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EVIDENTIA GROUP

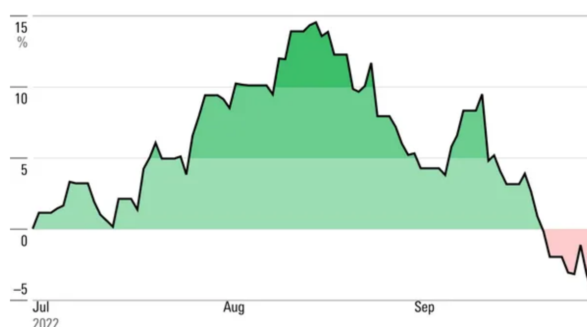
Quarterly Commentary

September 2022

Economic Review

The September quarter started positively with markets continuing to rally from their mid-June lows on hope inflation had peaked and the US Federal Reserve (Fed) would begin to ease the pace of its rate hikes. But by late August, enthusiasm had given way to pessimism when Fed chair Jerome Powell spooked markets with his Jackson Hole speech where he reasserted the Fed's commitment to fight inflation "until the job is done" even if it caused "pain to households and businesses."

By the end of September, global share markets had dropped to new lows. It was an especially poor quarter for fixed interest markets, which were also impacted by the view rates would be 'higher for longer' with the asset class failing to live up to its traditional safe haven role.



US Inflation has remained stubbornly high. The core (excluding food and energy) personal consumption expenditures (PCE) price index, widely recognised as the Fed's preferred inflation gauge, rose at an annualised pace of 4.9% in August, more than the 4.7% expected and well above its long-term 2% target. The US labour market also remained tight in August with 1.7 job openings for every unemployed person. Far from pivoting, the Fed lifted the federal funds rate by 75 basis points for a third straight time in September to 3%-3.25% and expects it will need to raise by another 125 basis points by year-end. If this happens, rate rises will total 425 basis points in 2022, compared to the 75 basis points markets had priced in at the start of the year.

Total Trailing Returns (%)

Period ended 30/9/2022	1 mth	3 mths	12 mths	3 yrs (p.a.)	5 yrs (p.a.)	10 yrs (p.a.)
Australian Shares	-6.3	0.5	-8.0	2.7	6.8	8.4
Australian Small Caps	-11.2	-0.5	-22.6	-0.8	4.1	4.6
Global Shares - All Country (Local)	-8.4	-4.9	-16.2	5.2	5.8	9.0
Global Shares - All Country (Unhedged)	-3.6	-0.3	-10.9	5.4	8.7	12.6
US Shares (USD)	-9.2	-4.9	-15.5	8.2	9.2	11.7
Europe Shares (EUR)	-5.6	-3.7	-15.9	-0.3	0.8	5.7
Emerging Market Shares (Local)	-9.4	-8.2	-21.5	1.1	1.1	4.5
Global Property (Hedged)	-11.8	-10.5	-19.7	-6.6	-0.5	4.9
Australian Property	-13.6	-6.7	-21.5	-5.3	2.6	7.7
Global Infrastructure (Hedged)	-10.9	-7.6	-3.4	-0.1	3.9	8.6
Australian Fixed Interest Composite	-1.4	-0.6	-11.4	-3.4	0.8	2.3
Global Fixed Interest Composite (Hedged)	-3.5	-3.8	-12.8	-3.6	-0.2	2.4
Cash - Bank Bills	0.1	0.4	0.5	0.4	0.9	1.7
Evidentia 70 Growth SAA Benchmark	-4.2	-0.9	-8.8	1.9	5.3	7.8

Most other major central banks tried to keep pace with the Fed to defend their local currencies and restore price stability and their own credibility. This included the Reserve Bank of Australia (RBA), which lifted the cash rate by another widely expected 50 basis points in September to 2.35%. The economy expanded by 0.9% over the June quarter, driven primarily by consumption and the external sector, and momentum appears to have carried over into the September quarter despite heightened cost of living concerns. Business conditions, labour demand and capacity utilisation remained well above long-run levels. The unemployment rate edged up to 3.5% but this was due to a rise in labour force participation, 33,500 jobs were added in August. Strong labour market conditions are helping to boost household incomes and insulate consumption, at least temporarily, from higher interest rates. Despite a slowing housing market, retail sales have remained impressively solid.

