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EVIDENTIA GROUP

Quarterly Market Update

December 2022

MARKETS SUMMARY

Key Markets - Trailing Total Returns (%)						
As at 31 December 2022	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australian Shares	-3.2	9.4	-1.1	5.5	7.1	8.7
Australian Small Cap Shares	-3.7	7.5	-18.4	1.4	2.9	5.1
International Shares (Hedged)	-4.8	7.1	-17.7	3.2		
International Shares	-5.1	4.1	-12.5	5.3	8.3	12.7
Developed Markets Shares (Hedged)	-5.1	7.2	-17.7	4.0	5.7	10.4
Developed Markets Shares	-5.4	4.1	-12.2	6.2	9.2	13.6
Emerging Markets Shares (Hedged)	-2.2	5.9	-18.1	-2.5		
Emerging Markets Shares	-2.6	4.0	-14.3	-1.5	1.5	5.8
Australian Property	-4.1	11.5	-20.5	-1.5	3.3	8.1
International Property (Hedged)	-3.8	4.0	-24.2	-5.6	-0.4	4.6
International Infrastructure (Hedged)	-2.8	6.4	-4.2	1.2	4.8	8.7
Australian Fixed Interest	-2.1	0.4	-9.7	-2.9	0.5	2.3
International Fixed Interest (Hedged)	-1.3	0.6	-12.3	-3.2	-0.2	2.3
Cash - Bank Bills	0.2	0.7	1.3	0.5	1.0	1.7

The December quarter produced a stronger than expected bounce across all asset classes after a tough year for investors. Fixed interest (bond) markets looked to have bottomed with prospective returns much better than they were a year ago. Australian and International shares both rallied as investors saw an end to rising interest rates which was the major headwind throughout 2022. In our view, the key issues and themes for investment markets remain inflation and interest rates, and the implications for company earnings and global economic growth.

OUTLOOK FOR INVESTMENT MARKETS

As we saw in the December quarter, markets are forward-looking. While we expect 2023 to be a challenging year for the global economy, with volatility in investment markets likely to remain elevated, the bigger question is how much of this has already been discounted by markets. Inflation appears to have peaked and we believe the unprecedented program of central bank rate tightening is mostly behind us, however financial conditions are all but certain to stay tight for some time. Peak cash rates have moved materially higher and the US Federal Reserve (Fed), whose decisions often influence those of other global central banks, has strengthened its hawkish stance and the lengths it is prepared to go to drag inflation back to its 2% target level (annualised PCE inflation is currently 5.5%). Cooling an overheated labour market is now seen as necessary for taming inflation. Based on where the Fed sees the unemployment rate heading to achieve this, it is getting harder to envisage a scenario where the US orchestrates a soft landing and avoids a recession.

As we have pointed out in the past, a market sell-off like we saw in 2022, usually provides for good prospective returns. We are however remaining cautious for the time being given the heightened uncertainty on how consumers and corporate earnings, which have remained resilient until this point, will cope with higher-for-longer interest rate settings. Consumer spending is softening rather than collapsing, but excess savings are falling as higher borrowing and living costs are absorbed. Even though company earnings have held up better than expected, there have been early signs of stress with major headcount reductions being announced. Historically, recessionary conditions have brought with them declines in corporate earnings, and it is hard to argue against this happening this time. Meanwhile, other risks continue to bubble away in the background that could move markets in both directions. A re-opening of China's economy and release of pent-up demand could create the same inflationary pressures we experienced in Western economies, but it could also prove beneficial for global supply chains and productivity. A de-escalation in the Russia-Ukraine conflict would be positive for markets, while an escalation would be destabilising in the short term.

