Perpetual Private | Quarterly Market Update

Perspective

Markets are getting 'noisier'. How can I increase my chances of finding 'signals'?

September 2023

Trust is earned.

Perpetual

Contents

Snapshot

The September quarter was the first negative quarter in 2023, as investors finally began to take central banks at their word, recognising that interest rates would be 'higher for longer'. This realisation has gone some way to closing the inherent contradictions between bond market and equity market positions.

Although the volatility expressed during the quarter was unpleasant to experience, we view these adjustments as necessary and healthy for the normal functioning of markets. The longer that anomalies persist in markets, the more disruptive they tend to be when they are finally resolved.

In addition, there is an element of seasonality reflected in the performance of financial assets, that allows us to discount some degree of the softness in asset prices during the period.

Although a broadly stable environment existed for a little more than a decade coming out of the financial crisis of 2007/08, that period is over and is unlikely to return soon. This is particularly the case given the trends that have established themselves in international trade. The most obvious impact of these trends is that they are likely to produce inflation at a structurally higher level than that which allowed the ultra-loose monetary policies of the prior regime.

As investors, we do not see these developments as necessarily good or bad. Only different. As such, we maintain the view that by engaging in diligent market and asset analysis, and by having the presence of mind to avoid getting caught up in the "madness of crowds", we ensure that we are in the best possible position to identify opportunities and minimise risk, as pertinent facts present themselves.

Asset class performance – September quarter

Australian equities

Having enjoyed an environment of increasing optimism, Australian shares had a challenging quarter, despite a relatively unremarkable earnings season. Although momentum carried markets higher in July, they softened through August and September, returning -0.7%[1] over the three months. Indeed, this was in spite of the RBA's ongoing pause to increases in the cash rate target.

Given the monetarily constrained environment, investors exhibited a clear preference for larger companies. The Small Ordinaries index meaningfully trailed the ASX 300, which trailed the ASX 200, which subsequently trailed the ASX 100 (-1.94%, -0.84%, -0.77% and -0.71% respectively). Given the economic adjustments brought on rising interest rates, an investor bias towards larger companies is not surprising,as some of their attractive risk attributes such as more diverse sources of revenue and better access to bank lending.

That Value[2] outperformed Growth[3] (+1.4% vs -2.0%) over the three months, further suggests traces of investor risk aversion. Whilst Growth had been dominant for much of the past decade, Value returned to the fore in 2022, before the emergence of Generative AI drove sentiment back towards Growth for the first half of 2023. With the belated acceptance that interest rates will indeed be 'higher for longer', the pendulum has again swung back in favour of Value.

When considering the various industry groups, the Energy sector[4] was the clear leader, delivering 11.6% over the quarter. This was clearly linked to the sharp increase in oil prices, which gained 28.7%[5], as robust demand, largely driven by a rebound in international travel, combined with tight supply conditions due to producer output curbs. Of the 11 main sectors we monitor in the Australian market, only Energy, Consumer Discretionary and Financials, produced positive returns for the period. Health Care was the poorest performing sector, losing 9.0%. The pandemic itself reduced and delayed procedures, whilst a constrained labour market has inhibited profitability in the time since.

International equities

International shares followed an almost identical path to that of their Australian equivalents in the three months to September. An upbeat July, followed by a complete retracement over the following two months, saw international equities[6] lose 0.4% over the quarter. Though most markets had a negative experience, including currency moves or not. The experience of Australian investors into U.S. markets were buffered by a strengthening U.S. dollar. Without the benefit of the appreciating dollar(USD), S&P 500 proved to be mildly more resilient (-3.4%) when compared the tech heavy Nasdaq (-3.9%), as enthusiasm for large tech companies began to wane. On an unhedged basis, these outcomes improve to -0.4% for the S&P 500 and -0.9% for the Nasdaq.

From a regional perspective, Japan[7] and the UK[8] were rare bright spots gaining 2.2% and 1.2% (+2.3% and +2.2% when reflecting currency effects) respectively, against a backdrop of consolidating asset prices. In the case of Japan, corporate reform measures and aggressive central bank actions seem to have awoken bullish market dynamics for the first time in decades. Meanwhile, the UK benefited from exposure to energy markets, alongside an economic environment that turned out to be far less pessimistic than many had expected.

With expectations for interest rates moving higher and further out along the curve, the relative attractiveness of Growth companies fell, reducing values by 1.9%[9] during a period where Value gained 1.2%[10].

Energy, as it did domestically, was the standout sector, delivering gains of 14.2%[11]. This is more than a 9% lead over the next best sector, Communication Services. The key laggards were Utilities, Real Estate, Consumer Staples and Information Technology, losing 5.8%, 3.7%, 3.3% and 3.2% respectively. The key drivers of the moves primarily stemming from changes in interest rate and inflation dynamics.

[1] Measured by the S&P ASX 300 index
[2] Measured by the MSCI Australia Value index
[3] Measured by the MSCI Australia Growth index
[4] Measured by the S&P/ASX 300 Energy index
[5] Measured by Brent Crude
[6] Measured by MSCI All Country World index
[7] Measured by the TOPIX index
[8] Measured by the FTSE 100 index
[9] Measured by the MSCI World Index Growth
[10] Measured by the MSCI World Index Value
[11] Measured by the MSCI AC World Energy index

Real estate

Despite a pause in interest rate increases from the RBA, domestic real estate markets continued to experience challenging conditions. Although July was encouraging for valuations in the asset class, the subsequent months were not kind. A-REITs[12] closed out September down 3.0% for the quarter however, this masks the fact that September saw a chastening 8.7% drawdown to get to that level.

On a global basis, outcomes for real estate assets were more mixed. The market as a whole, was down only 2.7%[13]. Below the surface, however, was a wide range of outcomes, with Hong Kong continuing to demonstrate weakness (-9.8%[14]) whilst German assets showed uncharacteristic strength (+25.2%[15]). Interestingly, Japanese[16] and Eurozone assets[17], which have delivered some of the lowest return profiles over the past 10 years, were the strongest regions in the quarter.

In a reflection of the dominant representation of the U.S. in global indices (by virtue of being underpinned by the largest capital markets), all sectoral indexes were down over the period, as U.S. assets were themselves down 7.5%. Office experienced the most positive outcome, losing only 2.4%, whilst Retail, Residential and Specialised gave up 7.9%, 9.7% and 9.8% respectively.

Fixed income

Fixed income assets were arguably the crucible of all market developments over the quarter as central bank messaging, which has been consistent and repetitive, began to be fully appreciated by investors. As inflation had given indications that it was likely to return back to target ranges, only slowly, we expected that interest rates would need to remain at elevated levels, for an extended period. In spite of this, market positioning suggested that a reasonable proportion of participants were expecting interest rate cuts in the foreseeable future. Indeed, based on price action in the market throughout the quarter, we have likely experienced a "good news is bad news" scenario, where continued economic strength has a negative impact on financial assets. Indeed, despite the RBA holding interest rates at 4.1% and the Federal Reserve increasing only once, from 5.0% to 5.25%; yields on respective 10-year government bonds increased by 0.5% and 0.8%. This is, at least partially, driven by the economic resilience that is being displayed, with labour markets in particular, continuing to defy expectations. As a result of these changing dynamics, Fixed Interest[18] declined by 2.1%, whereas Credit [19], benefitting from its shorter duration and floating rates, returned +1.3%.