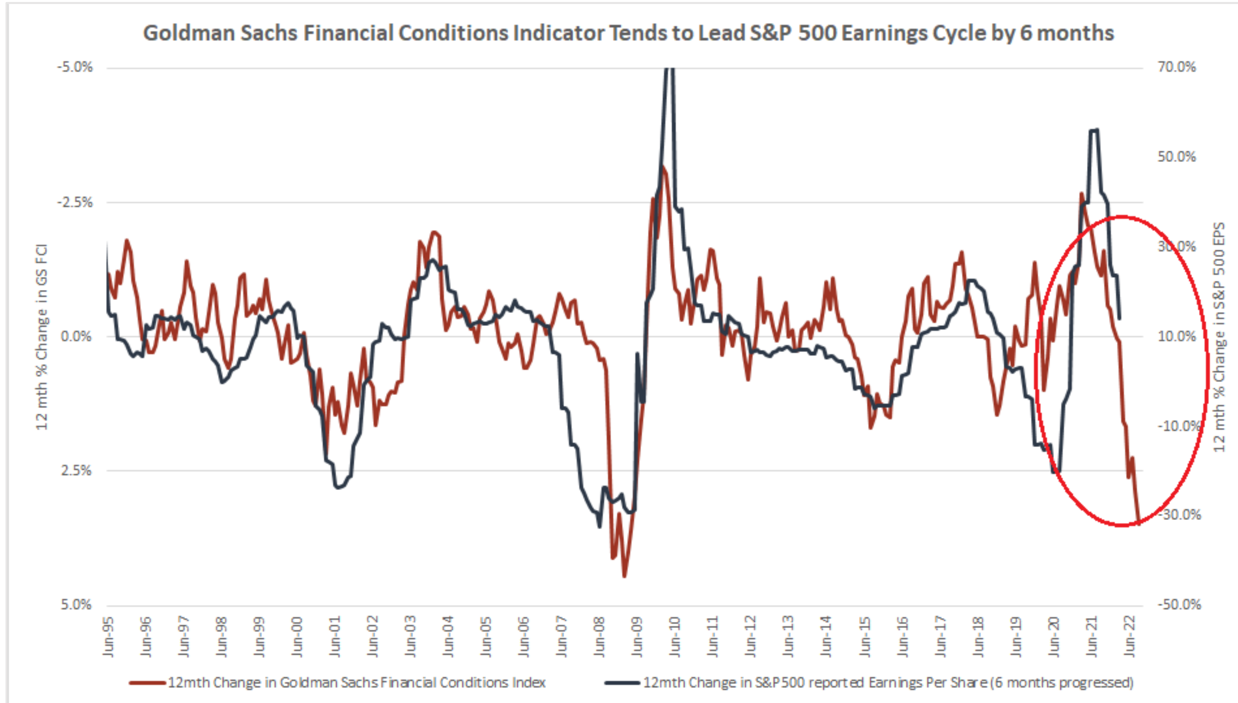
Besides central bank policy tightening, risk appetite continues to be impacted by lingering effects from the pandemic and Russia's invasion of Ukraine which have caused havoc in global supply chains and energy supplies. China, which represents close to 20% of global GDP, is struggling with a sharp economic slowdown. UK markets were also thrown into turmoil in September as bond yields surged and the pound plunged after the UK Government announced an ill-timed and unfunded fiscal stimulus package. The Bank of England stepped in immediately to restore order with a new round of quantitative easing, which ironically may add to the country's inflationary pressures. More recently, rumours have swirled around what appears a very unlikely Lehman Brothers-style collapse of Swiss bank Credit Suisse, which has rocked the bank's shares price and sent its credit default swaps soaring to record highs.

