June Quarter 2022 – Commentary and Outlook

Entrust
WEALTH MANAGEMENT

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Three months is a long time in financial markets!

In our March Quarter 2022 report we discussed the emergence of inflation and the resultant "prospect" for interest rate rises, coupled with the uncertainty created by the Russian invasion of Ukraine. Our thinking at the time being that *"equity market risk lies more to the downside and a slightly more cautious stance is appropriate"*.

Since this time, it feels like the range of uncertainties has both widened and to some degree intensified, including, but not limited to:

- Inflation continues to rise – how high will it go?
- Interest rate increases have commenced – how fast and how far will they rise?
- Energy concerns abound – will they get worse before they get better?
- Russia / Ukraine crisis enters its sixth month – what impact will this have on energy and food security and the broader global economy?
- China continues to pursue a zero-COVID policy – what impact will this have on global growth and importantly for Australia, demand for commodities?

Many of you would have noted portfolios have carried higher levels of cash than normal this year. This has been a by-product of our view on how high asset values had become in the back half of 2021. We view cash as providing us the optionality to buy assets for portfolios when values are attractive. In other words, and to borrow from Warren Buffett, *"we would like to be greedy when others are fearful"*.

While we read extensively on markets, we do not (and cannot) know how these issues will play out. Renowned US investor Howard Marks often talks about the uncertainty of markets and his view that *"You can't predict, but you can prepare"*.

In this respect we continue to manage our client portfolios with a focus on their specific goals and an approach that seeks to balance a range of potential economic and market outcomes.

In the June Quarter the above concerns were reflected in the performance across global equity markets (***Figure 1***).

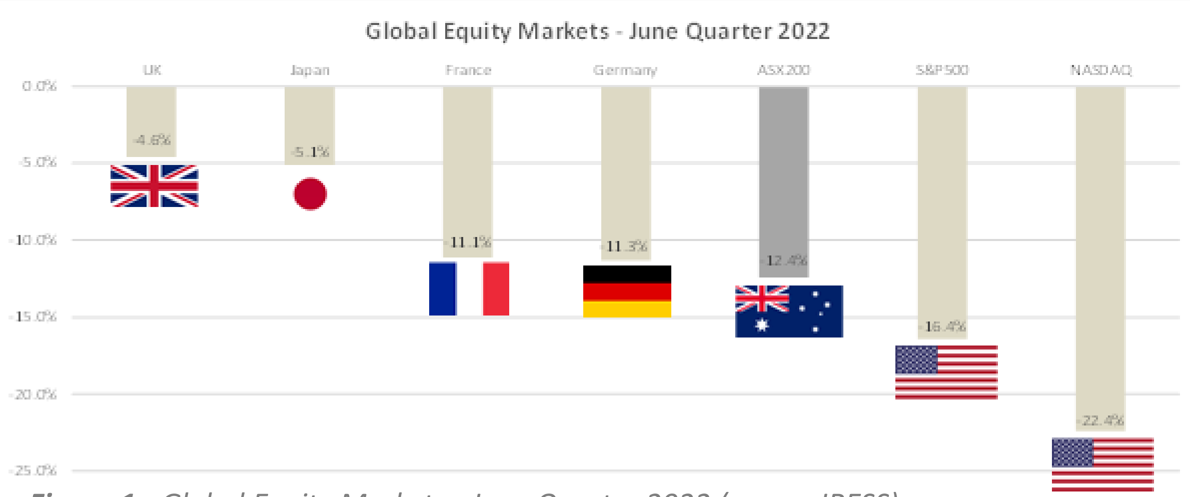

Figure 1 - Global Equity Markets - June Quarter 2022 (source IRESS)

Performance across the ASX200 (***Figure 2***) showed that the traditionally defensive sectors (e.g. Utilities, Health Care and Consumer Staples) performed relatively well, the IT sector continued to be sold off, while interest rate sensitive sectors (e.g. Property, Consumer Discretionary and Financials) were impacted by interest rate increases, both enacted and expected.

Figure 2 - ASX 200 Sector Performance (source IRESS)

Financial Year 2022

Difficult financial and economic conditions brought the 2022 financial year (FY22) to a close, with few places for investors to hide as most asset classes experienced losses.

In difficult periods for equity markets, Bonds and Bank Hybrids have historically provided some stability to portfolios. This was not the case in FY22 (***Figure 3***) as fixed interest assets produced negative returns as increasing interest rate expectations impacted the capital value of these assets. Our portfolios mitigated the majority of the draw down faced by passive investors in fixed interest by targeting assets that paid "floating rate income" which effectively increased the level of income received as the Reserve Bank began increasing the official interest rate.

Across client portfolios we held a relatively low exposure to traditional government bonds given the poor risk / return equation we foresaw. Following the recent material correction in the bond market we are now starting to see some relatively attractive opportunities to add bonds to portfolios as income levels are ahead of term deposit rates. In addition, historically bonds have generally performed well when economies enter a slowdown.

In a further boost to portfolio income Bank Hybrids are now paying income in excess of 5% p.a. In the event the Reserve Bank continues to increase rates as predicted, we believe these Hybrids may offer income returns in excess of 6% by year end.

