Monthly Commentary

August 2022

Economic Review

Global equity markets fell during August, as hawkish commentary from the Federal Reserve's annual Jackson Hole symposium softened investor sentiment. The building narrative of a nearer term Fed pivot and soft landing was discounted by the market, with expectations now that the current rate tightening cycle will remain higher for longer.

Equity markets had rallied strongly from their recent June lows, despite increasing evidence of a slowing global economy and emerging downside risk to forward earnings estimates. This resulted from growing expectations for a rate policy pivot, following ambiguous comments from Fed officials after the July FOMC meeting and some early signs of inflation peaking. This misguided expectation was dashed during the month by Fed Chair Jerome Powell in his Jackson Hole address. It was made clear that the Fed continues to prioritise price stability and will continue to move purposefully to a level of rates sufficient to return inflation to 2%. He acknowledged that there will likely be economic pain, and that growth will likely be below trend for 'a sustained period'. He also cautioned of the risk associated with loosening policy prematurely. As a result, markets have been forced to recalibrate expectations for rates to move higher, and remain so for longer, and acknowledge the heightened risk of a policy induced recession.

Economic data out of the US remains mixed. The S&P Global US Manufacturing PMI (51.5) is still in growth territory (above 50) but has declined significantly from 2021 highs of over 63. In recent months both output and new orders have been contracting and housing activity continues to weaken. However, recent Business and consumer confidence measures have improved and labour markets remain tight. Early signs are that US Inflation looks to have peaked. The Headline Personal Consumption Expenditure (PCE) price index in the US declined -0.1% in July to be up 6.3% year on year (June 6.8%). Likewise, Headline CPI was also flat in July and below market expectations. Consumer survey data has also revised down respondents' year-ahead and 5Y-ahead inflation expectations, with the 4.8% year-ahead estimate the lowest in eight months.

Key Market Returns as at 31 August 2022

Trailing Returns *Change, Total Return Basis*	Period ended 31/8/2022 1 mth	3 mths	12 mths	3 yrs (p.a.)	5 yrs (p.a.)	10 yrs (p.a.)
Australian Shares	1.2	-2.4	-3.7	5.6	8.2	9.3
Australian Small Caps	0.6	-2.6	-14.7	4.1	6.9	6.3
Global Shares - All Country (Local)	-3.0	-3.8	-11.8	9.1	8.1	10.2
Global Shares - All Country (Unhedged)	-2.0	-1.3	-10.3	7.4	10.1	13.3
US Shares (USD)	-4.1	-3.9	-11.2	12.4	11.8	13.1
Europe Shares (EUR)	-5.1	-7.0	-14.0	3.1	3.0	6.4
Emerging Mkts Shares (Local)	1.2	-3.3	-15.8	4.9	3.2	5.9
Global Property (Hedged)	-5.7	-6.4	-13.8	-1.8	2.0	6.4
Australian Property	-3.5	-3.2	-11.1	-1.5	5.8	9.4
Global Infrastructure (Hedged)	-1.0	-1.6	5.1	4.4	5.9	10.1
Australian Fixed Interest Composite	-2.5	-0.8	-11.5	-3.1	1.0	2.6
Global Fixed Interest Composite (Hedged)	-2.7	-1.9	-10.5	-2.7	0.5	2.9
Cash - Bank Bills	0.2	0.3	0.4	0.4	0.9	1.7
Evidentia 70 Growth SAA Benchmark	-1.0	-1.6	-6.8	3.8	6.4	8.5

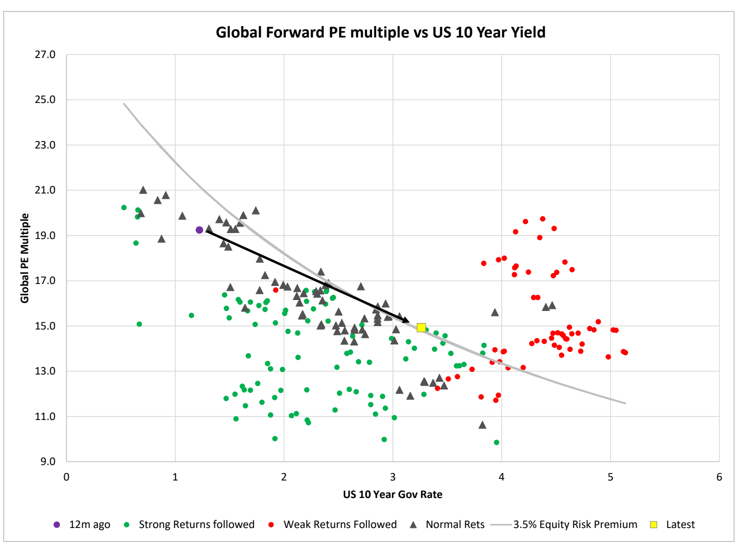
The Energy crisis in Europe has continued to intensify with Russia closing the single biggest gas pipeline to Europe claiming punitive economic sanctions imposed by the West are responsible for the indefinite halt to gas supply. Eurozone inflation prints continue to worsen. Headline inflation increased to 9.1% in the year to August, up from 8.9% in July, marking another record high. Core inflation is now running at 4.3%, also a record high.