Outlook for Investment Markets

Despite early signs that global economic growth is slowing and inflation may be approaching an inflection point, the market does not yet appear to believe this is enough to reverse the current trajectory of rising interest rates and further tightening of financial conditions by central banks. The past decade was one of complacency where investors had come to depend on the 'Fed Put', a notion that the Federal Reserve or other central banks around the world, would step in and bail out markets from any serious downturns. In recent months the goal posts have shifted, with central banks becoming far more explicit in their willingness to risk economic growth in order to control inflation. Labour markets remain tight and central banks will need unemployment to move higher before they can be confident inflation will be contained.

Futures markets are currently indicating that the Federal Funds Rate will peak at 4.5%, increasing the risk of a policy error and an economic 'hard landing'. Under this scenario, a rapid economic slowdown would invariably lead to company earnings pressure and further downside risk for shares notwithstanding multiples currently running at reasonable long-term levels. We are however cognisant of an alternative scenario in which short-term economic and inflation data surprises on the downside resulting in a quicker reduction in the pace of the tightening cycle which would be supportive for share markets.

On balance, our view is it is still too early to move decisively into shares given the significant uncertainty around the outlook for monetary policy, economic activity, and inflation. Our bear market playbook indicators all remain negative. We expect the central bank policy indicator to turn green early next year and depending on the path of earnings at that point, it may be the time to increase equity exposure.



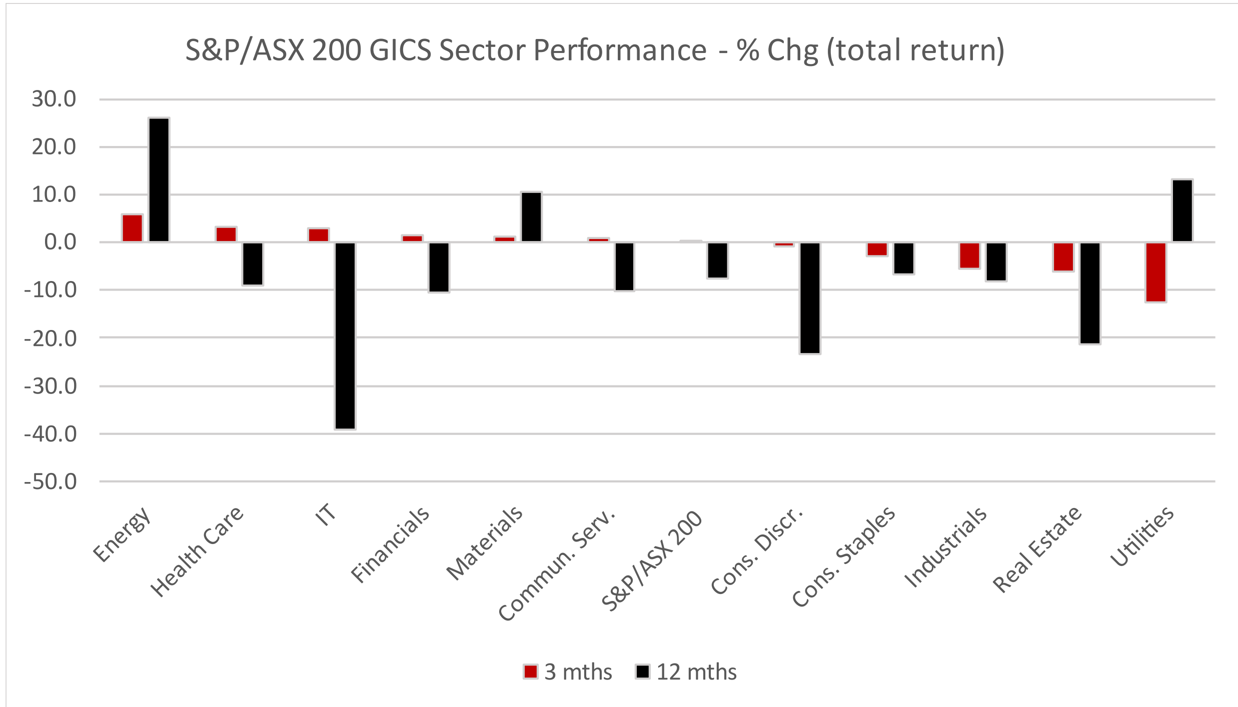
The chart above shows the change in S&P 500 company earnings typically lags the Goldman Sachs Financial Conditions Index by approximately six months and implies earnings downgrades are likely.

