translated through asset valuations and economic models. As these adjustments are made, the impacts will maintain heightened levels of volatility in markets. Whilst we have experienced the economic equivalent of an earthquake this year, we must prepare ourselves for the inevitable aftershocks.

An example of such an aftershock is the very public collapse of the cryptocurrency exchange FTX. Whether or not you're a believer in crypto as an investment, the liquidity issues which brought about the demise of this multi-billion dollar organisation, are not dissimilar to other large business failures during periods of significant market stress. The collapse of Lehman Brothers during the GFC is one such 'rhyming' (from the saying "history doesn't repeat but it does rhyme") event. Fortunately in this instance, FTX was not strongly integrated with the financial system, and so its impact has been significantly less.

On the more positive front, with some drivers of inflation already receding, we have good reason to believe that inflation will likely express a downward trend over the coming months. Should we see this trend become stable and the path to targeted levels become apparent, the strong rhetoric from central bankers is likely to soften, driving meaningful improvements in market sentiment. In this vein, it may already be the case that we've seen a market bottom for the prices of fixed income instruments. This does remain highly conditional but is realistic, nonetheless. Additionally, from a broader portfolio point of view, having been relatively unloved in recent times, bonds should again provide reasonable nominal returns whilst also increasing the defensive characteristics of asset blends.

As we have said throughout the year, whilst we do not enjoy such periods of market stress, our experience reminds us that these are also periods of great opportunity. Naturally, opportunity can cut both ways but just as we benefited from the volatility of the pandemic, our instincts drive us to be vigilant in searching for the conditions that will enhance investment outcomes (through risk reduction, return enhancement or both).

Looking through the noise

When thinking about how to respond in this environment, we like to reflect on core and timeless principles for investing. As is patently obvious, proactive investment changes are always preferable to reactive ones. Reacting to changing market conditions is a common way to destroy value as we're whipsawed by the volatility. From a strategic point of view, the best way to manage risk is by ensuring our asset allocation is optimised for our specific circumstances, primarily our time horizon. If we have done that correctly, we should have the comfort that allows us to ride through the turmoil and position ourselves well for better times ahead.

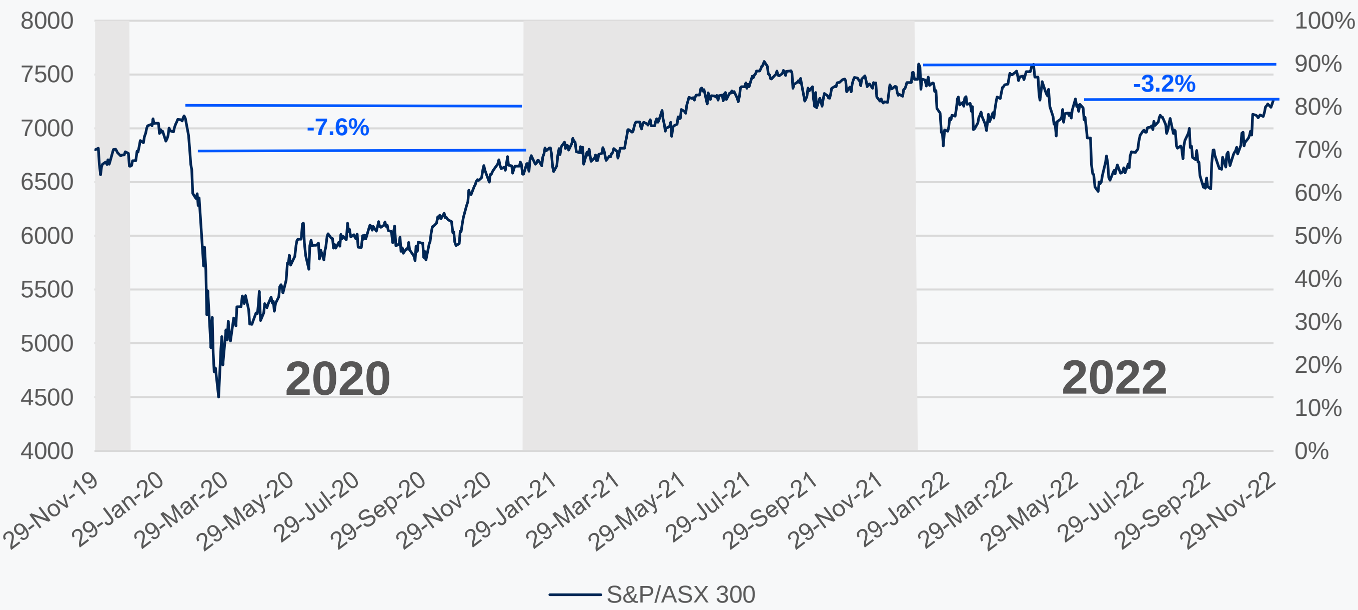
Staying calm through periods such as these, is usually one of the best actions investors can take. The reason why we have compared 2020 in this paper is primarily to demonstrate how market developments can turn out to be different to what we had initially expected - even for those such as the RBA, who are focused on such issues. With that said, there is something else we can glean.

For most Australian investors, 2022 has felt like a much more painful experience than that of 2020. From the point of view of Australian shares[24], as you can see in the chart below, the drawdown in 2020 was actually far more severe than what we have experienced this year. Additionally, the level of drawdown coming into the end of the year is smaller, this time around.

That the experience has felt worse, is a reflection of the behavioural aspects of investing. The key difference being, that the market pain from the pandemic was short and sharp, followed by a steady recovery. This year, the sell-off has been much less dramatic but the challenging conditions have been much more protracted.

Moving forward, learning to become comfortable in this sort of discomfort, is likely to assist us in avoiding making unforced errors with our investments.

Figure 9: 2020 vs 2022



Source: FactSet, Perpetual Private

[24] As measured by the S&P/ASX 300 index

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