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Investment Markets Report

Nick Ryder – Chief Investment Officer

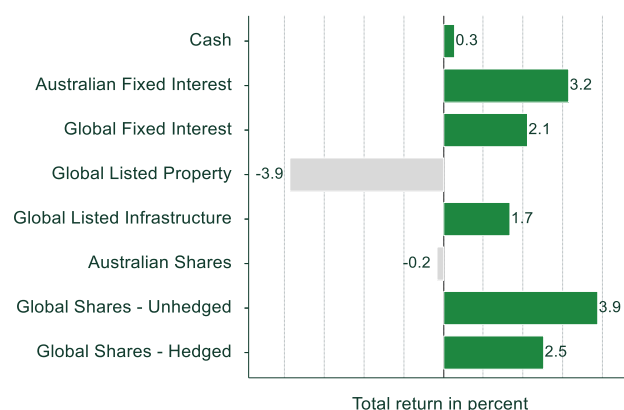
Our investment office unpacks what happened in the past month, current tactical positioning and what this means for our portfolio weightings to different asset classes.

What’s changed in March?

The collapse of US regional banks, Silicon Valley Bank and Signature Bank, along with the forced merger of Credit Suisse and UBS in Switzerland, saw falls in bank share prices in March. However, government bond yields fell materially as investors priced in rate cuts in 2023 due to the banking system stress, which is expected to slow lending and economic growth. The decline in bond yields lifted prices of rate-sensitive growth stocks, which helped lift global share prices, despite financial sector price falls.

- In currency-hedged terms, developed market equities (MSCI World ex-Australia) rose 2.5% in March despite the 8.3% fall in the financial sector share prices. Australian shares (S&P/ASX 200) underperformed, losing 0.2% in March.
- 10-year government bond yields fell by 32-43 basis points in Germany, the UK and US, 15 basis points in Japan and 56 basis points in Australia.
- Investment-grade corporate credit spreads in the US widened by 15 basis points (bps) to 145bps and US high yield bond spreads widened by 36bps to 458bps.
- The Australian Dollar fell 0.5 US cents to US\$0.6698.
- Oil prices fell 1.7% to US\$75.67 per barrel (WTI) before OPEC+ announced surprise production cuts in early April. Gold rose 9% to US\$1,980 per ounce. Iron ore prices rose 1% to US\$125.81 per tonne.

Asset class returns – March 2023



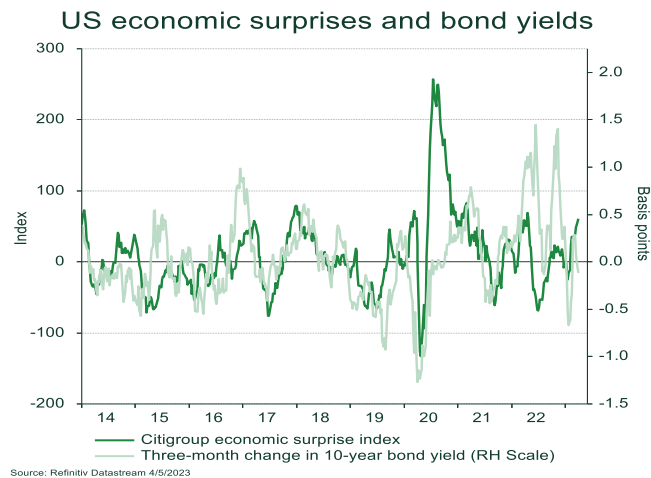
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Tactical Positioning

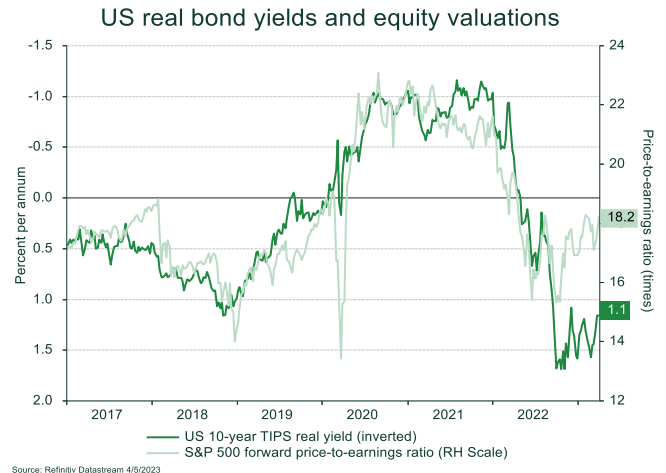
Global economic data in recent months has generally been stronger than expected with unemployment, retail spending and non-manufacturing business surveys pointing to a re-acceleration in global economic growth in early 2023. Although headline inflation has eased, other inflation measures have remained sticky. This meant that prior to the banking issues in March, fixed income investors were pricing in further rises in interest rates in the US, Eurozone and Australia in 2023, with no rate cuts until 2024.