Australian Shares

The S&P/ASX 200 rose +0.5% for the quarter but was unable to buck the global trend in September, declining -6.3% for the month. This was despite a reporting season that surprised mildly to the upside, and a resilient domestic consumer that is yet to feel the full cashflow impact of the RBA's recent tightening. Australian small caps finished the September quarter down -0.5%, in what has been a challenging 12 months for the sector which tends to be more sensitive to changes in the economy than its larger peers.

In terms of sector performance over the September quarter, Energy (+5.9%) continued the robust outperformance seen over the past year. Health Care (+3.0%) and Technology (+2.9%) also outperformed on the back of expectations of resilient revenue and a resurgent US dollar translating into strong local earnings. Financials (+1.5%), Materials (+1.2%), and Communications Services (+0.9%) also outperformed the broader market. The more interest rate sensitive sectors of Utilities (-12.5%) and Real Estate (-6.2%), were the worst underperformers in the period.

We believe headline valuations for Australian shares are below long-term averages, albeit less so for industrials. Small caps are trading at multi-decade valuation discount to large caps. Earnings estimates are however yet to be revised lower to reflect weaker conditions and risks to household consumption posed by the RBA's current rate path. Quality companies are preferred in this environment.



Managers are saying:

"With interest rates expected to keep rising, the likelihood that the US and Europe will enter a recession in early 2023 is increasing but it's less certain if Australia will follow suit. High energy costs coupled with better conditions for commodities will help cushion the blow to the Australian economy, but future rate rises could do some damage. An official interest rate of 4% has the potential to push mortgage rates to the 6% range, putting considerable pressure on a highly leveraged Australian consumer." ***Fidelity International***

Global Shares

Higher than expected inflation and widespread geopolitical events also weighed on global shares. A volatile September saw the MSCI All Country World Index fall -8.4% hedged and -3.6% unhedged, dragging down quarterly returns by -4.9% and -0.3% respectively. Unhedged returns were propped up by a weaker Australian dollar that fell to US$0.64 by the end of September.

Growth outperformed value over the quarter, but value has been the relative outperformer over the last 12 months by the widest margin since the early 2000s, reflecting the greater negative impact sharp rises in rates has had on the shares of longer-duration growth companies and the strong performance of energy and resources companies. Consumer Discretionary (+2.1%) and Energy (+1.4%) were the only sectors to post positive returns for the quarter, with more rate-sensitive Communications (-11.9%), Real Estate (-10.6%), and Technology (-5.6%) the worst performing sectors. Higher yielding defensive sectors like Utilities and Consumer Staples that have been some of the best performers over the past year, experienced their worst month in September, in part due to rising rates and competition from other high yielding investment alternatives.

US shares suffered in September which has historically been their worst performing month. The S&P 500 gave up -9.2% over the month and -4.9% over the quarter, while the tech-heavy NASDAQ 100 was down -10.6% in September and -4.4% for the quarter. Shares in Europe fell -5.6% in September and -3.7% over the quarter amid the ongoing war in Ukraine, disappointing corporate earnings, and fears of recession. Emerging Markets slid -9.4% in September and -8.2% over the quarter in local currency terms as the US dollar continued to strengthen against Asian currencies and weigh on market sentiment. China's stock markets fell particularly hard as COVID lockdowns, currency weakness, and signs of a flagging economy fueled concerns about the country's outlook.

