

Quarterly Commentary

September 2021

Market Review

Whilst global share markets tracked higher for the better part of the quarter, markets adjusted lower during the final month as multiple headwinds weighed upon global sentiment. Bond yields globally rose as offshore central banks adopted a more hawkish stance including the US Federal Reserve which telegraphed an intent to taper bond purchases. These developments accompanied mixed economic data, particularly in the US where consumer confidence fell, and jobless claims rose but where PMIs were still strong. Concerns about China's property market and the heavily indebted developer Evergrande, as well as energy shortages in certain markets also increased uncertainty about the future path of growth and saw some forecasters revise down nearer term growth estimates.

Domestically, more than half of the Australian population has been in lockdown through much of the quarter, amidst widespread delta variant transmission. The nearer term economic cost of this third wave is significant, with expectations for a 3-4% contraction in September quarter GDP. A re opening plan tied to vaccination coverage was announced, with progressive easing of restrictions as 70-80% of the ages 16+ population become fully vaccinated. Aided by improved supply and reduced hesitancy, vaccination levels have continued to rise, with lockdowns hopefully soon consigned to the past. A re opening of international borders, with more accommodative quarantine requirements, is also slated for November, albeit some state borders will likely remain closed beyond this. This is all expected to see improved mobility and a recovery in economic activity. Other economic data has held up reasonably well and suggest that broad based economic growth may resume in 2022. While job vacancies have fallen, they are still at relatively high levels; home building approvals remain historically high and suggest robust home building this year; credit growth is also robust with growth in housing credit running above 7%.

Key Market Returns as at 30 September 2021

Trailing Returns	Period ended	30-September 2021				
		1 mth	3 mths	12 mths	3 yrs (p.a)	10 yrs (p.a)
<i>% Change, Total Return Basis:</i>						
Australian Shares (ASX 200)	-1.9	1.7	30.6	9.7	10.8	
Australian Small Co (ASX Small Ords)	-2.1	3.4	30.4	9.4	7.7	
US Shares	-4.7	0.6	30.0	16.0	16.6	
Global Shares (AC World)	-3.5	-0.3	28.0	13.1	13.6	
Global Shares AUD (AC World AUD)	-3.0	2.9	27.0	13.2	15.9	
Emerging Markets	-2.8	-6.6	17.2	9.8	9.0	
Australian Property (ASX 300 A-REIT)	-1.9	4.8	30.7	9.2	13.5	
Global Property (Global REIT)	-5.1	0.8	32.8	8.3	10.8	
Global Infrastructure (Global Infrastructure)	-0.5	2.9	22.3	6.5	8.9	
Australian Fixed Interest	-1.9	0.3	-2.5	4.4	4.4	
Global Fixed Interest	-1.0	0.1	-0.8	4.1	4.8	

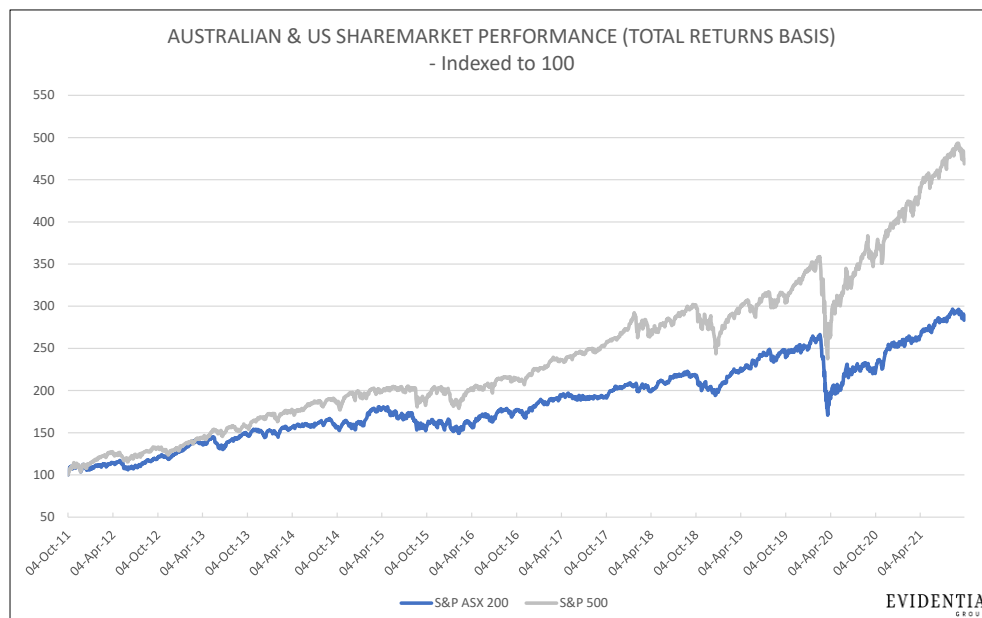
Outlook for Investment Markets

Global economic growth has now arguably peaked and this will increasingly create more uncertainty around the path ahead, especially as global policy seeks to normalise. However, we continue to see supportive medium-term fundamentals:

- Extensive fiscal stimulus and extremely accommodative monetary policy settings likely to continue for some time with negative real rates to persist for several years;
- Strong global growth forecasts albeit with some recent downward revisions, with a particularly strong pick-up in European mobility and activity data and consumer sentiment;
- High household savings rates; and
- Some subsidence in the global Delta variant with continued strong progress on global vaccinations

While policy makers and market participants alike continue to see inflationary pressures as transitional, some of the factors driving inflation are potentially longer term in nature and do create risks – however a modest uptick in inflation is unlikely to raise concerns amongst policy makers – especially in light of very high levels of government debt.

We have previously highlighted an expectation that the combination of economic growth momentum approaching peak levels with more calibrated earnings expectations, was likely to see a moderation of the positive earnings revisions trend which has been a major support to rising markets since mid 2020 and enabled markets to move substantially higher without a corresponding rise in valuation multiples. Whilst we view rates of earnings growth will likely remain above trend across the outlook period, broad based earnings upgrade momentum is unlikely from here. As central banks begin the process of adjusting policy settings, and liquidity is removed from the system, expensive valuations will be more difficult to justify, whilst a rise in bond yields will provide a headwind to valuations. Whilst equities remain attractive relative to alternate asset classes, we should expect more modest returns in the nearer term. One qualification to this view should be made, and that is that very low returns on bonds for an extended period can see greater flows into equities.



Managers are saying:



“There are two broad forms of inflation to consider:

1. *Cost pressures building from input prices and shortages, as we are seeing now. This usually resolves itself via reduced demand as prices rise or products are unavailable. But through this process we have a period of higher inflation and lower growth, which is not a good combination for equities.*
2. *Expectations of inflation translating into rising real wages as workers leverage labour shortages. This enables higher spending which reinforces inflationary pressure. This is a far more sustained inflation — the wage-price spiral — which ends only when central banks slam on the brakes.*

At this point we are witnessing the first form of inflation.

The hope is that it fades quickly as supply chains are restored and demand is fulfilled, easing inflationary pressure without any impact on growth.

The concern is that if supply chain issues persist too long and we get significant energy price spikes in the Northern hemisphere winter, it will drive a more severe impact on the global economy.

An additional fear is that current labour shortages in a number of countries — combined with central banks maintaining their current aim of higher real wages — would see inflation entrenched via wages.....

*There is a long way to go, but risks have risen.” **Pendal***

Australian Shares

The S&P/ASX 200 fell 1.9% during September, bringing an end to eleven consecutive monthly gains but still ended up +1.7% for the quarter to outperform most other regions. The ASX is now +14.8% higher calendar year to date and +30.6% on a rolling 12 month basis.

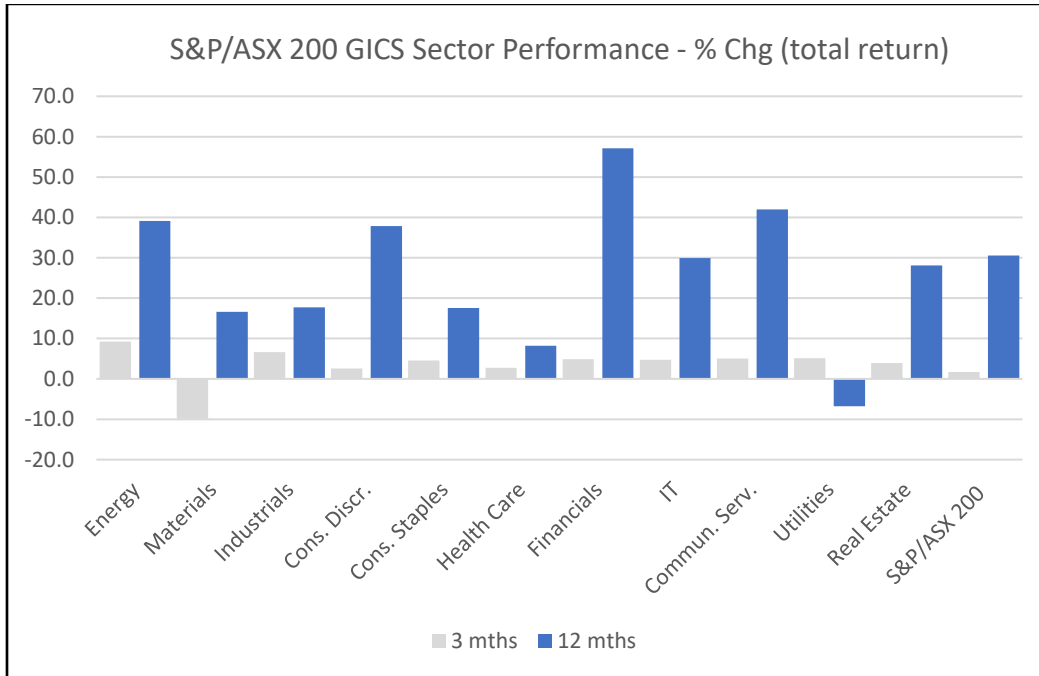
Full year F.21 earnings per share growth for S&P/ASX 200 stocks came in +28%. Despite having been progressively upgraded, there were still more companies where results bettered expectations than missed. There were also several instances where dividends significantly exceeded forecasts and/or capital management was announced. Outlook comments were cautious given immediate uncertainty around east coast lockdowns, leading to net downgrades to F.22 estimates and drawing to an end an extended period of positive earnings revisions. This positive revision trend has been a significant driver of market returns since mid 2020.