A few weeks and several banking failures later, fixed income markets have moved to price in only around one more rate rise this year in most economies, followed by rate cuts later in the year. While it is likely that commercial banks will have to hoard more cash, become more competitive with deposit rates and tighten lending, it seems unlikely that the banking issues will morph into another global financial crisis or sharp credit crunch. Equity markets are certainly not pricing in this eventuality, with markets seemingly ignoring the greater recession and banking sector risks.



The more likely scenario in our view, is that central banks pause rate rises, to let the dust settle from the bank collapses. Once it becomes clear that inflation is still too high and that depositor nervousness is not spreading, they will return to lifting interest rates. For this reason, we continue to hold an underweight allocation to fixed interest securities.

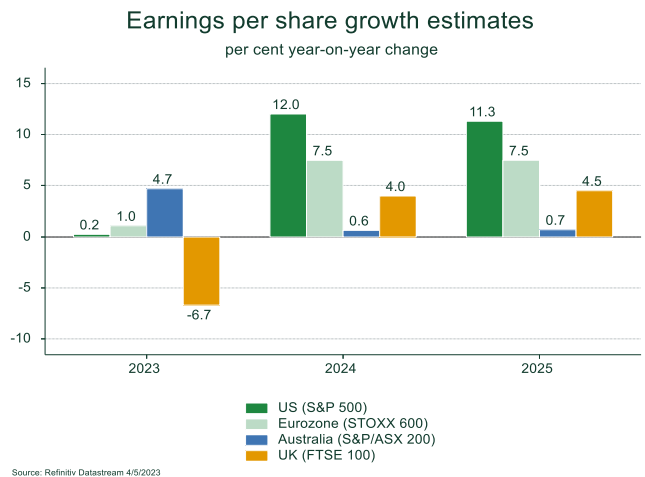
In relation to equities, we remain somewhat cautious, with a mild underweight to equities overall. We see limited equity upside over coming months and risks remain mainly to the downside. A resumption of interest rate rises to tame inflation would lower equity valuation multiples and increase the risks of a policy mistake and recession. The other key driver of equity returns, earnings, show no expected growth this year as profit margins are expected to continue contracting.



Equities:

Although bank stocks had a difficult time in March, equities held up relatively well. This was due, in part, to stronger economic momentum and partly because “bad news is good news” meaning the banking failures lowered bond yields which in turn lifted equity valuations. As discussed, we remain slightly underweight equities given valuations, particularly in the United States, are not cheap and risks appear mostly tilted to the downside. Earnings expectations in 2023 and 2024 also suggest limited upside for equity prices in the near term.

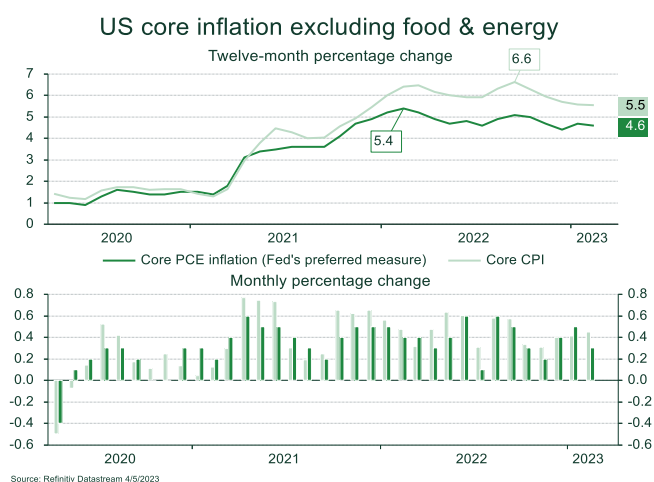
Within equities, we are currently neutral Australian shares and underweight global shares. The fall in global bond yields recently has benefited long-duration growth shares, particularly in the US information technology and communication services sectors, where earnings are seen as being less exposed to an economic slowdown. Global banking sector issues, expectations of rate cuts and fading hopes for major Chinese stimulus have seen more value-driven and more cyclical markets underperform recently. Overall, we would seek to increase exposure to higher quality companies that have less cyclical earnings and stable profit margins, given the downside risks discussed.