We believe the contraction seen in multiples is in-line with the rise in bond yields and global shares remain at fair value. Earnings remain robust but we are cautious on the earnings outlook as financial conditions tighten.

Managers are saying:

"October brings a raft of US company profit reports. Strong profitability over the past two years has been sustained beyond our expectations. However, we continue to be wary of profit downgrades as companies struggle to pass on the rising cost of doing business. Global share markets are unlikely to find surer footing until we see a sustained drop in broad inflation measures. This will take some time." ***Milford Asset Management***

Property and Infrastructure

September was another highly volatile month for property, dragging down the quarterly returns for the S&P/ASX 200 A-REIT Index by -6.7%. Global property fared even worse, falling -10.5% over the quarter. The last 12-month period has been tough for property. Having only just weathered the upheavals of the pandemic, REITs are now facing the impact of higher interest rate on two fronts – as bond proxies now offering relatively less attractive yields as they were when interest rates were lower, and also as their balance sheets begin to absorb the rising cost of debt.

Global infrastructure has held up relatively well, particularly when compared to global shares, and was in positive territory over the last 12 months until the large selloff in September. Infrastructure fell -10.9% in September and -7.6% over the quarter. A strong growth outlook for investment in infrastructure assets coupled with inflation resilience has seen the asset class demonstrate strong defensive characteristics.

Valuations remain fair for property and infrastructure, with spreads of forward dividend yields over government real yields near historical averages.

Managers are saying:

"Global listed infrastructure has outperformed global equities as inflation has risen over the past year. This is a reflection of listed infrastructure being a price maker, not a price taker. Infrastructure's tangible assets provide essential services, using contracted or regulated business models. These assets consistently demonstrate the ability to pass though the effects higher input costs and inflation to the end user. This can be achieved through regulated real returns for utilities, or through contracts which explicitly link tolls or fees to the inflation rate.

Infrastructure's capital-intensive nature provides high barriers to entry which have allowed incumbent operators in other sectors, such as mobile towers and freight rail, to achieve similarly robust pricing results even without explicit inflation links. Our analysis has found that more than 70% of assets owned by listed infrastructure companies may have effective means to pass-through the impacts of inflation to customers, to the benefit of shareholders." ***First Sentier Investors***

Australian Cash & Fixed Interest

Against a backdrop of hawkish remarks from the US Federal Reserve and turbulence in the UK, Australian fixed interest posted losses over the quarter as bond yields surged across the curve and spreads widened. The Bloomberg AusBond Composite 0+ Year Index, which measures the performance of all government, semi-government, and corporate bonds, was down -0.6% over the quarter including a step decline of -1.4% in the month of September. Higher bond yields were the main detractor from this underperformance, while investment grade credit was also softer.