[12] Measured by the S&P ASX 300 A-REIT index
[13] Measured by the FTSE EPRA Nareit Global index
[14] Measured by the FTSE EPRA Hong Kong index
[15] Measured by the FTSE EPRA Germany index
[16] Measured by the FTSE EPRA Japan
[17] Measured by the FTSE EPRA Eurozone
[18] As measured by the Bloomberg Global Aggregate Index
[19] As measured by the Bloomberg AusBond Credit (0+Y)

Alternatives

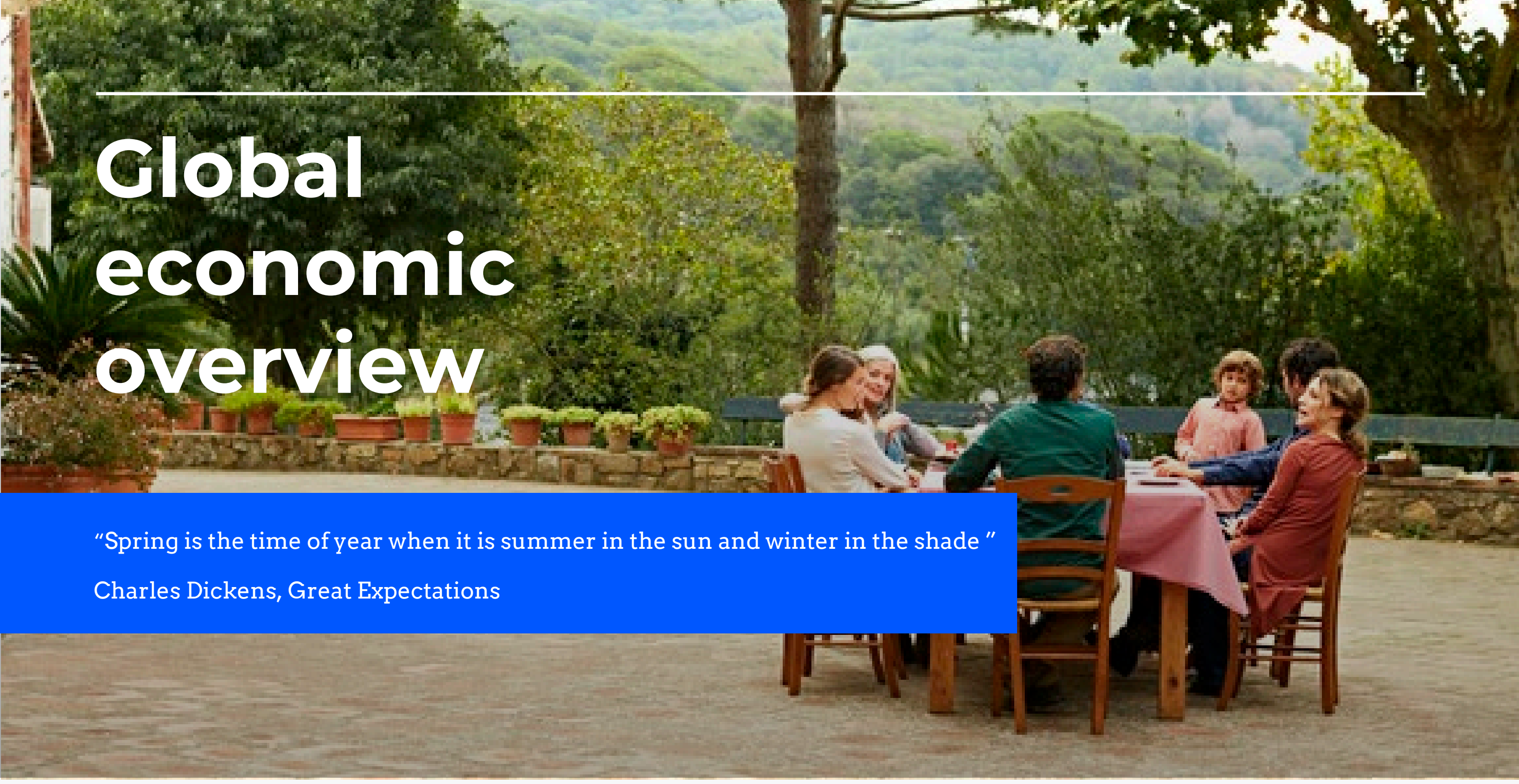
Whilst Alternatives contain features that are appealing when creating portfolios, and part of this appeal is related to the diversification they provide, they do still exist within the same economic reality as public markets. This is both an opportunity and a threat, as changes in the liquidity landscape produce motivated portfolio changes, with attractive assets available at appealing valuations. At present, uncertainty with regards to the forward paths of inflation and interest rates, is presenting as reduced transaction levels across most private/unlisted asset classes. Infrastructure, is one pocket where investors appear more confident, encouraged by contractually consistent and indexed cash flows.

Cash rate

The September quarter marks the first extended pause in interest rate increases, since the Reserve Bank of Australia (RBA) began tightening in May 2022. Current expectations for inflation returning to the 2-3% target range, according to the bank's own forecasts, currently sit in the closing months of 2025. This being the case, it does seem unlikely that policy rates might come down any time soon. Unless there are indications of the economy deteriorating at an uncontrollable pace, monetary policy can be expected to remain 'restrictive'. This leads us to anchor our near-term expectations around the current target rate of 4.1%.

Australian dollar

The story of currency moves over the quarter, is a familiar plot, based around the primacy of the U.S. dollar (USD). The Australian dollar (AUD) broadly maintained its relationship with those of our main trading partners, staying within +/- 1%. Even the regularly volatile AUD/JPY (Japanese Yen) exchange rate finished within 0.1% of where it started. Against the USD however, AUD depreciated by 3.0%, flirting with the long-term technical support level of 0.63 cents (per 1 AUD). A sputtering Chinese economy weighing on global growth, whilst risk aversion drives the safe haven value of USD, are themes that are likely to dominate foreign exchange relationships for the immediate future.



Global economic overview

"Spring is the time of year when it is summer in the sun and winter in the shade"

Charles Dickens, Great Expectations

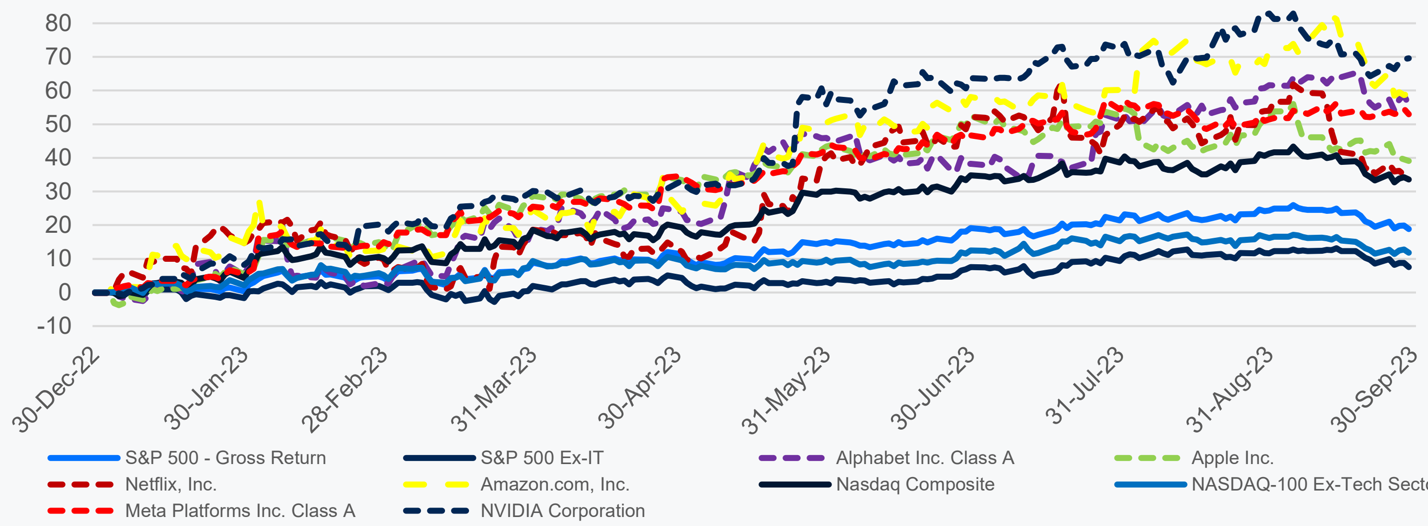
The September effect

During the September quarter, we began by enjoying 'summer in the sun', before finishing with 'winter in the shade'. That the period started with positive momentum, should not be of any surprise. Monetary policy pressed into service in the fight against inflation from May 2022, brought about a rapid adjustment in the valuation of financial assets. As a result, most asset classes and their components delivered negative returns for the 2022 calendar year.

As markets and investors adjusted to the new monetary landscape, the negativity of 2022 led to a sense that assets had reached 'over-sold' territory, pricing in some of the worst possible scenarios. As generative AI emerged into the public consciousness in early 2023, it generated positive sentiment in the Technology sector (the worst performing sector in 2022), which sparked the emergence of a more optimistic outlook for investors.

