March Quarter 2023 – Commentary & Outlook

Entrust
WEALTH MANAGEMENT

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Summary

- Global equity markets performed strongly over the March quarter, with major global indices up 9.8% on average, outstripping the ASX200, which delivered a positive return of 2.0%, increasing to 3.6% when taking dividends into account.

- After 10 consecutive interest rate increases between May 2022 and March 2023 encompassing a total increase of 350 basis points (3.50%) the RBA held rates steady at its early April meeting. However, the Board expects further increases will be necessary as inflation continues to run well above the RBA target rate of 2-3%.

- While interest rates and inflation continue to be the headline act, over recent months a number of left field events have impacted upon markets. While these events have occurred offshore, Australia has not been immune.

- In this respect, we believe the Australian banking and financial system is well-positioned, particularly relative to its US and European counterparts, due in large part to the structure of our industry and the vigilant approach of our regulatory bodies.

- Uncertainty, more so than usual, remains a key feature of the current investment environment. In summary, we see that there are known upside and downside risks to the economy, largely relating to inflation and resultant interest rate settings. Equity markets appear to be neither over-valued or under-valued. And of course, as we have discussed in recent notes, on the back of rising interest rates, investors now have other options available in seeking to generate returns. With this backdrop in mind, we maintain our relatively cautious approach.

The enclosed commentary provides greater insight into our thoughts.

Thank you again for entrusting the management of your portfolios to the Entrust team. Should you have any questions on your portfolio or investment markets in general, please give us a call.

Kind Regards

Rowan Jones
Head of Entrust Wealth Management

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What's Next?

In our September 2022 commentary we used former US Secretary of Defence Donald Rumsfeld's description of *"unknown unknowns"* to highlight the uncertainties faced by investors, specifically the likelihood that there were (and today, continue to be) things we are not aware of that will come along at some stage and impact investment markets. This has certainly been the case over the last six months.

While inflation and interest rate rises are very much the *"knowns"* impacting upon markets, some of their secondary impacts have figuratively jumped out of nowhere, to make their presence felt. These include:

- The UK Pension Fund crisis which we touched upon in our September commentary.
- Crypto-currency exchange FTX's collapse in November 2022.
- Silicon Valley Bank's (SVB) failure in March; the second largest bank failure in US history.
- Credit Suisse's effective failure, requiring its hastily arranged acquisition by UBS. An unexpected "feature" of the Credit Suisse situation was that holders of Credit Suisse Hybrid securities lost their total investment, while equity holders, (who rank lower in the capital structure) did not suffer the same fate. We discuss this in more detail later.

When the balls started rolling on the above, things moved rapidly, requiring urgent action from Central Banks and regulators to ensure as best as possible that the ructions did not spread to other areas of the financial system. These events brought to mind Warren Buffett's observation that it's *"only when the tide goes out, do we discover who has been swimming naked."*

In his recently released annual letter JP Morgan CEO, Jamie Dimon, noted *"Of course, there is always uncertainty. I am often frustrated when people talk about today's uncertainty as if it were any different from yesterday's uncertainty. However, in this case, I believe it actually is."* Mr Dimon highlighted the less predictable geopolitical environment in general and the complex adjustment to relationships with China as a key area of uncertainty.

In the same vein, Investment Manager Guy Spier recently commented that *"it's not hard to make the case that this is the biggest shift that's taken place in global dynamics since World War 2. The break-up of the Soviet Union in 1989 and the release of all those Eastern European countries from Russia's grasp and effectively into the West and many of them into NATO, was a happy growth period. You had this idea that Russia as a nuclear super-power was going to accept a reduced role in world affairs and was going to go off into history as many of the great empires have gone off into history (like the Netherlands or United Kingdom) and accept a diminished, yet productive role and it was doing that until it seems that Russia has decided that that fate wasn't acceptable to it. So suddenly we have raw super-power conflict which we haven't had since WW2."*

Spier finishes by highlighting ***"how this turns out, we don't know."***

We too do not know how things will turn out. This does not however change our approach to managing client portfolios. In structuring portfolios to meet the differing goals of our clients, we balance what we assess to be the range of potential outcomes offered by various asset classes in seeking to generate satisfactory returns while remaining focussed on protecting the downside risk to portfolios.

Implications for Australia

While the events discussed above have happened overseas, questions invariably arise as to what this means in an Australian context. We consider a few of these issues below.