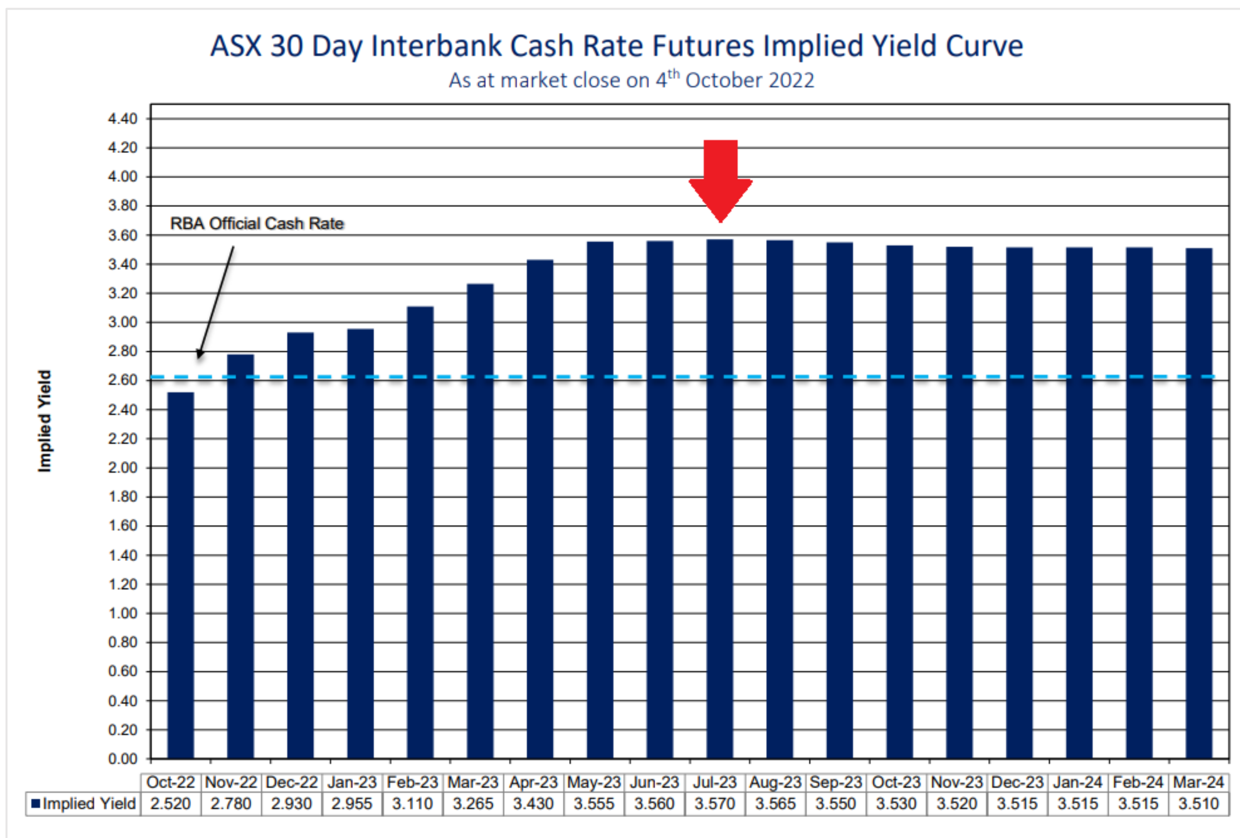
The yield on the Australian 2-Year Government Bond rose as high as 3.70% before ending the quarter at 3.47%, 63 basis points higher than at the start of the quarter. Further along the curve, Australian 10-Year Government Bond yields ended 28 basis points higher at 3.89%. The three-month bank bill yield ended the month 61 basis points higher at 3.06%, while six-month bank bills ended 56 basis points higher at 3.57%. Although the inflation-driven increase in rates has been painful for returns across the market, fixed interest is finally starting to offer investors an acceptable level of income that has been scarce in the low-rate environment of the past decade.

Yields on Australian duration are at attractive levels and offers upside if the economy slows, while shorter terms yields appear to be pricing in unrealistic RBA hikes. Credit spreads have widened to attractive levels, but we also remain cautious of fundamentals deteriorating if an economic slowdown occurs.

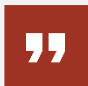
October RBA Meeting Update

Having aggressively increased the cash rate target by 50 basis points in each of its last four meetings, the RBA surprised financial markets at its October meeting with a smaller than expected 25 basis points lift to 2.6%, perhaps signalling an end in sight to the fastest tightening cycle in modern history. The decision triggered the huge intraday drops in shorter-dated Australian government bond yields and the largest one-day rise in the S&P/ASX 200 index in two years. The market immediately cut expectations for the cash rate target to peak at just over 3.5% by mid-2023 (down from over 4% before the RBA's decision) and potentially puts the RBA on a different path to the US Federal Reserve which recently signalled its federal funds rate is likely to end the year close to 4.5%.