Within the S&P/ASX 200, Materials (-9.9%) was the only sector to under perform the broader market, primarily reflecting weakness in iron ore and gold stocks. A strong rally in September from the Energy sector (+16.7%) saw it +9.3% for the quarter. Industrials (+6.6%), Communication Services (+5.1%), Utilities (+5.1%), Financials (+4.9%), IT (+4.7%) and Consumer Staples (+4.6%) were stronger performers. Whilst still outperforming the broader index, Consumer Discretionary (+2.6%), Health Care (+2.7%), and REITs (+3.9%) saw more modest gains.

After reaching all time highs of more than US\$220/tonne during July, amidst elevated demand and constrained global supply, the Iron Ore price declined by more than half before closing the quarter at US\$120/tonne. This sharp fall was a direct response to China capping steel production in an effort to curb emissions. This was

further exacerbated late in the period by the Evergrande situation and potential knock on effects to the broader Chinese property market, a key component of China GDP. China imports around 70% of the world’s iron ore, and accounts for more than 70% of Australia’s iron ore exports. Analysts already have prices well below US\$100/tonne in longer term forecasts and valuations, and cash costs for BHP, RIO, and Fortescue are well below US\$20/tonne, however lower prices clearly still impact nearer term earnings and cashflows.

In terms of other commodity prices, in USD terms Thermal Coal (+61.8%) was up significantly, Oil (+2.1%) was again higher, whilst Copper (-3.7%) and Gold (-0.9%) were softer over the quarter. The AUD was -3.8% for the September quarter to USD\$0.722.



Managers are saying:



“The medium-term outlook for shares remains supported by the prospect of strong economic growth, strong company earnings, continued low short-term interest rates and high levels of liquidity. The key headwinds for markets are relatively high valuations, generally optimistic investor sentiment and the prospect of rising inflation and interest rates. In the short-term we have become more cautious following strong share market returns and issues around supply chains and Chinese growth.” **Milford Asset Management**

Global Shares

In local currency terms global shares fell -3.5% in September resulting in a modest quarterly decline of -0.3%. Unhedged AUD denominated returns were stronger at 2.9% for the quarter with the AUD continuing to depreciate. The S&P 500 in the US rose +0.6% during the September quarter (-4.7% for month). The NASDAQ was -0.2% down for the quarter, with September -5.3% as rising bond yields impacted longer duration growth stocks. In European markets, the UK was +2.0% during the quarter, France rose +0.4%, whilst Germany recorded a -1.7% decline. Japan was +3.0%. Elsewhere in Asia, Hong Kong (-13.9%) and China (-6.0%) were impacted by various regulatory pronouncements out of China, uncertainty late in the period associated with the potential collapse of Evergrande (one of China's largest property developers) and broader concerns around recent energy shortages and a moderating nearer term growth outlook.

Evergrande Group appears to be on the verge of becoming one of China's biggest debt restructurings. Evergrande is the largest and the most levered property developer in China which expanded very aggressively during the property boom. It currently has over US\$300 billion in liabilities with limited cash and is unable to meet its debt repayments. Construction of unfinished properties has ground to a halt, leaving more than a million homebuyers in doubt. Fire sales are exacerbating an already fragile real estate market. Directly and indirectly the property sector accounts for about 25% of China's GDP.