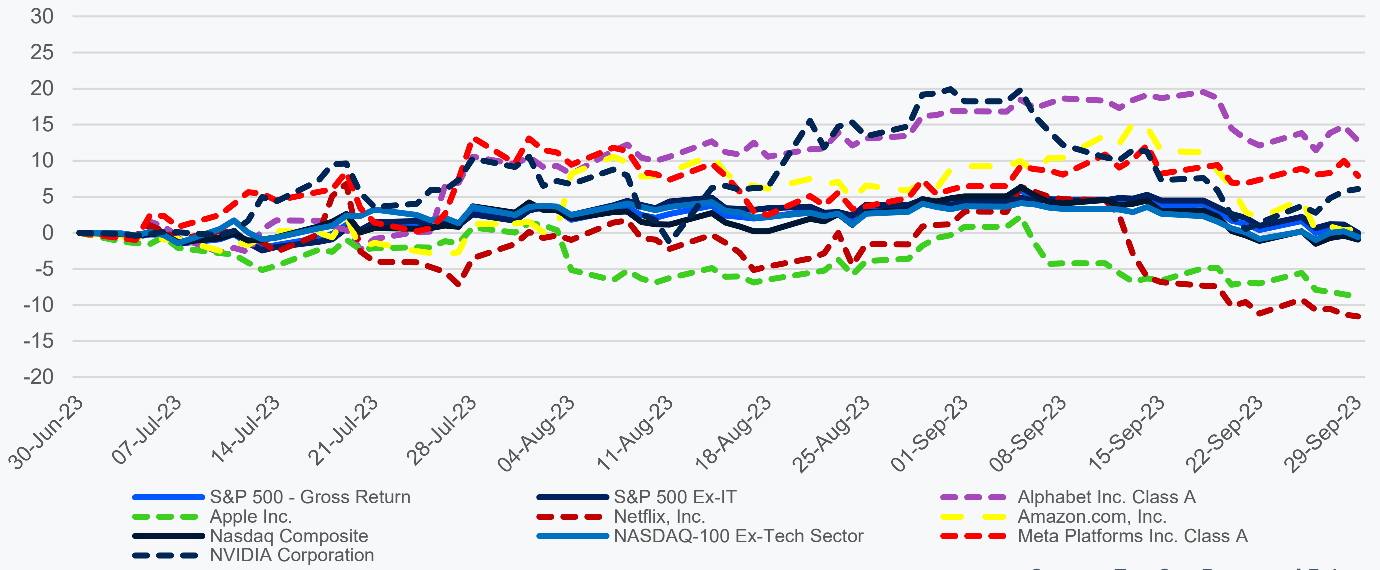
We shared in June (Figure 1) that just 7 companies had dragged U.S. indexes up for the first six months of the year, a fact that is both visually evident and directly explains approximately two-thirds of the S&P 500's 16.9% calendar year gains, into June 30. Clearly, if we look at the performance of the same companies for the quarter just past (Figure 2), the same 7 companies had clearly diverging fortunes, ceding their stock market leadership position.

Figure 1. Technology stocks lead the market up



Source: FactSet, Perpetual Private

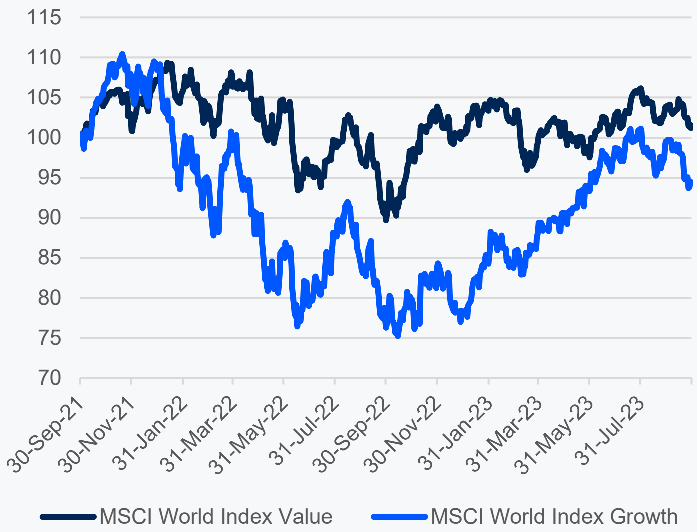
Figure 2. Technology is no longer driving markets



Source: FactSet, Perpetual Private

As the clamour for Technology stocks receded, the perennial question around whether Growth or Value investment styles would reign, again rose to the fore. The easy monetary policy regime that existed pre-2022, combined with the ascendancy of technology companies as vital components of our economic and social infrastructure, meant that Growth generated better returns and for years appeared unassailable as the most rewarding investment approach. As the price of money (in the form of interest rates) has dramatically increased over the past 18 months, the validity of certain business models has been called into question. The past two years has seen Value provide greater downside protection (Figure 3), as increasing discount rates and expectations for their future path, have dramatically swung the values of Growth assets from positive, to negative, then back again. To our mind, the way this relationship plays out is likely to provide crucial perspective for how market dynamics develop into the coming years.

Figure 3. Value vs Growth – Value has provided better risk adjusted returns



Source: FactSet, Perpetual Private

From an elevated vantage point, one could recognise a seasonal influence that has long been observed in share markets, known as the 'September effect'. Whilst we have seen many attempts to provide a satisfactory explanation for this effect in stock returns, we haven't found any that meet our standards for intellectual rigour. The simple matter that it can be seen to occur, and can clearly recognised in a monthly heatmap (Figure 4), is enough for it to provide us with context for underlying market behaviour.

Figure 4. Seasonality – September is regularly a challenging month

Monthly returns of the MSCI All Country World index

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2023	6.5	-1.9	2.5	1.4	-0.2	5.5	3.2	-2.0	-3.5	-1.3	0.0	0.0
2022	-4.6	-2.6	2.6	-6.5	-0.2	-7.4	7.1	-2.9	-8.4	6.1	6.3	-4.7
2021	-0.1	2.5	3.6	3.8	1.1	2.2	0.7	2.7	-3.5	5.0	-1.6	3.7
2020	-0.6	-7.6	-12.8	10.4	4.3	2.9	4.0	5.8	-2.7	-2.5	11.5	3.9
2019	7.3	3.1	1.6	3.7	-5.7	5.8	1.0	-2.0	2.3	2.0	2.9	2.7
2018	4.1	-3.5	-2.2	1.9	0.9	0.0	3.0	1.2	0.6	-6.9	1.4	-7.2
2017	1.6	3.0	1.1	1.3	1.7	0.2	1.9	0.4	2.1	2.7	1.3	1.3
2016	-5.4	-1.3	5.6	0.8	1.6	-1.0	4.2	0.7	0.3	-0.5	2.1	2.5
2015	-0.3	5.7	-0.3	1.6	0.9	-2.8	1.8	-6.6	-3.3	7.7	0.4	-2.0
2014	-3.3	4.0	0.4	0.7	2.4	1.5	-0.3	2.6	-1.3	1.2	2.7	-0.9
2013	4.9	1.2	2.3	2.5	1.4	-2.7	4.4	-1.8	3.8	4.0	2.0	1.8
Average	0.8	0.2	0.3	1.9	0.7	0.3	2.8	-0.2	-1.3	1.5	2.6	0.0

Source: FactSet, Perpetual Private

Always and everywhere a monetary phenomenon

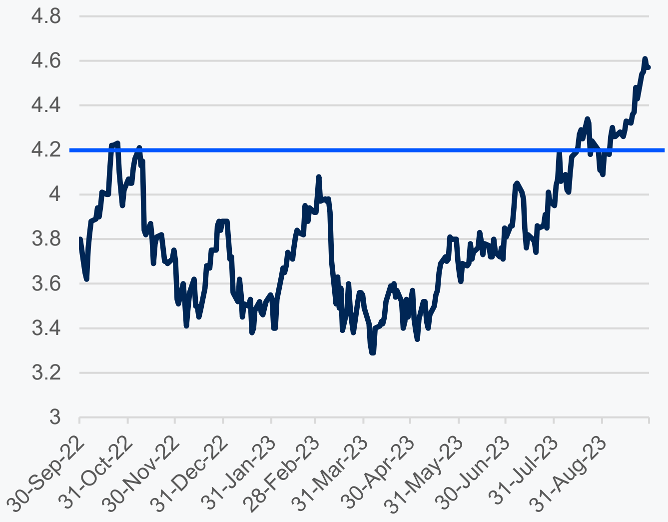
One curious aspect of market behaviour in 2023 is that it is born out of relatively pessimistic beginnings. At the start of the year, according to a Bloomberg survey, some 80% of economists expected recession. That economies proved to be significantly more robust than expected, provided optimism for equities investors, whilst expectations of negative growth kept interest rate expectations (particularly for periods greater than 5 years) low. This combination enabled global equity markets[20] to gain some 18.0% over the first 8 months of the year.