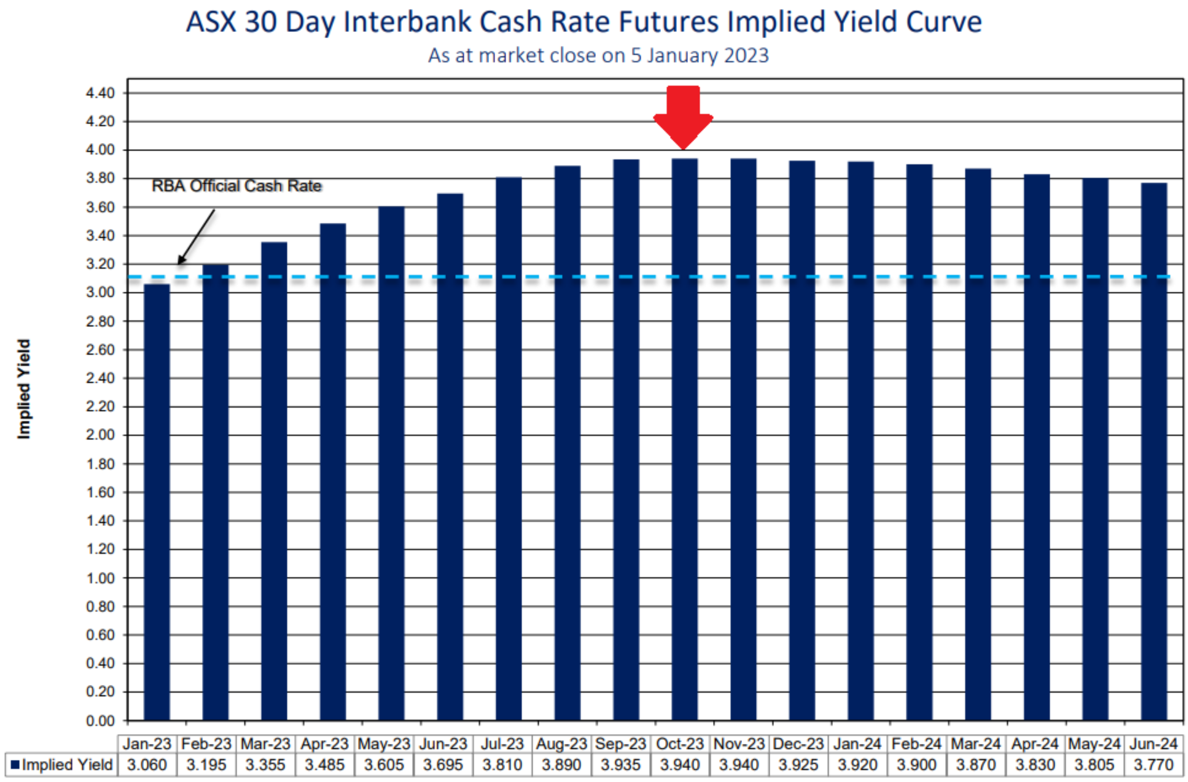
Despite our caution, we are mindful that when markets turn, they tend to turn quickly, which is why retaining exposure growth assets remains critical and why we believe retaining a neutral weighting is appropriate in the current environment. But of course, we cannot predict when markets will turn in the short term, so patience is required. More clarity on the outlook for interest rates, company earnings, and markets is expected to emerge over the coming months and will guide any changes we make to our current investment outlook and portfolio positioning.

ECONOMIC REVIEW

Australia

The Australian economy expanded by a solid 0.6% in the September quarter but is showing further signs that momentum is slowing. The consumer savings rate dropped from 8.3% to 6.9% over the same period and is likely to fall further to support households in the face of higher mortgage and living costs. Inflation continued to moderate, with CPI for the 12 months to October rising 6.9%, well below consensus forecasts of 7.6% and down from 7.3% in September. On a monthly basis, the drop was even more pronounced, with CPI falling from 0.6% in September to 0.2% in October. Although not a certainty, seasonality has been flagged as a factor with upcoming November and December data that could result in an increase in CPI, albeit most likely temporary.

Labour market conditions remain tight in Australia, with employment lifting by a stronger-than-expected 64,000 in November. The participation rate also moved higher to 66.8%, which left the unemployment rate unchanged at 3.4%. The Reserve Bank of Australia (RBA) lifted the cash rate by a widely expected 25 bps in early December, taking the cash rate to 3.1%. While noting monetary policy was not on a pre-set path, the RBA signaled that further rate rises were likely over the period ahead, with the interval and size of moves to be dictated by incoming data and the RBA's assessment of the labour market and inflation outlook. The futures market is currently pricing in a peak cash rate of 3.94% which is expected to be reached in late 2023, suggesting at least another three 25 bps rate rises.