The developments in China triggered market concern around the potential for broader contagion. These concerns have seemingly settled for the time being with most commentators expecting a debt restructuring and suggesting that the Chinese authorities have the tools available and the resolve to avoid broader social ramifications.

Managers are saying:



"If there is a positive it's that of the ~US\$300bn equivalent of liabilities held by the group at least 50% are accounts payable type debts including deposits from would be property buyers. It's very difficult to not see these being resolved favourably given the negative flow on effects of allowing thousands of property buyers to lose their life savings. In that regard we'd probably not expect a major systemic event ala Lehman Brothers." **Franklin Templeton**

"Several of our analysts and economists believe that authorities could let China Evergrande default and proceed into bankruptcy to send a message to other real estate companies. Central authorities in China's Communist Party or a local government entity may oversee an orderly unwinding of the group's assets and/or may provide some level of future policy support for the broader sector to contain any broader spill-off. Since social stability is the government's top priority, it's likely that restructuring efforts will be managed to restore confidence and protect rights of homebuyers and suppliers. China's government has successfully handled several problematic financial institutions in the past, and those problems were even more complicated than Evergrande." **Capital Group**

Australian & International Property and Infrastructure

Global Property outperformed global shares in the September quarter +0.8% but were more heavily impacted by interest rate rises and growth uncertainties in September -5.1%. Despite lock-downs, Australian listed property was a relatively strong performer amongst global sharemarkets delivering a positive 4.8% return for the quarter and performing in line with Australian shares in September -1.9%.

Having been one of the weaker growth asset classes over the past year and despite the rise in global bond yields, Global Listed Infrastructure shares demonstrated their traditionally defensive characteristics returning 2.9% for the quarter and falling just -0.5% in September.

Managers are saying:

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“Infrastructure is in a multi-decade secular growth cycle where the assets will play a pivotal role in the path to net-zero emissions. Trillions of investment dollars need to be made over the coming decades, which will underpin the allowed returns, and ultimately dividends. This will likely drive the asset base growth of these companies and provide a tailwind for infrastructure investors seeking income and the potential for capital appreciation”. **Clearbridge Rare Infrastructure**

“The impact of the Delta strain is evident when we look at the property sector performance over the past 3 months... with hotels giving back some of their strong performance from the re-opening trade... and the office sector also weak as the return to office has been deferred in many markets.

Looking at the recent reporting season covering the period ending the 30th June we saw a solid resurgence in operating metrics across most REIT sectors as activity levels rebounded with the easing of restrictions”. **Resolution Capital**



Australian Cash & Fixed Interest

In terms of domestic monetary settings, the RBA Board has reiterated its commitment to maintaining highly supportive monetary conditions to achieve a return to full employment in Australia and inflation consistent with the target. It maintains that it will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range believing this condition will not be met before 2024. The RBA Governor pushed back against market expectations for rate rises in 2023, citing the modest level of wage growth pressures, and suggesting labour markets will need to be tight enough to generate wages growth that is materially higher than it is currently.

Despite weak economic activity and subdued domestic inflation pressures, September saw a reversal on prior months trends of declining bond yields with the 10 year government bond yield increasing by 33 bps resulting in negative Australian fixed interest returns of -1.9% for the month (+0.3% for the quarter). These moves were largely on the back of increases in global rates.

APRA and the RBA recently decided to terminate the Committed Liquidity Facility (CLF) by the end of 2022. The Committed Liquidity Facility was established to help banks meet prudential liquidity requirements by allowing banks to secure a line of credit from the RBA backed by internally securitised mortgages and publicly traded RMBS as collateral. From the end of 2022 banks will need to hold the requisite liquidity in the form of direct government bonds. It is expected that Semi-government bonds would be strongly favoured given their relatively favourable yields. Banks may also issue more senior debt in order to use the proceeds to buy government bonds to help meet the liquidity requirements. As a result semi government bond spreads are expected to tighten while senior bank spreads are expected to widen.