As we have observed here previously, to expect sufficient economic weakness to give monetary authorities cause to reduce interest rates, whilst also believing it to be buoyant enough to avoid recession, seems to be a clear example of cognitive dissonance. That interest rate expectations increased, would appear to have been the path of least resistance, as labour markets and consumer behaviour continue to defy gravity, despite an increasingly challenging environment.

Although there is little indication that this path could have been predicted with high confidence, central banks have been clear in their assertions that they would do 'whatever it takes' to contain inflation. Indeed in a press conference following the December 2022 Federal Reserve FOMC meeting, Chairman Powell, stated that interest rates would stay high until the Board was "really confident that inflation is coming down in a sustained way," and "that will be some time" [21].

In spite of this, the market retained a view that interest rate cuts were relatively imminent. This held, as such things do, until it didn't. As the yield on U.S. 10 year bonds broke through the 4.2% level (Figure 5), equity markets began a painful reconciliation [22] .

Figure 5. US Benchmark Bond - 10 Year – Yield. Increasing long term rates break higher

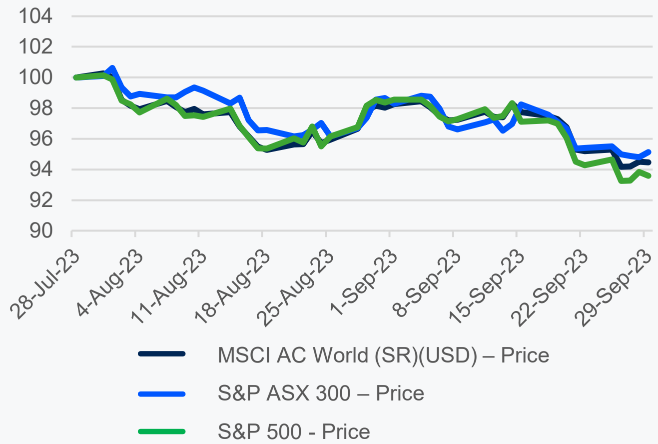


Source: FactSet, Perpetual Private

[20] Measured by the MSCI All Country World index
[21] Jerome Powell, Federal Reserve FOMC Press Conference, 14th December 2022
[20] Measured by the S&P ASX 300 index
[21] Measured by the S&P 500 index
[22] Jerome Powell, Federal Reserve FOMC Press Conference, 14th December 2022.

In the two months that followed the July 2023 breach of the 4.2% level, Australian Shares[20], U.S. shares[21] and Fixed Income fell by 3.6%, 6.3% and 4.3% respectively (Figure 6).

Figure 6. Long rates moving higher, neatly coincides with financial assets beginning their move down



Our contention here is that a higher discount rate was the primary driver of asset value changes during the quarter, just as it has been for most of the past two years. Regardless, it wasn't the only driver. At a more granular level, reporting season for Australian companies was relatively 'normal' in outcomes. By this, we are referencing our observation that idiosyncratic (company specific) risk, is returning to an appropriate level of importance within investment considerations. Additionally, for reasons that seem inherently sensible, many companies abstained from providing detailed forward guidance.

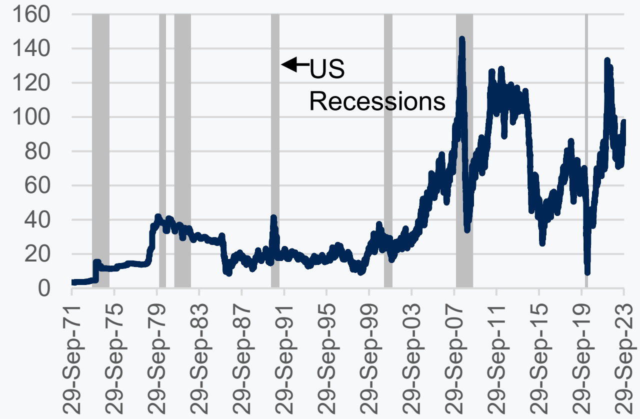
Climbing a wall of worry

With a pervasive, 24-hour news cycle, it can be easy to lose the 'signal' in the 'noise'. Human instincts of self-preservation, such as fight-or-flight, are poorly suited to optimal investment decisions. As such, it is usual that in periods of change that as investors we can become either overwhelmed or desensitised by the competing factors of risk and return. Of course, being aware of biases can often be the best antidote against them. Producing commensurate and consistent investment returns, requires us to face into investment risks, balancing them off against one another in a calculated and methodical manner. Below, we explore what we see as the most pertinent areas of focus for determining areas of opportunity in the markets, moving forward.

Energy

- Oil prices[23] gained 22.3% between June and October.
- Buoyant consumer behaviour driving travel spending, combined with OPEC+ members constraining supply, has tightened the market for energy prices.
- At the time of writing, the conflict in the Middle East is escalating. Early indications suggest a horrifying level of violence and many deaths, and we feel saddened by the emergence of yet another new conflict. From an economic point of view, the obvious and immediate impact will be to further tighten energy markets.
- Until we have fully transitioned away from fossil fuels for logistics and transport, rapidly increasing energy prices will have a dampening effect on economic activity. Not only does it inflate costs within and across the supply chain, its indirect inflationary effects also necessitate higher interest rates.
- These features along with the simple fact that rising oil prices were meaningful contributors to recessions in the mid 1970s, early 1980s, early 1990s and were also associated with the Global Financial Crisis of 2007/08, lead our view that developments in the energy complex could have a material influence on economic and market performance, and deserves our attention over the coming months.

Figure 7. Brent oil price - Oil prices spikes regularly coincide with recessions

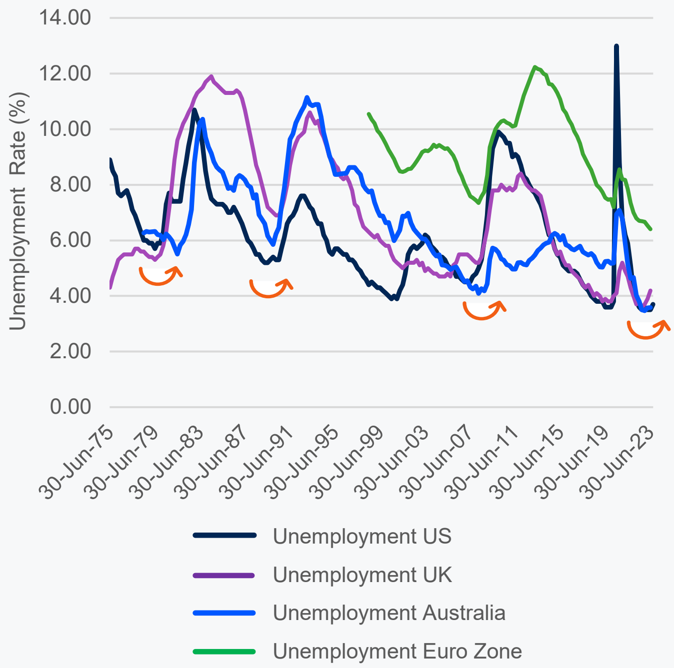


Source: FactSet, Perpetual Private

Labour market

- Given the persistence of exuberant consumer behaviour, a key catalyst for change could arrive via weakness in the labour market.
- Should this occur, it would likely have an impact on consumer spending through two channels; the loss of income directly, and a reduction in consumer confidence.
- These impacts can form into feedback loops with the labour market, further reinforcing the early stages of a slowdown. When we observe labour markets across time and regions, a tendency for weakness to accelerate once it gathers some momentum, can be observed in the broad upswings that occur periodically.