China's Covid situation compounded concerns about the growth outlook as Chengdu was plunged into lockdown. The Caixin China Manufacturing PMI fell back into contractionary territory in August, reflecting tightened Covid restrictions, a deepening property market slump, recent heatwave/power outages, and softening external demand. Retail sales, industrial output and investment all slowed in July and missed economists' estimates, also pointing to ongoing weakness. In response, China's central bank cut both 1 year and 7 day lending rates by 10b.p. New credit in July increased at the slowest pace since 2017, highlighting increased reluctance to borrow and suggesting the need for Chinese policy makers to do more.

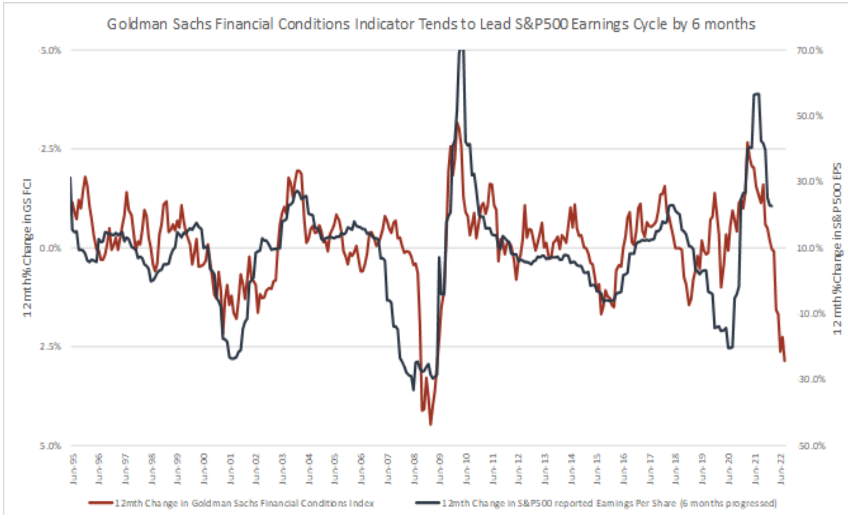
Domestically, Australia's economy continues to grow solidly supported by a strong terms-of-trade and record trade surplus. GDP in the June quarter increased by 0.9% to be up 3.6% over the last year. Labour markets remain tight with job vacancies at high levels. Forward indicators are softening. Australia's PMI fell into contractionary territory in August with a reading of 49.8 compared to July's 51.1. The survey indicated a contraction in private sector output as inflation and interest rate hikes dragged on sales. However, input and selling price inflation eased to a six-month low and business sentiment remained in optimistic territory

Outlook for Investment Markets

While equity markets have fallen substantially since their peaks earlier this year (S&P500 -16.7%, MSCI World -15.2%), we broadly view the de-rating in equities to be in-line with what should be expected given the rise in nominal bond yields to maintain an equivalent equity bond risk premium, as shown on the first chart below. With valuations at a fair level, the risk to equities going forward lies in the earnings outlook. While forward earnings expectations have flat-lined (or moderated slightly) in recent months they are still showing strongly positive outcomes in the year ahead (12% for MSCI World) and are based on elevated profit margins which tend to be cyclical and mean reverting. These margins are against a backdrop of tightening financial conditions, slowing global growth and input cost pressures. We therefore see greater risk to earnings than currently factored into analysts' consensus forecasts. The chart further below shows that the change in S&P500 Reported Earnings typically lag the Goldman Sachs Financial Conditions Index. The potential for material earnings downgrades, particularly in a recessionary environment, likely frames the downside risk for equity markets from here.



*Comparison of historical relative valuations between government bonds (x-axis: US 10 year bond yield) and equities (y-axis: MSCI World Forward PE). Scatter-plot colours indicate strong (>10%) or weak (<5%) subsequent 5-year equity market performance from time of observation. Grey line indicates where Earnings Yield (inverse of PE) is 3.5% above bond yields.