Source: ASX

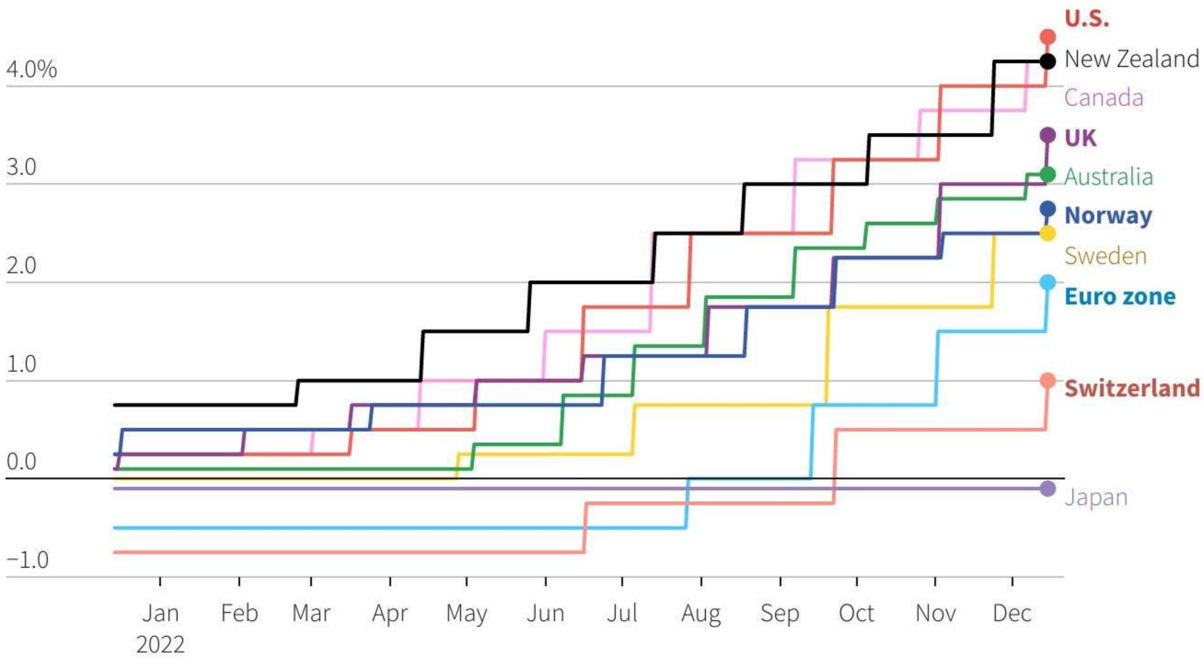
US

September quarter GDP data released in December grew at an annualised rate of 3.2%, stronger than estimates. The labour market remains strong on the surface, with 223,000 jobs added in December and the unemployment rate edging down to 3.5%. But cracks are appearing, with wage growth falling from 4.8% in November to 4.6% in December. While remaining elevated, the latest CPI print for November showed inflation slowed to 0.1% over the month and 7.1% over the year. The Personal Consumption Expenditures price index (PCE), the Fed's preferred inflation gauge, fell from 6.1% in October to 5.5% in November, with prices for goods falling sharply but services inflation remaining sticky. The Fed raised rates at the fastest pace in history during 2022 in an effort to stamp out decades-high inflation. Over the December quarter, this included a 75 bps rise in November followed by a slightly less aggressive 50 bps rise in December to take the federal funds rate target to 4.25%-4.50%. Chair Jerome Powell struck a hawkish tone after the Fed's December meeting, flagging a higher peak rate than expected. The Fed is now projecting a peak rate of 5.1% in December 2023, up from 4.6% in the prior projection from September 2022, implying three more rate hikes of 0.25% and no cuts through to the end of the year. Futures markets are expecting a peak of 5.0% in July 2023 before cuts in late 2023.

Europe

The eurozone faced its most challenging year for inflation in its history, though signs emerged towards the end of the December quarter that there may be some respite with the region's latest data signalling a slowdown in headline inflation, helped by falling energy price pressures. The region's inflation measure, the Harmonised Indices of Consumer Prices (HICP), fell to 10.1% from 10.6% in October. On the GDP front, the eurozone economy grew by 0.3% in the September quarter but is expected to contract in the December quarter and the first quarter of 2023, owing to the energy crisis, high uncertainty, weakening global economic activity and tighter financing conditions. Nevertheless, the European Central Bank (ECB) continues to tighten monetary policy conditions, maintaining its hawkish message and indicating future rate hikes. The ECB raised interest rates by 50 bps in December to 2.5%, which followed two successive 75 bps hikes.