Selected Market Pricing

	Mth end	Change -1 mth	Change -3 mth	Change -12 mth	Change 10 Yrs Ave
Australian cash rate	0.10	0.00	0.00	-0.15	-1.75
Australian 10 Year Bond yield	1.49	0.33	-0.04	0.70	-1.07
Australian BBB credit spread (to 10 Year bonds)	0.71	-0.09	0.10	-0.74	-1.09
US Fed Funds rate	0.25	0.00	0.00	0.00	-0.51
US 10 Year Treasury (yield)	1.53	0.23	0.08	0.85	-0.52
US BBB credit spread (to 10 Year bonds)	0.92	-0.09	0.01	-0.90	-0.67
ICE BofA US High Yield Index Spread	3.15	-0.06	0.11	-2.26	-1.61

Managers are saying:



*“We remain positive about the outlook for credit, particularly those industries that have been hardest hit but offer high income while we wait for the recovery and inevitable capital gains. Tourism, airports, universities, and retail are set to benefit the most from the broader economic recovery as Australia gets a second wave of growth from pent up demand, latent savings and return to travel. We believe that the thematic is still strong and we expect these sectors to perform strongly as the economy opens.” **Janus Henderson***

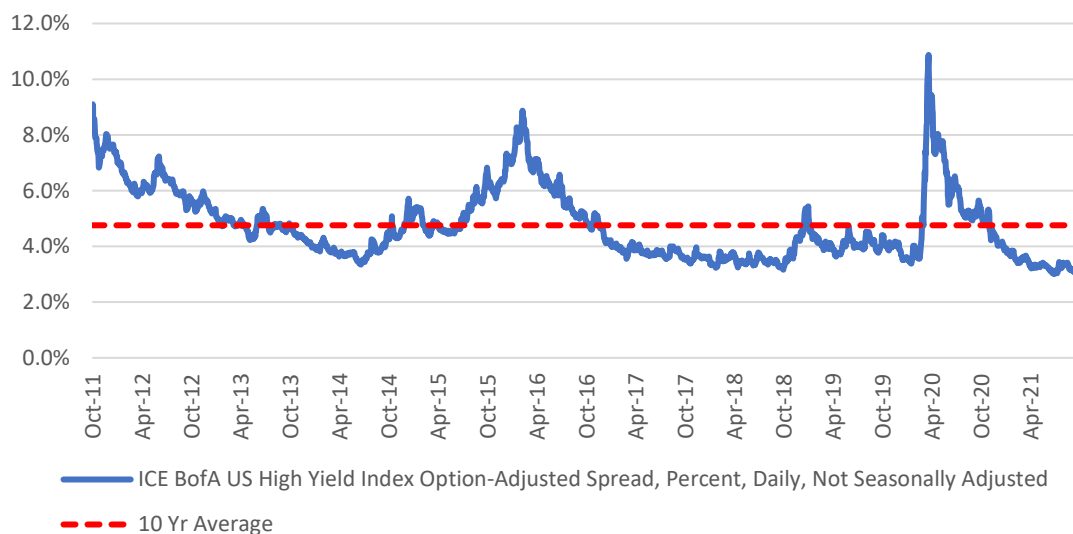
“Banks will need to raise cash to buy the government bonds they need to replace the CLF. And much of this will have to come via banks issuing additional debt. Coolabah’s detailed modelling shows that Aussie banks are going to issue about \$168bn a year of wholesale debt, on average, for the next 3yrs as a result of:

1. *APRA shutting the \$139bn CLF; and*
2. *The need to repay the RBA the \$188bn it very generously lent—at between 0.25% and 0.1% per annum—the banks under the ultra-cheap, 3-year Term Funding Facility (TFF).” **Coolabah Capital***

International Fixed Interest

Global government bond yields moved higher in September with a greater focus emerging on the potential persistency of inflation and offshore central banks indicating they may tighten monetary policy sooner than previously expected. Chairman Powell, appeared to amend his relatively dovish tone from Jackson Hole, noting that transitory inflation may last longer than expected. The US Fed gave advanced warning of tapering at its September FOMC meeting, indicating it would most likely commence the taper of its \$120b/month bond purchase program in November, and complete this process by mid-2022. Global fixed interest delivered a negative 1% return in September to be broadly flat over the quarter. Higher yielding credits experienced some spread widening over the quarter while investment grade credit was largely unchanged.

ICE BofA US HIGH YIELD INDEX-OPTION ADJUSTED SPREAD



Managers are saying:

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“While yields throughout the market should rise over time as the Fed normalizes, the past 12 months have shown just how stubborn low yields can be. Concern about the longevity of robust economic growth has been one factor. Investors began to understand the persistence of COVID-19 when Delta and other strains caused new infection surges. The Chinese economy, a source of global economic strength over the past decade, has also been slowing. Lastly, investors believe the Fed’s inflation narrative — that the high rate we’re seeing is just transitory.

*Some investors may fret or become nervous about the Fed pulling back. Yet, policymakers will only do so when they’re confident the economy can sustain it. Ultimately, normalization should help ease the concerns about inflation that have cast a long shadow over markets this year.” **Capital Group***

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