*The GS FCI combines short-term interest rates, long-term interest rates, the trade-weighted dollar, an index of credit spreads, and the ratio of equity prices to the 10-year average of earnings per share to indicate the tightness of financial conditions.

Managers are saying:

"While we cannot exclude further volatility in equities, further downside could be limited in magnitude as investors try to catch the market bottom after months of extremely bearish positioning….

However, we remain neutral on equities overall as there are important geopolitical risks and margin pressure could become more intense in Q3 as economic activity slows.

We are aware of the economic challenges ahead, especially as the risk of an energy crisis grows in Europe"
Pictet

Australian Shares

The S&P/ASX 200 outperformed developed markets, rising +1.2% during the month (now -3.6% calendar YTD), driven by a better than feared reporting season and strength in Resource stocks (+5.9%) relative to Industrials (+0.4%). Recent company reporting has highlighted resilient earnings within a more challenging operating environment.

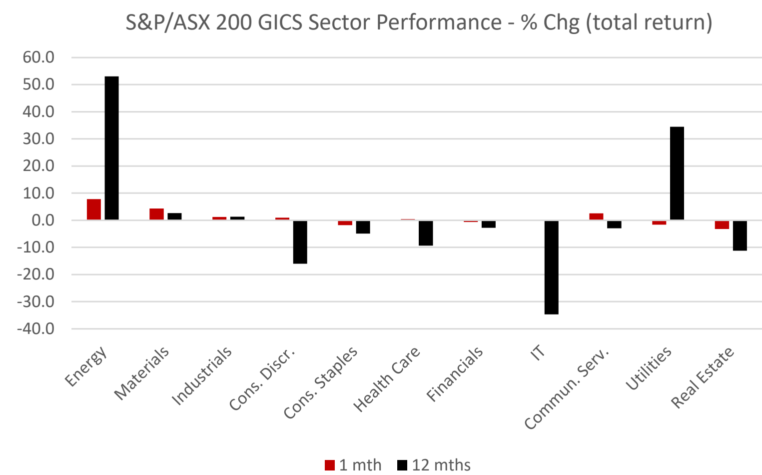
In terms of S&P/ASX 200 sector performance, Energy (+7.8%) and Materials (+4.4%) strongly out-performed. This was more reflective of strong reported earnings and cash distributions than recent commodity price trends, which have been less supportive. Communication Services (+2.5%) and Industrials (+1.2%) also out-performed the broader index. The strong rise in bond yields and softer forward guidance for several stocks saw REITs (-3.2%) as the largest under performer, whilst signs of customers trading down saw Consumer Staples soften (-1.8%) given investors' defensive positioning in the sector. Utilities (-1.6%), Financials (-0.6%), Information Technology (-0.1%), Health Care (+0.4%), and Consumer Discretionary (+0.9%) also underperformed the S&P/ASX 200.

The recently completed domestic reporting season came in better than feared, with more than two thirds of companies delivering upon, or modestly exceeding, earnings expectations. In absolute terms it was a solid year of growth, with 23% EPS growth for the S&P/ASX 200, albeit flattered by 38% EPS growth for Resources on the back of rising commodity prices. Industrials (ex Resources, ex Financials) EPS growth was 7%, driven by solid growth in revenues, slightly offset by modestly lower margins.

Consumer demand has to date proven more resilient than many feared in the face of rising interest rates and higher inflation, with activity levels continuing to defy a sharp deterioration in sentiment indicators. There are signs of raw input prices peaking, whilst supply chain bottlenecks and logistics costs continue to normalise. Labour shortages remain acute in certain sectors (such as mining, construction, healthcare), whilst there is a watching brief for any signs of more broad-based wage inflation.

A number of companies have so far demonstrated an ability to effectively pass-through cost increases, and therefore largely maintain margins. However, we view that it will become more challenging to pass further cost rises onto consumers as the demand outlook softens.

Whilst the reporting season did see downgrades to F.23 earnings expectations, these revisions have been modest to date. Across S&P/ASX 200 companies, EPS estimates have been revised down by a median of -1.2% since 30 June (lesser -0.3% median revision for Industrials). From a top-down perspective, we continue to view circa 10% F.23 EPS growth for ASX 200 Industrial stocks as optimistic amidst a softening outlook for both top line growth and margins.