Central Bank Policy Rates - 12 Months to 15 December 2022



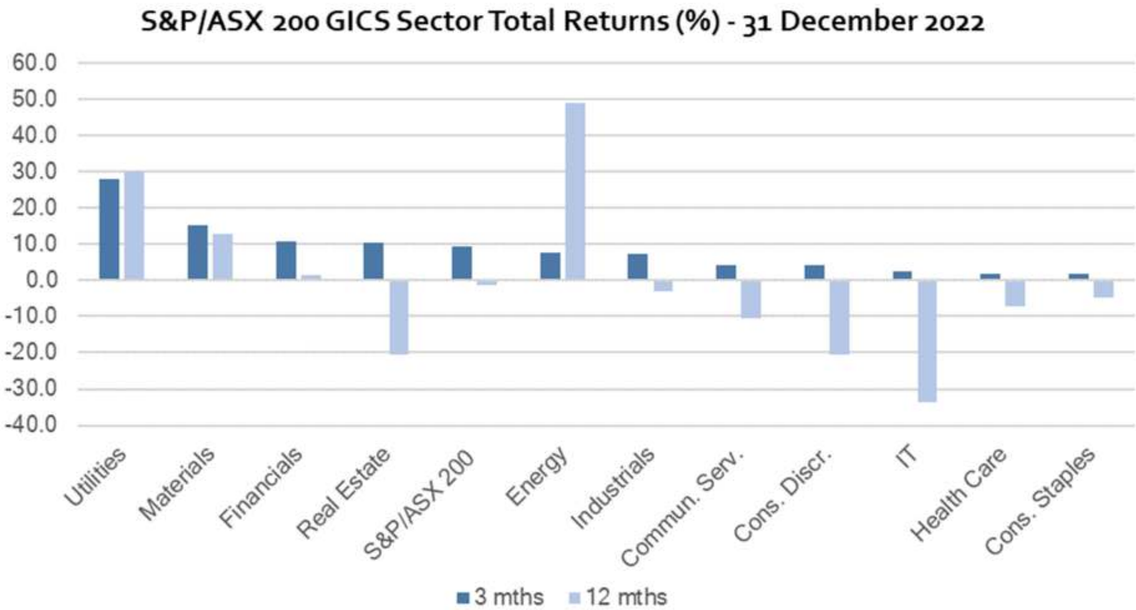
Source: Reuters

Asia

A key event for markets in December was the decision by the Bank of Japan (BOJ) to widen the band in which it has been controlling 10-year government bond yields. Although such a change had always been seen as a logical first step towards monetary policy normalisation, the timing of the decision surprised markets. News of the change, which was only to the control band and not an actual interest rate rise, resulted in the Yen strengthening and bond yields spiking, and also reflects a belief Japan's inflation rate is finally moving into a more sustainably positive range after decades of deflation. The relaxation of China's zero-Covid policy restrictions on the local population and international arrivals helped boost optimism regarding an earlier-than-expected re-opening of the economy but rising numbers of Covid cases are likely to create headwinds for economic growth in the very near term. Government support for the housing sector also added to positive sentiment in China over the quarter.

Australian Shares

Australian shares fell in December but produced a strong quarter as the S&P/ASX 200 Index jumped 9.4% and only narrowly missed out on posting positive returns over a turbulent year. The S&P/ASX Small Ordinaries Index also performed well lifting 7.5% over the quarter but lagged the broader market. Given the fortunes of small companies are more sensitive to economic conditions and interest rates, they fared significantly worse in 2022 than their larger peers, falling -18.4% compared to -1.1%. At a sector level, an increase in base metal prices on China's re-opening hopes helped Materials (+15.2%) outperform the S&P/ASX 200 Index over the quarter. Utilities (+28.0%) also outperformed thanks largely to outsized contributions from takeover targets AGL Energy and Origin Energy. Financials (+11.0%) and Real Estate (+10.4%) outperformed, and although no sectors had negative returns over the quarter, Consumer Staples (+1.8%), Health Care (+1.9%), and Information Technology (+2.5%) all lagged the broader market.



"Whilst the year that passed was largely characterised by higher interest rates responding to rising inflation, investors will need to factor in the actual impact of rising rates on the real economy and company earnings in the year ahead. As higher rates slow the economy, companies will be under pressure in terms of their ability to increase prices when consumers start consuming less, straining the cost structure of businesses, and impacting profit margins. Another pressure is that we're living in a world of labour shortages and whilst companies usually shed labour when demand weakens, we may be in an environment where companies choose to hold onto labour for longer potentially impacting margins.