Figure 3 *- FY22 Returns - Australian Equities, Bonds & Hybrids (source IRESS)*

Unlisted Assets

We thought it worth touching on unlisted assets such as property and private equity. Assets listed on public markets (such as the ASX) provide "price discovery" as they trade daily and reflect market sentiment very quickly. While not a perfect system, given these assets can see large bouts of (sometimes irrational) volatility, it does provide investors a price each day at which the asset is valued by the market. On the contrary, private or unlisted assets do not have this ongoing price discovery element and as a result are seen as much less volatile than public market assets.

This can at times result in prevailing valuations for unlisted assets being slow to reflect changed circumstances. In recent weeks, this issue has drawn attention from the financial press on the back of portfolio returns being reported by some Industry Superannuation funds. Industry Superannuation funds tend to have a higher proportion of unlisted assets, valuations for many of which will not have been adjusted to reflect recent changes in value.

If and when asset revaluations are updated the changes can be significant. A recent example is the raising of capital by Commonwealth Bank-backed Buy-Now-Pay-Later (BNPL) company Klarna. Klarna recently raised capital at an implied valuation of $US6.7bn an 85% decline from the US$45.6bn it was valued at just 12 months earlier.

Across many client portfolios we have invested in unlisted property assets for a number of years. We are currently assessing our unlisted property exposure, which has materially outperformed ASX listed property. We are cognisant of the lag in property prices being revalued relative to interest rate changes and are considering profit-taking in particular positions.

Outlook

With the current level of uncertainty, we approach the coming period with caution, though alert to opportunities that may present. As noted above we currently see reasonably attractive opportunities amongst Bond and Bank Hybrid markets to generate levels of income that haven't been available for many years.

We also expect to see opportunities in regard to direct equities, though this will more likely be on a stock specific basis. Amongst the sectors that have been sold off (shown in ***Figure 2***, above) we are starting to see some value emerging. Of interest a number of retail stocks with strong management and good balance sheets are starting to look appealing, notwithstanding that consumer discretionary spending is expected to be under pressure as interest rates continue to rise.

The recent sell-off in markets has caused the valuation multiples on which some companies trade on to reduce to levels that may be considered attractive. However, while valuation multiples have contracted, we are yet to see across-the-board reductions to earnings estimates. As ***Figure 4*** shows, as at 30 June 2022, consensus estimates for all ASX200 sectors (excluding Materials and Energy) were for earnings to continue to grow in FY23; a situation that would appear unlikely to occur across a number of sectors given the current economic outlook.

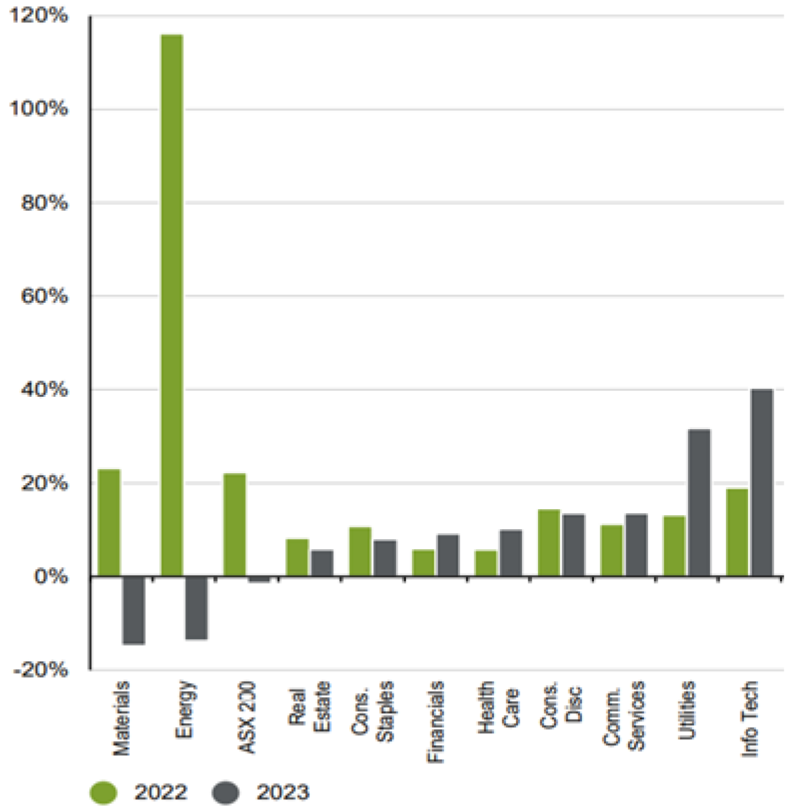

Figure 4 *- ASX200 earnings per share growth estimates (source JP Morgan)*

In August the full year reporting season for the majority of ASX-listed companies will take place. This will provide some insight into how companies have been performing over the last few months along with their views as to the outlook for the coming period. We saw a relatively large dispersion of performance and outlook statements during the February reporting season and we would expect a similar outcome this time.

We will be keeping a close eye on how the market reacts to earnings results as headline numbers may not reflect market expectations. We have learnt over time that when we witness a negative headline result that corresponds with an increasing share price, that this tends to indicate that markets may have become too negative and this can be the early signs of a market recovery.

If you have any questions on your portfolio or investment markets in general, we encourage you to please call the team.

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