Figure 8. Unemployment at 50 year lows - When labour markets move they tend to move meaningfully



Source: FactSet, Perpetual Private

Geopolitics

- We typically don't give much weight to considerations of geopolitics when it comes to our investment mindset. This isn't because we are callous, nor are we foolhardy. Quite simply, in most instances, geopolitical developments have very little bearing on economic outcomes. We don't necessarily expect for this to change any time soon. We do however, note that some broad trends may be emerging

[23] Measured by Brent Crude (continuous)

- "Economic fragmentation" is a trend that is becoming apparent in the actions and intentions of international trading partners. Here, in part because of the inherent contradiction between more authoritarian, control based regimes, and the Western, more nominally liberal systems, alongside China's perceived ascendancy to being the world's largest economy and the strategic tension this creates with the incumbent (the U.S.); trade has become more politicised. This development looks certain to be a growing feature within the global economy as we move forward, effectively feeding into a building trend of de-globalisation, complicating supply chains, reducing the benefits of specialisation and scale and effectively placing a rising floor under inflation.
- Conflict is increasing. Russia/Ukraine has been the most obvious example in recent years, more recently Israel/Palestine has emerged, not to ignore Nagorno-Karabakh/Azerbaijan. Conflict specifically is confounding in its limited impact on most financial assets. Risks lie not only with the obvious threat of escalation, but also with disruptions to shipping disrupting trade and the movement of key commodities. Here too, the most obvious threat is that such disruptions feed inflation.
- China, whilst being a key actor in economic fragmentation, also faces significant challenges internally. As the Chinese economy has grown, its building sector has become a significant, if not the primary, engine for growth. This has helped drive up prosperity and the 'wealth effect', as Chinese citizens tend to significantly prefer property investments. However, the sector has outgrown its usefulness. This is evident in the slow-motion collapse of property titans Evergrande and Country Garden. Just as the sector has given, it now appears to be taking away, generating a negative wealth effect and adding fear to an already cautious consumer, scarred by oppressive anti COVID measures. Anaemic consumer confidence and structural problems in a crucial economic sector is challenge enough, however it is becoming clear that the implementation of the 'One Child' policy between 1979 and 2015 has created a demographic time bomb. When we reflect on reports that China may already have more residential accommodation than its current population would require, and the fact that the population is expected to fall by approximately 200m people in the next 25 years, you can readily recognise that a significant oversupply situation could act as a challenging headwind for the Chinese economy in the years ahead; and that's before we consider the impact of the burden of an elderly population falling to an increasingly small labour base.
- We are now just 12 months before voting starts for the U.S 2024 presidential elections. Given that the likely contenders will again be Trump and Biden and given that neither of them inherently appeals to the majority of voters, campaign strategists we've spoken to have suggested that campaigning by both candidates is likely to be particularly negative. This means that both sides will seek to emphasise their opponents flaws above anything else. This is against a backdrop of U.S. politics which has already become increasingly fractious, with events such as Jan 6 2020 'insurrection', through to the first ousting of the Leader of the House of Representatives in history, and the now almost annual tradition of government shutdown brinkmanship. These elements add to the heightened levels of background 'uncertainty', and whilst they won't necessarily result in a greater level of realised risk, it does though feed into the drivers of volatility.

Recency bias

Despite some recent fraught gyrations in markets, our long-term view remains intact. We continue to expect volatility to remain high and for economies to continue digesting the new monetary paradigm. We also expect consumers to remain under pressure and as the possible 'front line' of economic fortunes. What appears to be lost on the more skittish cohort of investors, is that economic change takes time. The relationships between and across asset classes, the dynamics of business models and their implementation, and the circumstances of consumers and their outlook, are all interrelated and in themselves dynamic. As such, adjustments take time to filter though, and trigger cascading sympathetic adjustments. This means that we expect market ructions to continue as we build the foundations for the next assortment of stable relationships that will underpin markets for the years ahead.

Figure 9. Seasonality – The fourth quarter tends to be kinder to financial markets

Quarterly returns of the MSCI All Country World index

	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
2023	7.2	6.7	-2.4	-1.3
2022	-4.6	-13.5	-4.7	7.5
2021	6.0	7.2	-0.3	7.1
2020	-19.9	18.4	7.1	12.9
2019	12.4	3.4	1.2	7.8
2018	-1.7	2.9	4.8	-12.4
2017	5.8	3.3	4.5	5.5
2016	-1.4	1.4	5.2	4.2
2015	5.0	-0.4	-8.1	5.9
2014	1.0	4.7	-0.9	3.0
2013	8.6	1.2	6.4	7.9
Average	1.3	3.0	1.2	4.2

Source: FactSet, Perpetual Private

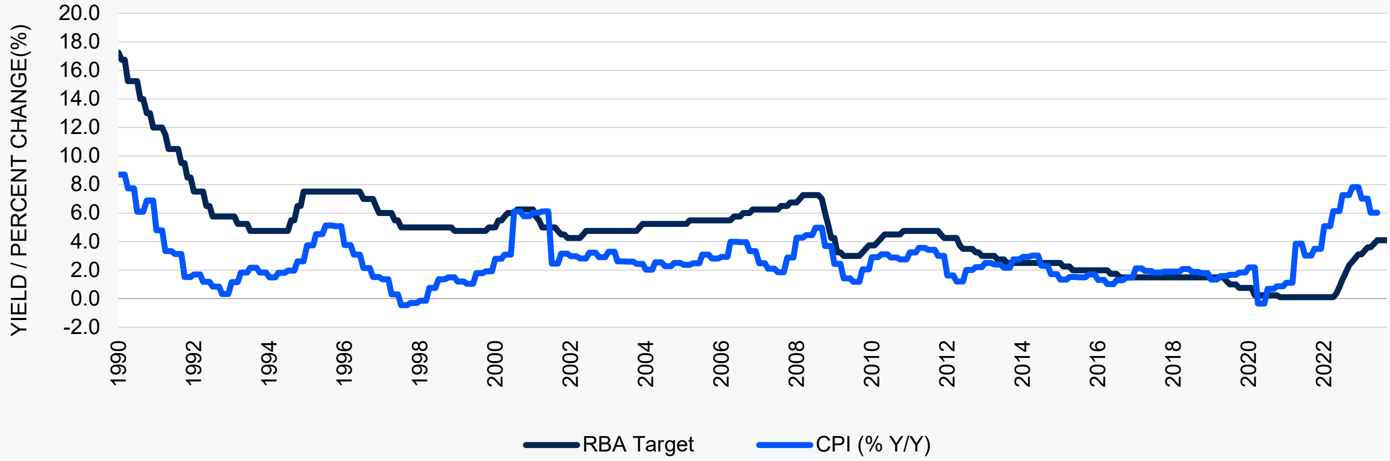
When we take investment decisions, we find that rationalising our thoughts against a longer-term perspective, helps add clarity to our process. In doing so, the 'noise' in our short-term information flow becomes more readily apparent and we are better able to train our focus on the pertinent facts. It is with this in mind that we again refer to a 'seasonality' chart (Figure 9), as we did in our opening comments. The underlying data is the same, however we've grouped it into calendar quarters. The September effect that was apparent in Figure 4, remains and is evident in the Jul-Sep column. What also becomes clear from this cut of the data, is that just as Q3 tends to be characterised by negative returns, Q4 can regularly provide meaningfully positive returns.

Australian cash rate

We have reached a plateau in interest rates, as the Reserve Bank of Australia ‘waits’ to determine if monetary conditions are sufficiently tight. Having witnessed the pressure and criticism placed on the prior Governor, we suspect that new Governor Bullock will proceed with caution. Given the lagged effects of monetary policy, particularly in relation to our domestic mortgage practices (fixed/variable structures), it is reasonable to expect that even in the absence of further rate increases, conditions continue to tighten.

This leads our belief that trends in inflation will continue to be crucially important, with any indication that it is unlikely to return to its target range by the end of 2025 as expected, will drive the Monetary Policy Committee to act. In the absence of such a development, we have no reason to believe that they will find reason to adjust the cash rate target otherwise. At present, the strength of the economy, in particular the labour market, suggest that there will be little justification for interest rate cuts absent some degree of unforeseen shock .

Figure 10. Australian long-term cash rate vs inflation



Source: FactSet, Perpetual Private.