First Sentier Investors

Source: Evidentia

International Shares

International Shares - Trailing Total Returns (%) All Local Currency						
As at 31 December 2022	1 mth	3 mths	12 mths	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Australia	-3.2	9.4	-1.1	5.5	7.1	8.7
US	-5.8	7.6	-18.1	7.7	9.4	12.6
Europe	-4.3	14.6	-9.5	2.6	4.0	6.4
UK	-1.5	8.7	4.7	3.1	3.3	6.3
Japan	-4.6	3.3	-2.5	5.7	3.2	10.6
China	4.8	12.5	-20.7	-7.3	-4.5	2.5
Asia (Ex-Japan)	-0.9	8.2	-15.4	0.1	0.7	4.8
Latin America	-4.0	2.5	4.2	1.4	5.3	5.4

International shares were up over the quarter but fell in December. The MSCI AC World Index rose 4.1% over the December quarter, while hedged international shares finished up 7.1% reflecting the recent strength in the Australian dollar. Most Developed Markets sectors performed well in the December quarter, including Financials (+13.0%), Materials (+13.1%), and Industrials (+14.1%), while Consumer Discretionary (-4.8%) was a notable exception with Tesla's decline an outsized influence. While posting positive returns for the quarter, the US tech-heavy Communication Services and Technology sectors were the worst places to be invested in 2022. The six largest US tech companies – Apple, Microsoft, Alphabet, Nvidia, Amazon, and Meta Platforms, dominate these global sectors and together lost nearly US$4 trillion in market value in 2022. Emerging markets performed in line with Developed Markets over the quarter. As they have done all year, value companies significantly outperformed growth companies over the quarter (+12.4% vs +2.5%), a result of high starting valuations for growth companies and the effects of rising interest rates.

The broader US share market made robust gains over the December quarter with the S&P 500 up 7.3% but fell sharply in December. Most sectors rose over the quarter, a number climbing significantly. The Energy sector was again the winner as rising oil and natural gas prices, sparked by OPEC production cuts and the fallout of Russia's invasion of Ukraine, contributed to gains for the sector. While falling in December along with all global markets, European shares notched up a strong advance in the December quarter lifting 14.6% which was supported by hopes that inflation may be peaking in the region and the ECB would raise interest rates at a slower pace than its previous hike. Returns on Asia (ex-Japan) shares were robust over the quarter, with a recovery in Hong Kong and Chinese listed shares continuing in December after the Government loosened its zero-Covid policy restrictions that have constrained economic growth since early 2020. China is one part of the world where few would argue that a lot of bad news has already been priced into markets. The MSCI China Index has fallen 50% from its 2021 peak and was down -20.7% in 2022, even after a strong 12.5% rally over the December quarter.

> *"As we move into 2023, we expect to see further pressure on corporate earnings due to higher operational and financing costs, while weakness in demand tempers revenue growth. Well-managed companies anticipate and plan for these periods in their business cycles and emerge stronger. In our opinion, pessimism leads to buying opportunities and the best potential for long-term outperformance. We are finding opportunities in companies with strong balance sheets and business models that we believe can withstand economic weakness and emerge as industry leaders in the cycle that follows a slowdown."*
> ***Franklin Templeton***

Property & Infrastructure

The defensive qualities of international infrastructure cushioned performance in December, where the asset class fell -2.8% but outperformed broader international shares. Over the quarter, global infrastructure returned 6.4%, and although it was one of the better asset classes to be invested in during 2022, finished the year down -4.2%. In what has been a difficult year for listed property, which is highly sensitive to rising interest rates, the S&P/ASX 200 A-REIT Index finished the year positively up 11.5% over the December quarter. The S&P Global REIT Index was up 4.0% over the quarter.

> *"We should see a fundamental strengthening of terms in 2023. After a long period of low interest rates, during which a lot of real estate seemingly offered the same standardised yield almost regardless of quality, we're now moving into a period of more rational pricing. This creates the potential for more differentiated returns between sectors, property types, and locations that active real estate investors can take advantage of."*
> ***Fidelity International***