Global Shares

The MSCI AC World Index was -3.0% in local currency, with Developed Markets -3.5% (Emerging Markets +1.2%). After rallying strongly in July, the S&P 500 declined -4.1% in August (now -16.1% calendar YTD), whilst the NASDAQ fell -4.5% (-24.1% YTD). Despite this pullback we note that the S&P 500 still closed the month +8.8% from the recent lows reached in June.

Value stocks (-2.3%) modestly outperformed growth stocks (-4.6%) with Energy (+2.8%) the only sector to generate a positive return whilst Technology (-5.7%), Healthcare (-5.4%), and Realestate (-5.4%) saw the weakest sectoral returns.

Unhedged returns outperformed hedged returns over the month as the Australian dollar depreciated 2% to US$0.68c.

Quarter 2 earnings season saw S&P revenues in line with market forecasts while earnings were slightly above showing that margins have remained resilient to date. In addition, earnings guidance has also been a little better than expected.

Managers are saying:

"There are two very different paths forward from here:

***Positive case**: The combined effect of diminishing supply chain pressures, slowing labour demand and rising participation allows the Fed to avoid raising rates too far. Falling inflation requires only a moderate economic slowdown. Risk premiums fall, along with the outlook for rates, enabling markets to recover.*

Negative case**: Inflation remains embedded too high. Combined with the European power crisis and ongoing lockdowns in China, this forces central banks to raise rates into a global economic slowdown. Such an environment may induce some form of additional financial shock, further exacerbating the downturn and market pessimism".* ***Pendal

Australian & International Property and Infrastructure

Australian Listed Property (-3.5%) and Global Listed Property (-5.7%) were two of the weaker sectors in August on the back of higher bond yields, reversing some of the strong gains made in July. Global Infrastructure continues to demonstrate its defensive characteristics declining by just -1.0% in August. Over the past year, Listed Infrastructure has increased by 5.1% against a backdrop of a nearly -12% decline in global equity markets.

Managers are saying

" Elevated inflation and rising interest rates will create some challenges for asset prices. Within this context we think REITs are relatively well positioned. We look at the supply and demand fundamentals which are in decent shape; moderate outlook for supply and rising construction costs will limit new supply looking forward. We look at the balance sheets of the vehicles which are generally in pretty good shape with moderate leverage and lengthened debt maturities. REITs and real estate also have the ability to provide that inflation hedge with increases in annual cash flow and rising replacement costs provided that pricing power holds. Also compared to the underlying real estate, REITs are now trading at a discount and that typically closes over time ..... If REITs continue to trade at the discounts they are, ultimately that will be arbitraged by Private Equity accessing some of the high quality real estate in the listed market ." ***Resolution Capital***

Australian Cash & Fixed Interest

The RBA tightened monetary policy at its September meeting, increasing the Official Cash rate by a further 50bps to 2.35%. This is the fifth increase in interest rate by the RBA since early May. The RBA reaffirmed its position that returning inflation to within its 2-3% band remained a 'high priority' but also noted that they are seeking to keep the economy on an even keel. Their statement noted significant challenges in meeting these dual objectives stating:

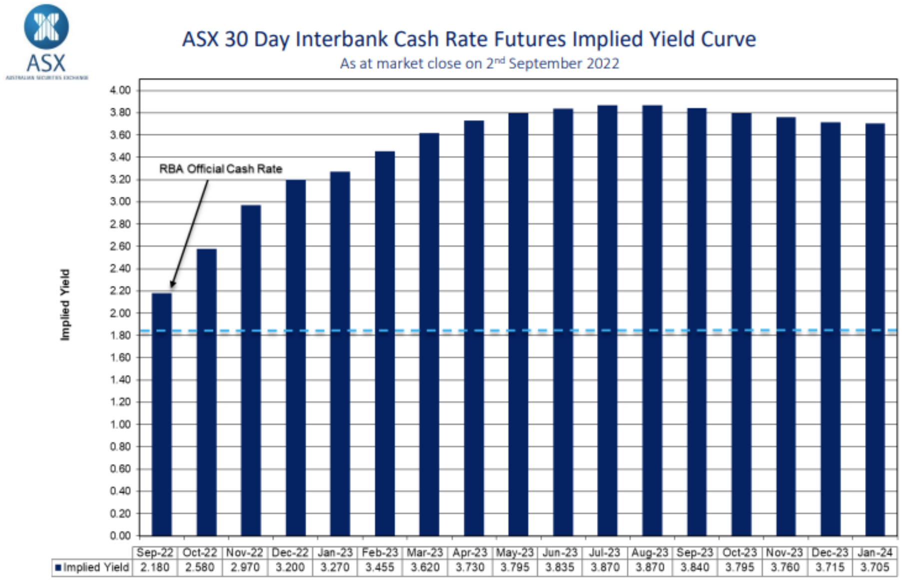
" The path to achieving this balance is a narrow one and clouded in uncertainty, not least because of global developments. The outlook for global economic growth has deteriorated due to pressures on real incomes from high inflation, the tightening of monetary policy in most countries, Russia's invasion of Ukraine, and the COVID containment measures and other policy challenges in China".