Australian dollar

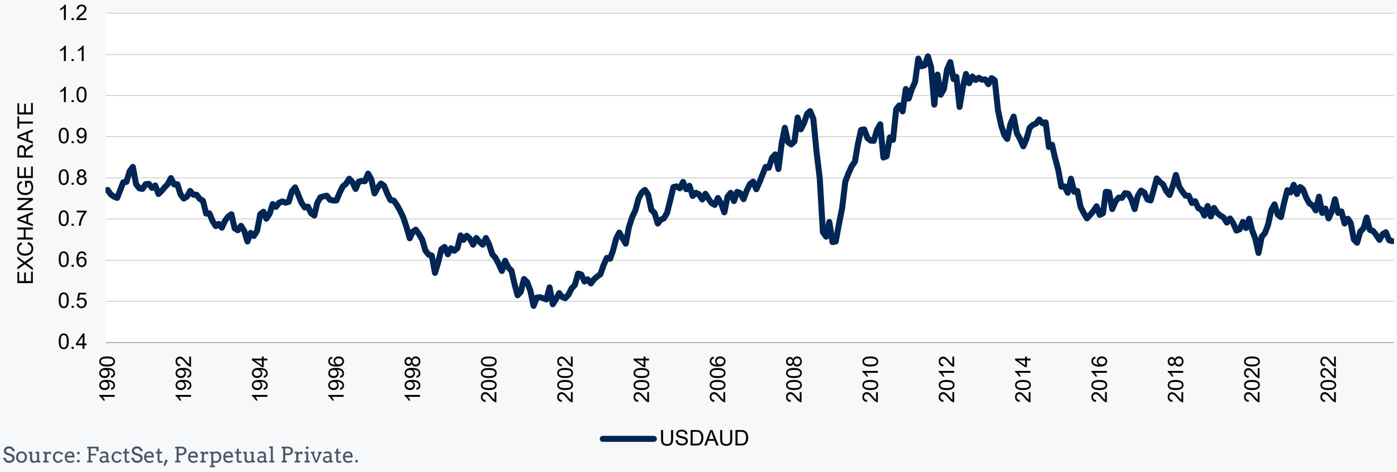
The Australian dollar (AUD) is nominally considered to be a 'risk' currency. As such, its fortunes are closely tied to that of the global economic outlook and for commodities in particular. The U.S. dollar (USD), on the other hand, is the prime example of a 'safe haven' currency, alongside the Swiss Franc - CHF), strengthening when investors and markets are uncertain about future prospects.

A slowed Chinese economy and the implication of such on commodities demand, along with economic uncertainty, have driven weakness in the AUD/USD cross. Indeed, if we reflect on how AUD has moved in relation to our major trading partners, it has broadly stayed within close ranges of its long term average, exhibiting little in the way of meaningful change away from long term relationships. Against safe haven currencies however, it has lost approximately 10% per annum in value against USD and CHF, over the past 3 years.

Australian dollar outlook

We tend to avoid taking short term views on the prospects for the Australian dollar. Noting that it tends to be primarily dictated by trade flows and momentum. In the medium to long term, we expect that as the cycle turns AUD is likely to strengthen against USD and gravitate toward its de-pegged average of approximately 0.76c.

Figure 11. USD per AUD long-term exchange rate



Source: FactSet, Perpetual Private.

Australian equities

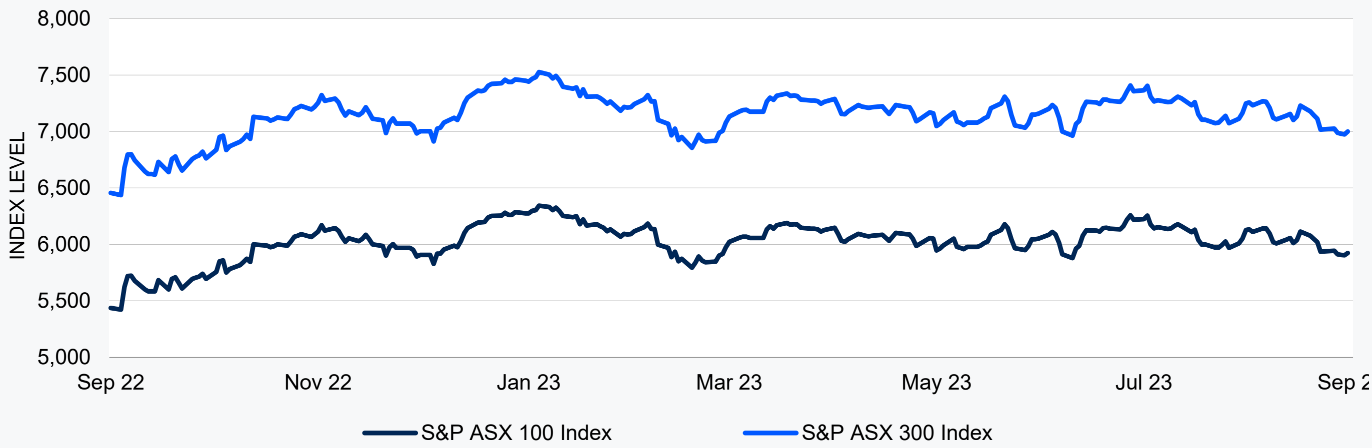
Australian Equities finished slightly down for the September quarter, with the S&P/ASX 300 Accumulation index decreasing by 0.8% over the period. Australian equities outperformed global equities, with the MSCI All Country World Index by comparison decreasing by 2.5% in local currency terms. In AUD terms though, global equities were only down 0.4% given the weakening of the Australian dollar over this period.

The August 2023 reporting season was the main event for the quarter. Australian companies delivered mixed results through reporting season as they continue to face ongoing cost pressures from labour, rent and debt interest costs. While companies' FY23 profit results were broadly in-line with expectations with more resilient consumer spending, it was the forward earnings guidance that was broadly speaking softer than anticipated.

This caution around future earnings also saw the average dividend payout ratio drop considerably. Those more resilient businesses with pricing power were better positioned to pass on these higher costs to consumers to maintain margins. For those businesses without pricing power, management teams have undertaken targeted cost out programs.

Over this period, we saw value stocks outperform growth stocks and large cap names outperform small cap companies. At a sector level, the standout performer was the Energy sector (+11.6%), with the only 2 other positive sectors being Consumer Discretionary (+5.5%) and Financials (+2.3%). All other sectors delivered negative returns for the period, with the most notable detractors being Healthcare (-9%), Consumer Staples (-5.8%) and Technology stocks (-4.9%).

Figure 12. Australian Shares – Large Companies



Source: FactSet , Perpetual Private.

Australian equities outlook

We continue to see a wide dispersion of returns by stock and sector and expect this to continue. For the past circa 18 months the key forces driving equity markets have been inflation data and forecasts and the subsequent monetary policy actions taken by central banks. We are now at the point though where interest rates are perceived to be at or close to the peak, with the new RBA governor having kept the cash rate on hold for the fourth straight month at their recent October meeting. While inflation has moderated somewhat, it remains stubbornly high, and so further tightening of monetary policy may be needed to return inflation to target within a reasonable timeframe.

We believe there are still risks surrounding the outlook for certain sectors of the market and the pressure on corporate earnings from higher interest rates and a slowing economy has further to play out. Quality industry-leading companies with the pricing power to pass on these higher costs, and strong balance sheets without elevated debt levels, should be relatively well positioned in the current environment.

We expect volatility in markets to continue for some time, against the backdrop of economic and geopolitical uncertainty. We are in a stock picker's market, which is presenting bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations as markets gyrate. With the various macroeconomic forces in mind, we favour those managers that have a stronger regard for valuations and balance sheet strength and are focused on investing in businesses with strong pricing power or thematic tailwinds.

International equities

The MSCI All Country World index reversed course during the third quarter of 2023, with the benchmark returning -2.5% in Local Currency term. In Australian dollar (AUD) terms, the benchmark returned -0.4%. The AUD fell relative to the USD during the quarter helping returns.

For most of the quarter, the 'AI' led rally dominated markets, however late in the quarter, markets began to question the sustainability of the rally over the first half of the calendar year as macroeconomic data suggested that interest rate decreases remain some way off.

Against the backdrop, Growth stocks underperformed Value stocks, albeit both delivered negative returns as measured by the MSCI World Value Index and MSCI World Growth Index. At the sector level Energy, Communication Services and Financials were the strongest performers, delivering 12.0%, 0.9% and 0.3% respectively (Local Currency). Interest rate sensitive sectors of Utilities and Real Estate delivered -7.5% and -6.1% respectively (Local Currency). Finally, Emerging Markets outperformed Developed Markets on a Local Currency basis.

Figure 13. 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. While uncertainty remains around the outlook for economies globally, we expect volatility (both upside and downside) 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 the proposed and future rate hikes needed to stem inflation. We believe that inflation has peaked for the time being, which subsequently contributed to the continued strong recovery in equity markets on the presumption that central banks are successfully taming inflation and could therefore slow the pace and size of further rate hikes in the near future. That said however, any further tightening through higher rates is likely to limit the upside for equities as markets begin to reassess appropriate forward-looking valuations.
- The earnings outlook for corporates – It is the earnings expectations or outlook that has declined amid weakening business conditions. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which at some point begin to weigh on consumer spending, and subsequently future corporate earnings. That said, many corporates were able to expand their margins through the COVID-19 period, and as such there is room for some margin contraction – this likely only buys time, rather than changes the outcome.
- Valuations across most markets and sectors are near or around their post GFC averages. At this point in time, we do not see a strong valuation signal to drive an overweight position to equities across portfolios. Any volatility should present our bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations.