Australian Banks

Failures in the US and Europe understandably raise the question as to whether or not similar risks may be carried by Australian banks. In response, local regulators and banks alike have proclaimed the strength and resilience of the Australian banking system. We think this confidence is well-grounded:

- The Australian "Big 4" oligopoly (arguably "Big 4 + 1" with Macquarie's ongoing growth in domestic banking services) is from time to time criticised for limiting competitiveness in the Australian market. In times of volatility however, the Australian banking structure and the security afforded by its well-managed scale, reveals its benefits.
- High capital buffers – Banks must hold levels of capital above guidelines set by the Australian Prudential Regulatory Authority (APRA). Internationally, the Big 4 Australian banks hold the four highest levels of Common Equity Tier 1 (CET1) capital amongst international peers.
- Liquidity Ratios – APRA requires that Banks hold sufficient high-quality liquid assets (HQLA) to at least cover the expected net cash outflows over a 30-day period of stress. Liquidity Coverage Ratios (LCR) for the Big 4 are well above APRA guidelines. Additionally, the type of assets that APRA permits in its definition of HQLA is much stricter than those of other jurisdictions.
- Australian Banks are subject to numerous other measures to ensure their soundness. One notable example highlighted by the AFR is Australia's position as the only jurisdiction in the world that mandates large banks carry capital to address the risk of rising interest rates as part of their core capital requirements, known as Interest Rate Risk in the Banking Book (IRRBB). One of the key reasons behind the collapse of SVB was its unhedged exposure to rising interest rates, something that this seemingly peculiar, at least to the layperson, Australian requirement aids in providing further protection against.

While largely anonymous to the broader population, we think that APRA has done a good job over a number of years in ensuring the strength and stability of the banking system, without going so far as to squash the ability of Banks to meet the needs of consumers and businesses alike, whilst generating reasonable profits relative to the capital they deploy.

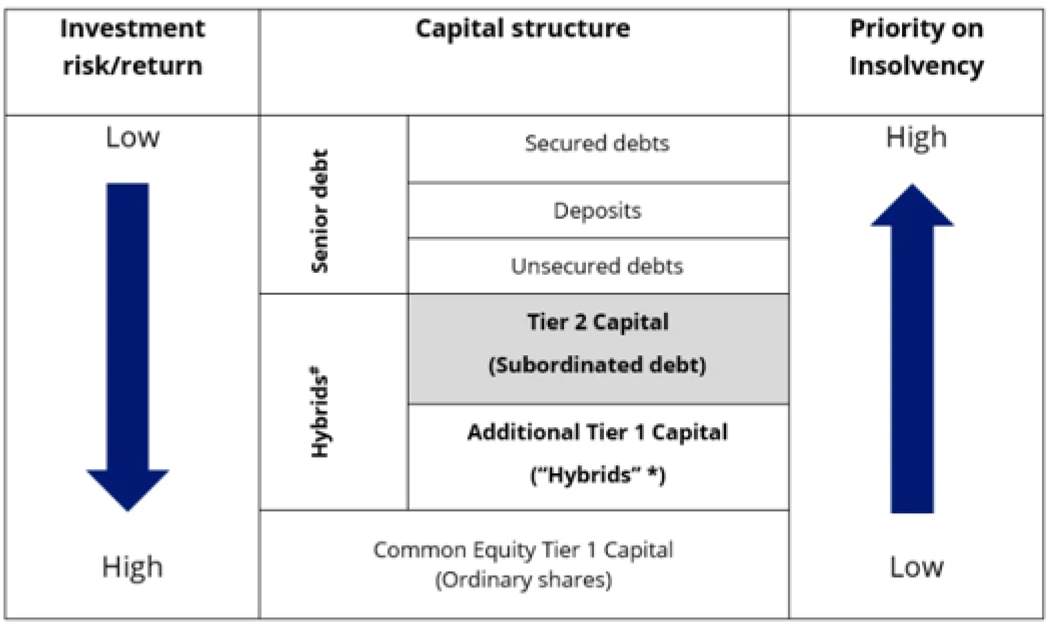
Pleasingly, the strong position of our banking system isn't being taken for granted. APRA Chairman, John Lonsdale recently noted that APRA was *"not complacent or blind to the potential impact overseas events can have on financial stability here. No matter how resilient our financial system, what happens globally affects us to a greater or lesser extent."*

While we can never have 100% certainty, we think that Australian investors and depositors can rest easy in the knowledge that a) our Banks are well-capitalised, and more importantly, b) they are well regulated.

Bank Hybrids – Australia is not Switzerland

As part of Credit Suisse's arranged acquisition by UBS, holders of Credit Suisse's ~$17bn of Hybrids (known as AT1's) lost their full investment, while equity holders who are generally considered to rank lowest in the capital structure *(**Chart 1**)* were not subject to a full loss of their investment.