The interest rate futures market has increased its expectation of further tightening in monetary policy, with rates expected to be 3.8% in June 2023 (refer chart below from the ASX). These expectations, if realised, would likely have a material adverse impact on domestic economic activity.

Bond markets responded to the more hawkish outlook in August, with the Australian 10 year yield rising 54 b.p. to 3.60%. Australian fixed interest posted losses of -2.5% in August. Despite the risk off sentiment, credit spreads contracted marginally in the month.

Fixed Income Rates and Spreads

	As at 31/8/2022 Month End	1 month earlier	3 months earlier	12 months earlier	10 Year Avg
Australian RBA Cash Rate	1.85	1.35	0.35	0.10	1.51
Australian 10 Year Bond Yield	3.60	3.06	3.35	1.16	2.44
Australian Corporate Composite Bond Spread	1.75	1.79	1.61	0.92	1.20
US Fed Funds Rate	2.50	2.50	1.00	0.25	0.82
US 10 Year Bond Yield	3.20	2.65	2.85	1.31	2.06
US Aggregate Corporate Bond Spread	1.40	1.44	1.30	0.87	1.25
US High Yield Bond Spread	4.84	4.69	4.06	2.88	4.33
Bloomberg Ausbond Comp 0+ Yrs	3.64	3.11	3.18	0.84	2.30
Bloomberg (Barclays) Global Aggregate	3.10	2.60	2.59	1.03	1.61



Managers are saying:

"With much of the heavy lifting done, the RBA is likely to shift to 'business as usual' 25bps tightening increments… and we look for the cash rate to peak at 3.1% by late 2022/early 2023 and hold at that level until early 2024. Such a profile has the RBA feathering the monetary brakes attempting to engineer a soft landing that sees inflation gradually fall back to the top of the RBA's 2% to 3% target band.

Market pricing is more aggressive, building in a 3.85% cash rate mid-2023. Reflective of the sell-off in yields mid-June, markets do not see this as a cyclical high, but the prevailing cash rate for the rest of the decade.

This seems implausible to us as it assumes that one of the biggest and fastest tightening cycles in the current inflation targeting era results in a neutral or terminal cash rate around 150bps above the RBA's estimate of 2.5%. Accordingly, we see value emerging during periods where aggressive tightening is priced in without regard to the economy's response to restrictive monetary settings.

*Commitment to tackle high inflation through tightening in global liquidity will continue to generate volatility in credit markets. To navigate the environment ahead investors should command improved compensation for risk." **Janus Henderson***

International Fixed Interest

The Federal Reserve's annual Jackson Hole symposium provided the pivotal moment for markets in August with the Fed appearing to squash views of an early pivot to looser policy settings. At Jackson Hole, Jerome Powell said Federal Reserve policy will remain restrictive and act with resolve to arrest inflation, "until the job is done." He also noted there will likely be economic pain, and growth will likely below trend for a "sustained period." Markets reacted by pricing in more rate hikes with the US cash rate now expected to reach 3.9% in April or May 2023. US 10 year yields also rose by 55 b.p. to 3.2%. Global fixed interest fell - 2.7% in August.

Managers are saying:

"Inflation in the US has peaked, global growth this year has slowed meaningfully, and potential growth weakness suggests a continuation of both of these trends. The Federal Reserve's (Fed) resolve to maintain the downward trajectory of US inflation was reiterated at the Jackson Hole symposium….. The constantly reiterated refrain from all Fed governors continues to be that inflation is unacceptably high. The more interesting message is that policymakers want to maintain policy rates in a restrictive stance for an extended period of time, allowing inflation to come down gradually. As monetary policy acts with a lag, the effect of the rate hikes and higher Treasury and market yields are already going to have a further tightening effect. With the downward trajectory of inflation now firmly in evidence, a policy rate of 3.50%-3.75% held for a sustained period appears to be a reasonable base case" ***Western Asset***