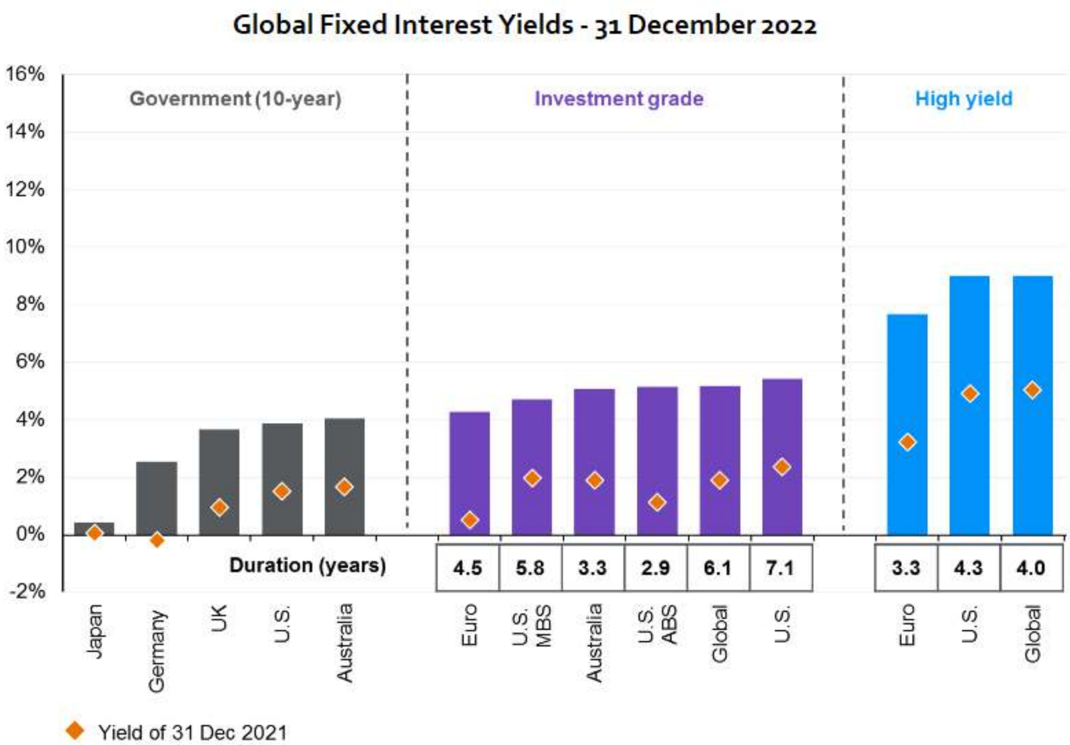
Fixed Interest

Fixed Interest - Rates, Yields & Spreads

As at 31 December 2022	month end	1 mth earlier	3 mths earlier	12 mths earlier	10 yr average
Australian RBA Cash Rate	3.10	2.85	2.35	0.10	1.49
Australian 10 Year Bond Yield	4.05	3.53	3.89	1.67	2.46
Australian Corporate Bond Spread	1.91	2.01	1.90	1.13	1.21
US Fed Funds Rate	4.50	4.00	3.25	0.25	0.94
US 10 Year Bond Yield	3.88	3.61	3.83	1.51	2.13
US Corporate Bond Spread	1.30	1.33	1.59	0.92	1.25
US High Yield Bond Spread	4.69	4.48	5.52	2.83	4.31
Bloomberg Ausbond Comp 0+ Yrs Yield	4.09	3.69	3.99	1.46	2.32
Bloomberg International Aggregate Yield	3.73	3.53	3.70	1.31	1.68

Australian fixed interest posted a gain over the December quarter with the Bloomberg AusBond Composite 0+ Yr Index up 0.4%. Bond yields had initially fallen (and bond prices risen) on hopes the tightening paths most central banks were on were beginning to slow, only for them to rise in December as risk appetite began to wane following hawkish Fed comments and the unexpected decision by the BOJ. The Bloomberg AusBond Composite 0+ Yr Index fell 2.1% in December. At the shorter end of the yield curve, the Australian and US 2-Year Government Bond yields rose 11 bps and 16 bps respectively over the quarter to end at 3.42% and 4.43% but had been significantly lower in early December. Further out the curve, the Australian and US 10-Year Government Bond yields were relatively flat, ending the quarter at 4.05% and 3.88%, again disguising significant volatility during the quarter. Credit spreads tightened across the quarter on improved risk sentiment, although the strong performance was tempered slightly into year-end. The credit spread is the difference in yield between bonds of similar maturity but with different credit quality. US and European investment grade and high-yield credit generated positive returns and outperformed government bonds over the quarter.

> *"There are a number of reasons why bonds are becoming increasingly attractive and we are expecting to see greater investor demand for fixed income in 2023. Firstly, there are signs that inflation pressures are easing, led by US disinflation. Secondly, slower growth dynamics – particularly in the US. Thirdly, central banks are closer to ending their rate-hiking cycles, particularly those economies with a greater sensitivity to higher interest rates. Lastly, bond valuations are attractive, with yields a lot higher relative to a year ago."*
> ***Schroders***



Source: J.P. Morgan Asset Management