Chart 1 – Traditional Capital Structure of a Financial Institution



Source: VanEck.

This outcome set the proverbial cat well and truly amongst the pigeons, completely upending the understanding of the risk and return characteristics of the traditional capital structure.

In recognising the unique nature of this (Swiss) situation, to head off unintended consequences, the following day the European Central Bank (ECB) in concert with other European regulators issued a statement making it clear that *"common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 (AT1) be required to be written down."*

Elstree Fixed Interest Managers note that in an Australian context the documentation supporting bank hybrids is materially different. Under Swiss banking rules, when a bank reaches a point of intervention by the regulator, the AT1's are written off. In Australia, and many other jurisdictions, the point of intervention generally results in a conversion to equity.

Whilst the treatment of Credit Suisse AT1's came as a complete surprise to many market participants, most damningly including professional investors specialising in investing in this form of security, a simple read of the terms and conditions, would have made it clear where the risks to Credit Suisse AT1's lay *(**Chart 2**)*.

Chart 2 – Read the Small Print

Yet as Bronte Capital founder and CIO John Hempton pointed out on Substack, a closer look at the legal documentation could have forestalled those sleepless nights. The 2013 prospectus for the 7.5% tier 1 capital perpetual notes includes the following:

> Furthermore, any write-down will be irrevocable, and, upon the occurrence of a write-down, holders will not. . . receive any shares or other participation rights in CSG or be entitled to any other participation in the upside potential of any equity or debt securities issued by CSG or any other member of the group. . . The write-down may occur even if existing preference shares, participation certificates and ordinary shares of CSG remain outstanding.

Source: Almost Daily Grant's (21 March 2023)

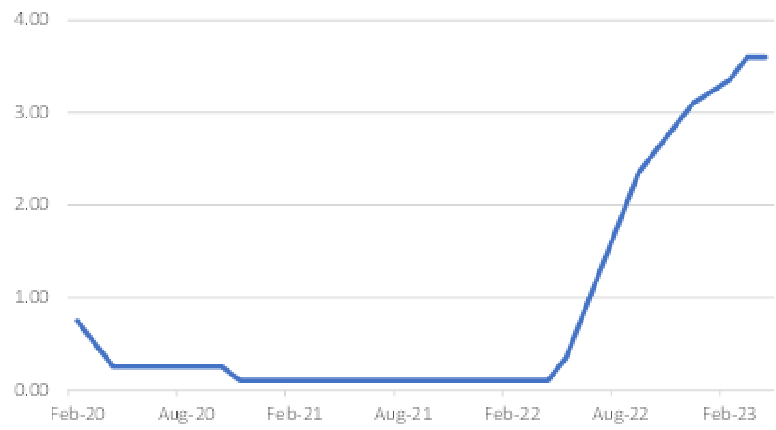
Things We're Thinking About

In addition to the above curveballs that the market has thrown, other things grabbing our thoughts include:

Interest Rates & Inflation

Following 10 consecutive interest rate increases delivered by the RBA between May 2022 and March 2023, encompassing a cumulative 350 basis point (3.50%) increase in the official cash rate ***(Chart 3)***, the RBA decided to hold rates steady at its recent April meeting.

Chart 3 – RBA Cash Rate



Source: RBA

The annual inflation rate (CPI) was 6.8% in February 2023, while this has reduced over recent months and indicates that we have likely seen inflation peak it remains well above the RBA's target band of 2-3% ***(Chart 4)***.

Chart 4 – Inflation

Source: RBA

In pausing rate increases the RBA has noted *“it expects that some further tightening of monetary policy may well be needed to ensure that inflation returns to target”.*

Liquidity

Liquidity or the flow of credit is a lifeblood of the economy. When liquidity dries up economies can grind to a halt. One of the risks we’re thinking about is the ongoing flow of liquidity within the financial system and the economy in general. We think that Australia, in large part due to the strong position of the banking system is well-placed.

We see the potential risk as more pronounced in the US. With its ~5,000 mostly smaller regional banks there is risk as noted by US Federal Open Market Committee (FOMC) member Tom Barkin that even resilient banks can impact the broader economy if, to minimize their liquidity risk and protect capital, they choose to tighten access to credit.

Unlisted Assets

In our June 2022 commentary we first discussed the mismatch we were starting to see between the valuations attributed to unlisted assets and those reflected by equity markets. Subsequent to this we commenced redeeming a number of unlisted property exposures across portfolios; funds from these redemptions will continue to be received over time.