We expect the macroeconomic outlook to continue driving equity markets over the near term, with higher volatility expected to continue. The upcoming earnings season should provide a guide as to how corporates are coping with this dynamic.

Over the remainder of 2023, we expect inflation to fall, however do not believe that the path will be linear, and its impact will continue to be felt across the corporates. Geopolitical events may cause issues, such as oil price spikes. As such, we expect financial markets to focus on fundamentals later this year, specifically, earnings growth, margin sustainability, cost control, free cash flow conversation and balance sheet strength. Managing investment portfolios in this environment poses multiple challenges for investors, however we believe that focusing on quality and valuation will provide investors with the right levers to navigate the environment successfully.

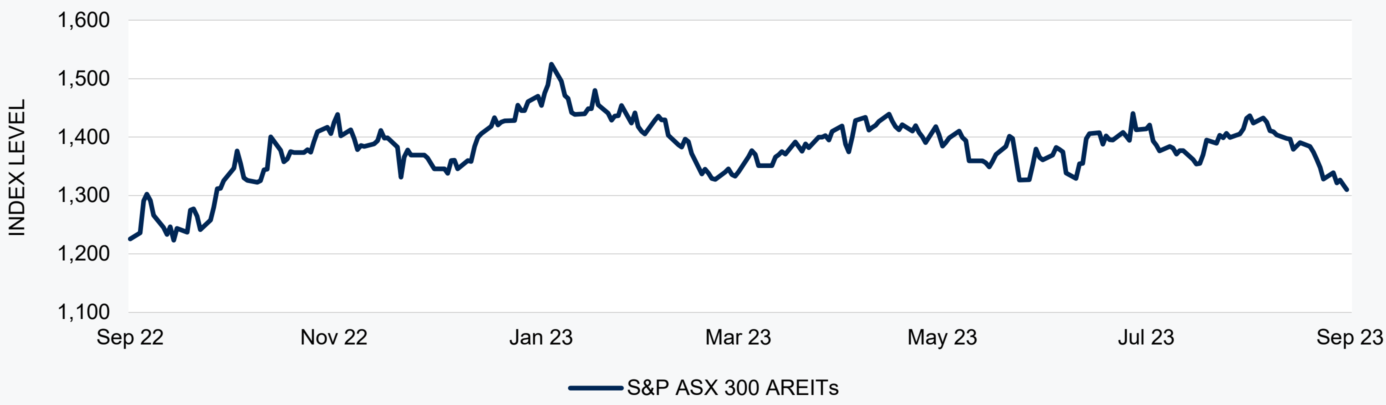
A-REITs and G-REITs (Listed property securities)

Real estate markets began the quarter positively but sold off during September as bond yields rose dramatically in major markets including the US and Australia. Australian Real Estate Investment Trusts (A-REITs), represented by the S&P/ASX 300 A-REIT sector fell -3.0% over the quarter while the S&P ASX 300 declined -0.8%. Global Real Estate Investment Trusts (G-REITs) as measured by the FTSE EPRA/NAREIT Developed Index (Unhedged) was -2.9% lower in AUD terms compared to -0.4% for the MSCI World Index.

REIT markets continue to trade at discounts to NAV reflecting lower valuations as a result of rising cap rates and the ongoing price uncertainty that remains due to light transaction levels. The sell off in September comes about as markets adjust to broadly positive economic data suggesting that recession can be avoided while rates will stay higher for longer.

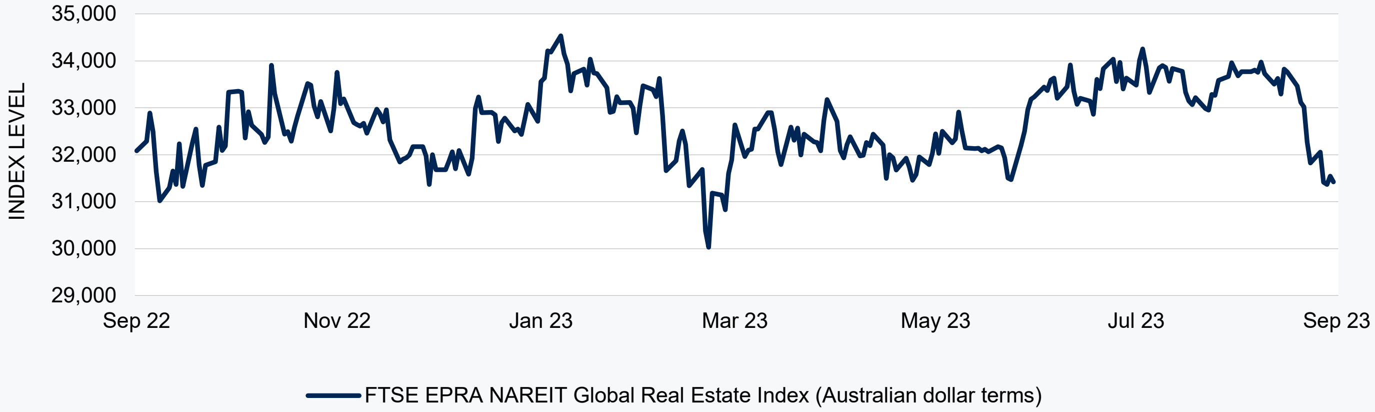
Self storage was the worst performing sector over the quarter with industrial the best performer. On a regional basis, Japan and Europe outperformed as the US and Hong Kong were weaker.

Figure 14. Property – Australian Real estate Investment Trusts (A-REITs)



Source: FactSet, Perpetual Private

Figure 15. Property – Global Real Estate Investment Trusts (G-REITs)



Source: FactSet , Perpetual Private.

REITs outlook

We expect both domestic and global REITs to experience ongoing volatility, with changing perceptions of the path of interest rates driving market direction.

Valuations across REIT markets are at multi-year lows compounded by the sell off over the quarter. Sector and geographic allocation remain important as prospects diverge.

The outlook for REITs varies meaningfully by sector driven by macro-economic factors, market themes and stock specific actions. Our active managers are focused on those 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 investments.

Fixed income

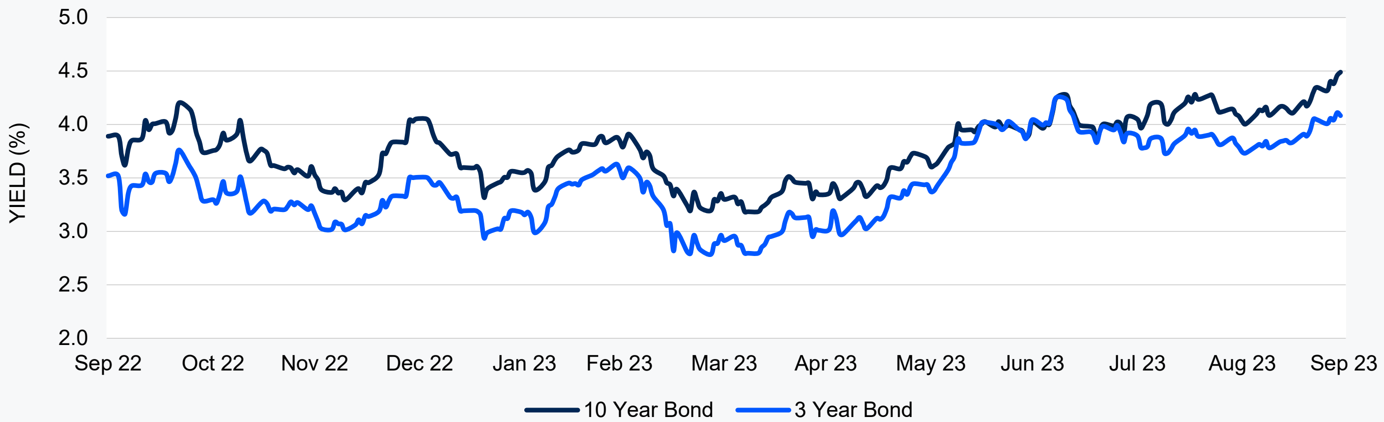
In the domestic bond market, the Bloomberg AusBond Composite Index returned –0.72% during the September 2023 quarter. Australian 10-year bond yields rose during the period as the market adjusted its expectations for long term inflation. At the end of September, the Australian 10-year bond yield rose from 4.02% to 4.49% over the quarter. Inflation did fall in Q2 relative to Q1 but remains much higher than the RBA's target of 2-3%.