"A further increase in inflation is expected over the months ahead, before inflation then declines back towards the 2–3% range. The expected moderation in inflation next year reflects the ongoing resolution of global supply-side problems, recent declines in some commodity prices and the impact of rising interest rates. Medium-term inflation expectations remain well anchored, and it is important that this remains the case. The Bank's central forecast is for CPI inflation to be around 7.75% over 2022, a little above 4% over 2023 and around 3% over 2024." **RBA Governor Philip Lowe.**



Managers are saying:



"The UK gilt meltdown last week was another in a long list of bond market volatility events. The UK isn't Australia and the RBA's decision was a solid reminder of the clear differences between the two in terms of central bank response and challenges. The issue for Australian bond markets in an environment where nerves are frayed and uncertainty high is that it has been all too easy for markets to extrapolate from offshore experience into a local context. All major economies share some of the same challenges – low unemployment, a surprisingly strong post COVID rebound and inflation pressures. But the differences with the UK, which literally imports most of its electricity for example, and Australia are stark. This market nervousness however does explain why when an event like that which happened in the UK occurs, it quickly flows through to a local context." ***Franklin Templeton***

Fixed Interest Rates & Spreads					
As at 30/9/2022	Month End	1 month earlier	3 months earlier	12 months earlier	10 Year Average
Australian RBA Cash Rate	2.35	1.85	0.85	0.1	1.5
Australian 10 Year Bond Yield	3.89	3.6	3.66	1.49	2.45
Australian Corporate Composite Bond Spread	1.9	1.75	1.84	1.02	1.2
US Fed Funds Rate	3.25	2.5	1.75	0.25	0.85
US 10 Year Bond Yield	3.83	3.2	3.02	1.49	2.08
US Aggregate Corporate Bond Spread	1.59	1.4	1.55	0.84	1.25
US High Yield Bond Spread	5.52	4.84	5.69	2.89	4.33
Bloomberg Ausbond Comp 0+ Yrs	3.99	3.64	3.55	1.04	2.3
Bloomberg (Barclays) Global Aggregate	3.7	3.1	2.91	1.17	1.63

Global Fixed Interest

Global fixed interest markets finished down -3.8% for the quarter due to concerns around tightening financial conditions. As the Fed raised rates, yields on US Treasuries climbed rapidly. The yield on the US 10-Year Treasury rose to 3.97% on the 27 September, its highest level since 2010, and settled at the end of the quarter at 3.83%. The 2-Year Treasury yield ended the quarter even higher at 4.22%, up from 2.84% at the start of the quarter—a very large move for a short-term government bond. With short-term Treasury yields higher than long-term yields, the bond market is in what is called an inverted yield curve, often seen as a precursor to a recession. UK bonds had their worst quarter on record after the Government's ill-timed fiscal package announcement.

We believe yields on global duration are at attractive levels and offer upside if the economy significantly slows. Credit spreads have widened to attractive levels, but we also remain cautious of fundamentals deteriorating if an economic slowdown occurs.

Managers are saying:

"With higher yields across maturities, we believe the case is now stronger for investing in bonds. We believe high quality fixed income markets can now be expected to deliver returns much more consistent with long-term averages, and we think the front end of yield curves in most markets already price in sufficient monetary tightening.

In addition to higher income potential, yields are high enough to provide the potential for capital gains in the event of weaker-than-expected growth and inflation outcomes or in the event of more pronounced equity market weakness. We expect that more normal negative correlations between high quality bonds and equities will re-assert themselves, thus improving the hedging characteristics of quality core bonds, which generally should rise in value when equities fall. Also, the higher yields offered in bond markets today could help compensate those who choose to wait out this period of uncertainty and potentially higher volatility." ***Pimco***

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