We have been somewhat surprised that this situation has continued now for some time. Having said that, recently we have read reports that APRA is taking a more active role in ensuring that super funds are correctly valuing their unlisted asset holdings. The AFR reports that unlisted assets of more than $650bn are held by super funds, including most large industry funds.

This is an important issue. Consider, for example, if the value of unlisted assets of a Fund were inflated, those members exiting (at the inflated price) will be obtaining a benefit, at the expense of both the remaining members and any new member entering the Fund. Widespread recognition of such mismatches, in an extreme example, could lead to a large proportion of members seeking to exit the Fund at the inflated values at the same time. Investors heading for the exits at the same time have the potential to bring liquidity issues, particularly when the underlying investments are in unlisted, often illiquid, investments.

A large portion of these unlisted assets are held across Commercial Property, encompassing Office, Retail and Logistics / Industrial assets.

For many years falling interest rates and bond yields have been a tailwind for increasing property valuations due to the inverse nature of their relationship. ***Chart 5*** implies that relative to recent upward moves in interest rates (reflected below in the 10-year Bond Yield) that the yields reflected in property valuations are yet to respond.

Chart 5 – Property Yet to Reflect Increased Rates

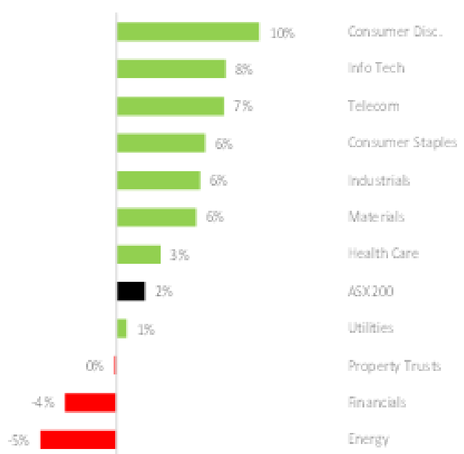
Source: Firstlinks

Equity Market Performance

Notwithstanding the various issues thrown the way of markets since the start of 2023, the ASX200 delivered a positive 2.0% return for the March quarter ***(Chart 6),*** increasing to 3.6% when taking dividends into account.

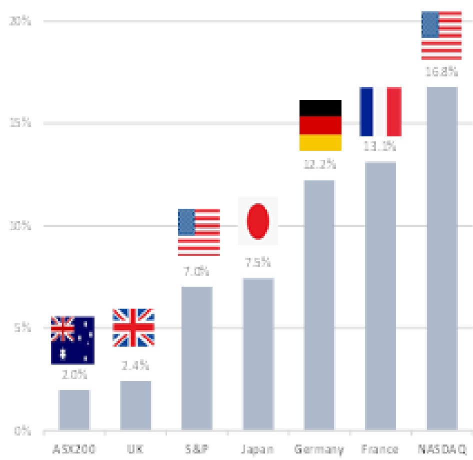
The ASX200 performance paled into comparison against the strong performance of major international indices ***(Chart 7)*** over the period, reflecting the higher concentration of Financial stocks in the Australian market.

Chart 6 – ASX200 Sector Performance



Source: Iress, Entrust Wealth Management

Chart 7 – Global Equity Markets



Source: Iress, Entrust Wealth Management

Outlook / Positioning

It is an interesting time from an investment perspective:

- The Australian economy continues to look relatively resilient, underpinned by high levels of employment.
- Interest rate increases have started to see a slowdown in economic growth.
- This slowing is expected to continue as previous rate rises filter through the economy, further increases are likely and fixed-rate mortgages roll off during the year with most borrowers rolling into significantly more expensive loans.
- Domestically and internationally there remains risk that inflation remains stubbornly high and that interest rate rises over and above current expectations are required (to date, US economic data has continually surprised to the upside).
- As we discussed earlier, there are likely other risks bubbling away below the surface which are largely unknown.
- Against this backdrop equity markets are trading roughly in line with their long-term averages. The ASX200 index currently trades on a PE multiple of 15.0x; roughly the mid-point of its 10-yr average of 15.9x and 20-yr average of 14.5x.

In summary, we see that there are known upside and downside risks to the economy, largely relating to inflation and the resultant interest rate settings. In addition, there may well be some downside risks that we are presently unaware of. At a headline level, equity markets appear to be neither over-valued or under-valued. And of course, as we have discussed in recent notes, with rising interest rates, investors now have other options available to generate returns (e.g., Bank Hybrids, Term Deposits, Bonds). With this backdrop in mind, we maintain our relatively cautious approach.

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