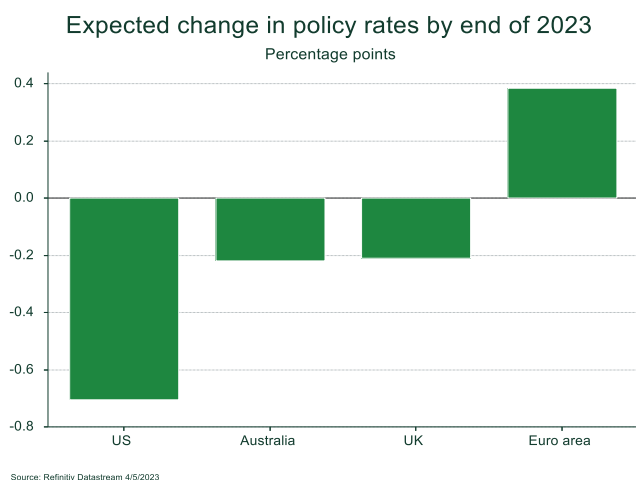


Fixed income:

Although headline inflation has been falling in annual terms, helped by base effects and falling energy prices, core inflation remains sticky and well above central bank comfort levels. We expect central banks to pause or slow rate hikes in the coming months, but risks remain that their job is not done yet, and rates may need to move higher than current pricing suggests and then remain higher for longer. In our view, the hurdle for central banks to cut rates over the next 12 months is very high. For example, it would probably require a big jump in unemployment or larger scale banking crisis.



The move by investors to price in rate cuts is undoing part of the work that central banks such as the RBA and US Federal Reserve have done over the past year to tighten financial conditions. As discussed, economic data has been relatively strong in early 2023, and central banks may find themselves in a situation where bank lending and economic activity do not slow dramatically in response to the issues in US regional banks. This would see the expected rate cuts currently priced in get reversed, leading to a fall in bond prices.



We are, therefore, happy to remain underweight fixed interest and would look to reduce the underweight once it becomes

clear that central banks are closer to the end of their tightening cycle, which could be later this year.

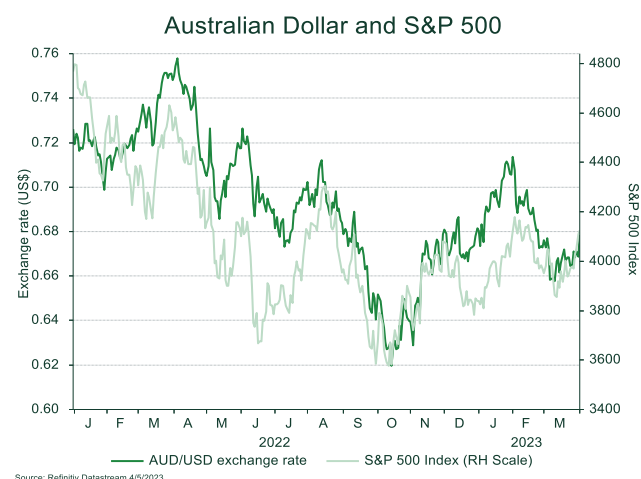
Property and Real Assets:

Global listed property was the worst-performing asset class in March for a few reasons. Firstly, several institutional office property owners in the US defaulted on loans. Higher office vacancies, due to the work-from-home trend and tech sector layoffs, combined with rising interest rates, has created a tough environment for office owners. Additionally, US regional banks are large lenders to the commercial real estate market, so the expected tightening of credit conditions is seen as another headwind for US commercial real estate.

Unlike listed property, global listed infrastructure has benefited from its more defensive long-term inflation-linked income streams and the decline in bond yields. We continue to hold a small underweight to property and real assets with a preference for listed over unlisted assets, given public market valuations are more attractive than private market valuations, which have been slow to adjust to rising bond yields and falling asset prices more broadly.

Alternative assets:

Liquid alternative assets posted a loss of 1.2% in March, according to the HFRX Global Hedge Fund Index. Only merger arbitrage, convertible arbitrage and growth-focused equity long/short funds posted positive returns. We continue to recommend an overweight to alternative assets in portfolios for diversification purposes at a time when other asset classes are more correlated to changes in interest rates.



Currency:

The Australian Dollar continues to play a role as a diversifier and portfolio shock absorber, moving more broadly in line with risk sentiment. Our cautious view on equities means we continue to prefer that global share exposures remain predominantly currency-unhedged.