After 2 consecutive rate rises in May and June, the RBA has kept the target cash rate steady at 4.10% for the last 4 months. The new RBA Governor, Michelle Bullock, chaired her first meeting in October, reiterating that inflation has passed its peak but remains high. She explained that the decision to keep the target cash rate steady in October was due the uncertain economic outlook and will give the RBA time to assess the impact of rate rises.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned -0.47%. Credit outperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning 0.04% over the quarter. High yield debt as measured by the Bloomberg Global High Yield Index (Hedged) strongly outperformed investment grade credit, returning 3.3% for the period.

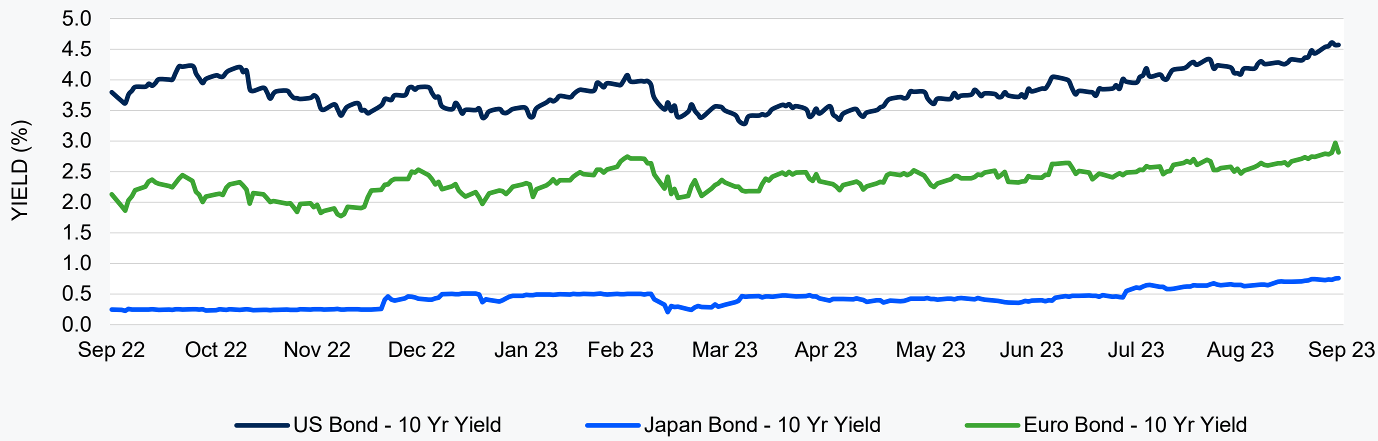
After rising to 0.69 in early July, the AUD/USD fell sharply, finishing the quarter under 0.65. At the end of July, the US Federal Reserve increased its target range from 5.00%-5.25% to 5.25-5.50%, the highest rate in over 20 years. They stated that job growth was "robust" and unemployment was low while inflation remain high. The US 10yr yield rose significantly to 4.57% from 3.81% over the quarter as the market priced in the possibility of further rate rises.

Figure 16: Australian Government bonds



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

Figure 17: Global Government bonds



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

Figure 18: Global credit markets

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

Fixed income outlook

Last quarter we wrote about the supply side of the inflation shock being behind us. There is a risk that the unfortunate events in the Middle East could lead to a much larger regional conflict that effects energy prices. Outside of any shocks, our view is that inflation will remain higher for longer.

Our current thinking around duration is that the yields are high enough to help with the volatility associated with rates markets and in the event of a recession, the long duration positions should add value to a diversified portfolio. The risk is that rates move even higher and that credit remains strong. We may have been a few months early with our move to duration, but we are still confident that yields represent good value over the medium to long term.

The high cost of debt has led to higher defaults in the high yield market, albeit from a low base. We do expect defaults to increase as EBITDA's are strained by slowing economic activity on the US and Europe. Luckily, economic activity in both regions was better than expected and our credit positions benefited from that. We remain neutral on our outlook for credit as base rates are high and spreads are reasonable.

Alternatives

Growth alternatives

Traditional asset classes continued to rally through Q3 2023, despite some weakness in the latter part of the quarter, while unlisted asset classes continued to exhibit more modest movements. Transaction volumes across all asset classes (private equity, real estate and infrastructure) remain soft in light of uncertainty around the cost of debt and the macroeconomic outlook.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. Regulated assets are positioned well to deliver returns through the current inflationary environment with the ability to pass inflation-linked cashflows through to investors. A number of energy transmission assets are well positioned to benefit from the 'energy transition' as renewables connect into the grid. Despite higher long bond rates, many private assets appear to be well insulated with most external valuations carried out on a 'through the cycle' basis resulting in limited movements in valuation assumptions. There is some speculation that some of Australia's capital city airports are likely to trade. Should these transactions eventuate, it will provide a guide as to the sustainability of current valuations.

Within Private Equity (PE), Leveraged Buy Out (LBO) transaction volumes have slowed, reducing the pace of deployment and realisations in Q2 23. We have observed Private Equity managers are beginning to look to smaller sized deals (bolt-ons) which can be funded by existing debt facilities or free cash flow, rather than having to take on more debt for bigger acquisitions which have a negative impact on balance sheet strength and cash flow metrics. Despite the changing market dynamics, we remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. We are optimistic that 2023 will be a fruitful investing environment and expect to deploy in line with our plan through this current year and into 2024.

Sector and geographical dispersion remains elevated within Real Estate markets. Our focus remains on the nexus between availability of capital and valuations. Until the nexus is found we expect limited transaction evidence to support valuation. Much has been said of the 'return to office', however this appears to be mainly an issue in the US, with the rest of the world seeing workers return (albeit not to pre-COVID levels). The next test will be whether Industrial assets valuations can be supported as the cost of debt increases, the macro outlook softens. Looking forward, we are focused on whether there are opportunities in markets which were earlier to suffer from 're-pricing' (eg. Western Europe).

Changing market dynamics (inflation, path and pace of interest rates, weakening economic environment) warrants continued reassessment of our thinking and outlook. For now, our focus remains on central bank policy decisions, and on the health of the 'real economy'. We are responding by ensuring our exposures are able to weather interest rate cycles, avoiding excessive leverage, while generating strong and sustainable cash flow. Within hedge funds we are constructive on strategies with a focus on security selection (equities and credit). Within Private Equity we are favouring General Partners who have demonstrated skill in operational capability (as opposed to balance sheet optimisation).

Income alternatives

US Leveraged Loans printed a positive return for the quarter, outpacing US High Yield which finished the quarter relatively unchanged. For leveraged loans, better than expected earnings period, rising rates and a period with very low defaults contributed to positive returns. High Yield was negatively impacted by the rise in rate expectations despite having a good period in terms of spreads.

We had expected an increased number of downgrades by ratings agencies and higher defaults. This will weigh mostly on the value of some of the market linked assets such as High Yield, Leveraged Loans and CLOs. Private Debt is somewhat shielded from the mark to market because of its illiquidity but it is not immune from delinquencies and defaults.

Historically, we've had a preference for 1st lien unlevered private debt. For the most part, these are 1st lien senior secured loans diversified across Europe, North America, and Australia. These investments are expected to underperform more recent vintages of private debt but are more seasoned and are expected to mature within the next few years.

Over time, we see sense in less exposure to 1st lien unlevered private debt in favour of more liquid securities for their improving dynamics. The liquid investments also provide some optionality for reinvesting in private assets, such as more private debt or insurance linked strategies, as and when we identify appropriate opportunities.

Andrew Garrett, CFA CAIA
Investment Director, Perpetual Private

Andrew Garrett provides investment research, portfolio construction and bespoke investment advice for Perpetual Private's clients. He works closely with advisers by providing specialist investment knowledge on Perpetual's investment process and strategy implementation, focusing on delivering optimal solutions to our stakeholders and partners. This is further augmented by his provision of transparent and accessible knowledge of financial markets and asset classes both globally and locally. Andrew is a holder of the Chartered Alternative Investment Analyst and the Chartered Financial Analyst designations.

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