Current Balanced portfolio positioning summary

Asset Class	Positioning	View
Cash	Underweight	Rising returns on cash deposits are expected with banks likely to need to pay higher interest on deposits as a result of global banking stress and deposit outflow. The RBA is likely to lift rates further but large rate cuts are being priced in late 2023 suggesting cash returns may begin to fall.
Australian Debt	Overweight	Although the peak in interest rates is closer, risks remain that the RBA will need to continue to lift rates more than market pricing suggests, given inflation remains well above the RBA's inflation target range of 2-3%. Within our overweight allocation to Australian Debt we would maintain an underweight exposure to interest rate duration with a higher exposure to floating rate securities.
Global Debt	Underweight	Economies remain in relatively good shape and interest rate rises have had no noticeable impact on growth, employment and spending yet. Once the stress in the banking system subsides, central banks such as the US Federal Reserve and European Central Bank will need to push back on expectations of rate cuts and return to lifting interest rates to tackle ongoing inflation pressures. Maintain an underweight exposure and/or a lower exposure to interest rate duration.
Alternative Defensive	Overweight	Maintain an overweight exposure to alternative strategies where returns are not correlated with interest rate changes and broader risk sentiment.
Property & Real Assets	Underweight	Office properties face many headwinds from rising vacancies and interest rates. Listed real estate valuations are more attractive than unlisted at present. Real assets such as infrastructure are becoming more attractive as bond yields get closer to their peak. Real assets tend to have earnings more closely linked to inflation which is also attractive.
Alternative Growth	Overweight	Maintain an overweight exposure to alternative strategies where returns are not correlated with interest rate changes and broader risk sentiment.
Australian Shares	Neutral	Earnings outlook is muted due to falling net interest margins and slower credit growth at the major banks. The lack of Chinese property and infrastructure stimulus post lockdowns means demand for iron ore is also unlikely to lift. Equity valuations are about average relative to history.
Global Shares	Underweight	Equity upside appears limited with soft earnings outlook over the next year due to expectations of slowing economic growth and profit margin pressures. Further large falls in bond yields, which have supported valuations recently, appear unlikely. Prefer quality companies with sustainable pricing power.
Currency hedging	Mainly unhedged	With the RBA likely closer to the end of its hiking cycle than other central banks, interest rate differentials between Australia and other countries could widen which is less supportive for the Australian Dollar. Commodity price rises also appear less likely in a slowing global economy without additional Chinese stimulus. Given the risk-sensitive nature of the Australian Dollar and asymmetric downside risks to equities, remain largely currency unhedged.



Strategic Asset Allocation (SAA) and Dynamic Asset Allocation (DAA) weights

Portfolio	Conservative		Moderate		Balanced		Growth		High Growth	
	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA
Defensive Assets	70	70	50	50	35	35	20	20	5	5
Cash	10	3	7	3	5	3	2	3	2	3
Australian Debt	30	36	22	22	15	16	9	6	2	2
Global Debt	30	18	21	14	15	10	9	5	1	0
Alternative Defensive	0	13	0	11	0	6	0	6	0	0
Growth Assets	30	30	50	50	65	65	80	80	95	95
Property & Real Assets	5	4	7	6	8	7	9	8	10	8
Alternative Growth	0	2	0	3	0	4	0	4	0	5
Australian Shares	15	16	25	25	32	32	39	39	45	45
Global Shares	10	8	18	16	25	22	32	29	40	37
Total	100	100	100	100	100	100	100	100	100	100

Major financial markets

To 31 March 2023	Latest	1 Month	3 Month	Year-to-date	1 Year	3 Year	5 Year
Equities		Total returns including dividends in percentage, not annualised					
Australia - S&P/ASX 200	7,178	-0.2	3.5	3.5	0.1	58.2	35.4
Japan - Nikkei 225	28,041	3.1	8.5	8.5	3.1	57.1	43.3
US - S&P 500	4,109	3.7	7.5	7.5	-7.7	66.8	69.9
US - NASDAQ Composite	12,222	6.8	17.1	17.1	-13.3	62.5	81.0
UK - FTSE 100	7,632	-2.5	3.6	3.6	5.4	49.1	31.1
Europe - STOXX 600	458	-0.2	8.6	8.6	3.7	55.6	44.0
Developed Markets - MSCI World	2,174	2.6	7.6	7.6	-5.0	61.4	57.3
Emerging Markets - MSCI EM	59,416	2.2	3.8	3.8	-6.2	30.2	11.9
Government bond yields		Change in annual yield in percentage points					
Australia - 2 year	3.08	-0.60	-0.34	-0.34	1.28	2.82	1.05
Australia - 10 year	3.31	-0.56	-0.73	-0.73	0.52	2.51	0.72
US - 2 year	4.04	-0.76	-0.36	-0.36	1.76	3.81	1.77
US - 10 year	3.48	-0.43	-0.35	-0.35	1.16	2.78	0.74
UK - 10 year	3.49	-0.34	-0.18	-0.18	1.88	3.13	2.14
Germany - 10 year	2.31	-0.32	-0.25	-0.25	1.76	2.77	1.82
Currencies and Commodities		Change in price					
Australian Dollar (US\$)	0.6698	-0.005	-0.008	-0.008	-0.081	0.058	-0.097
US Dollar Index	102.51	-2.36	-1.02	-1.02	4.20	3.46	12.54
Gold (US\$/ounce)	1,979.70	155.10	167.35	167.35	37.55	370.75	655.85
Iron Ore (US\$/tonne)	125.81	1.35	9.25	9.25	-30.93	42.01	62.80
Crude oil (WTI, US\$/barrel)	75.67	-1.28	-4.56	-4.56	-24.61	55.19	10.76



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