September Quarter 2022 – Commentary & Outlook

Entrust
WEALTH MANAGEMENT

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Summary:

- In what proved to be a “quarter of two halves” global equity markets were down between 1 and 6% during the September quarter.

- Comments at Jackson Hole from US Federal Reserve Chair Jerome Powell, unequivocally conveyed to markets that aggressive rate rises will continue until inflation in the US is back to its target level of 2%.

- On the back of Mr Powell’s comments and the resultant expectation of higher interest rates, the US Dollar strengthened against all major currencies including the $A, which declined 7% over the period.

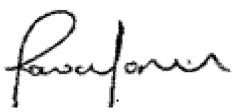
- Looking ahead, many of the uncertainties we identified in our June Quarter 2022 report remain. As such our cautious stance is maintained, reflected in portfolios generally holding lower than target weightings to growth assets.

- We do however remain alert to opportunities to invest where appropriate, as equity markets have historically proven to rebound strongly following large declines.

The following commentary provides greater detail on the above.

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

September Quarter 2022 – "A Quarter of two Halves"

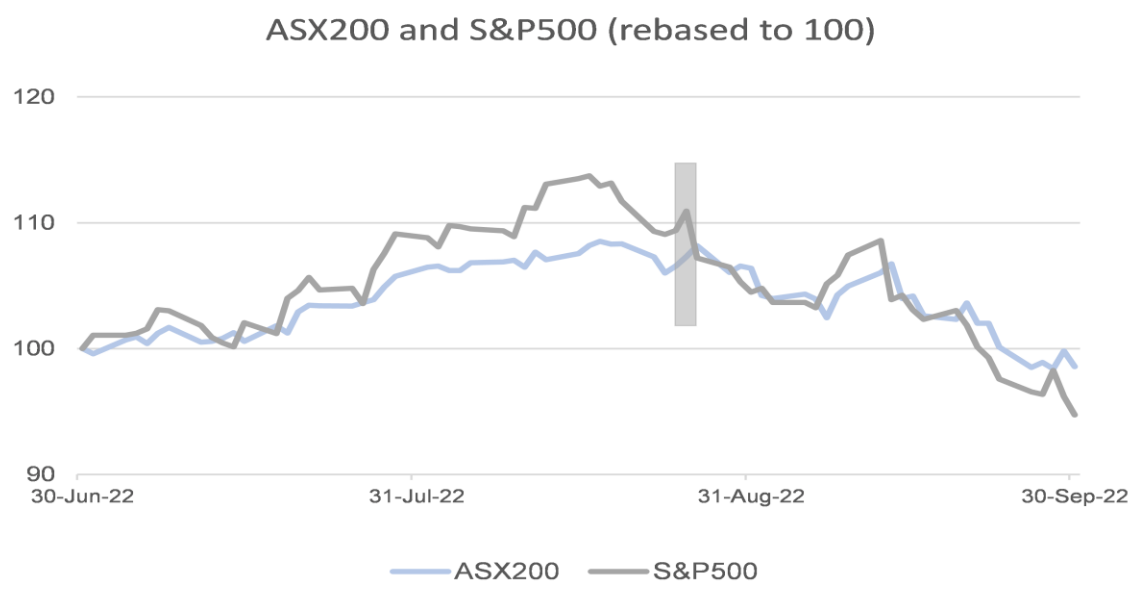
Each year the Federal Reserve Bank of Kansas hosts an Economic Symposium at Jackson Hole in Wyoming, United States. Attended by members of the United States Federal Reserve (the "Fed"), policy makers and foreign central bankers, the three-day event has become a key date on the global economic calendar.

This year, was no exception.

When US Federal Reserve Chair Jerome Powell took to the podium, he delivered a short sharp speech making it clear to market participants that the Fed's *"overarching focus"* was to bring inflation back down to their 2% goal, notwithstanding the likely pain this will bring to the overall economy.

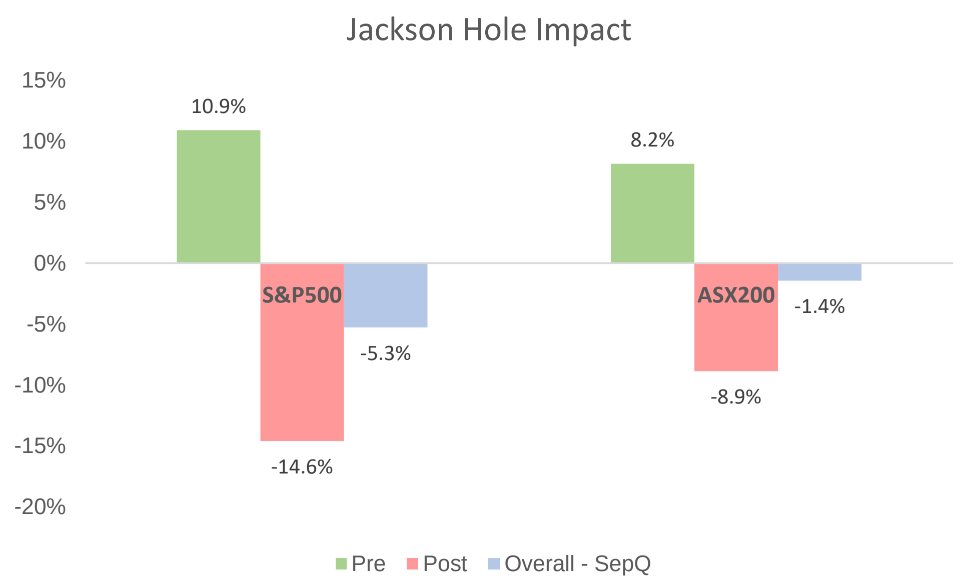
The impact of this proverbial smack in the face was starkly reflected in equity markets (***Charts 1 and 2***). Having started the September quarter strongly, from the time of Mr Powell's speech on 26 August 2022, US and Australian equity markets quickly reversed course, delivering negative returns overall.

Chart 1 – September Quarter Market Performance



Source: Iress, Entrust Wealth Management

Chart 2 – Market Performance (Pre and Post Jackson Hole)



Source: Iress, Entrust Wealth Management

In the period since Mr Powell's speech, we have observed that any time a US Fed representative has spoken publicly their comments have been very "hawkish". To our mind, this represents a co-ordinated effort to enforce the Fed's message that they are intently focussed on seeing inflation return back to their 2% target rate.

This was again emphasised upon the recent release of the minutes from the Fed meeting on 21-22 September, which included the following commentary:

"Many participants emphasized that the cost of taking too little action to bring down inflation likely outweighed the cost of taking too much action. Several participants underlined the need to maintain a restrictive stance for as long as necessary, with a couple of these participants stressing that historical experience demonstrated the danger of prematurely ending periods of tight monetary policy designed to bring down inflation".

In lieu of the need to aggressively raise interest rates, maybe Belarussian President Aleksandr Lukashenko has the answer to tackling inflation, by simply "banning" it. On October 6th, Reuters reported that Lukashenko had banned price increases in the country, with immediate effect, following an 18% increase in CPI over the prior year.

Interest Rate Expectations

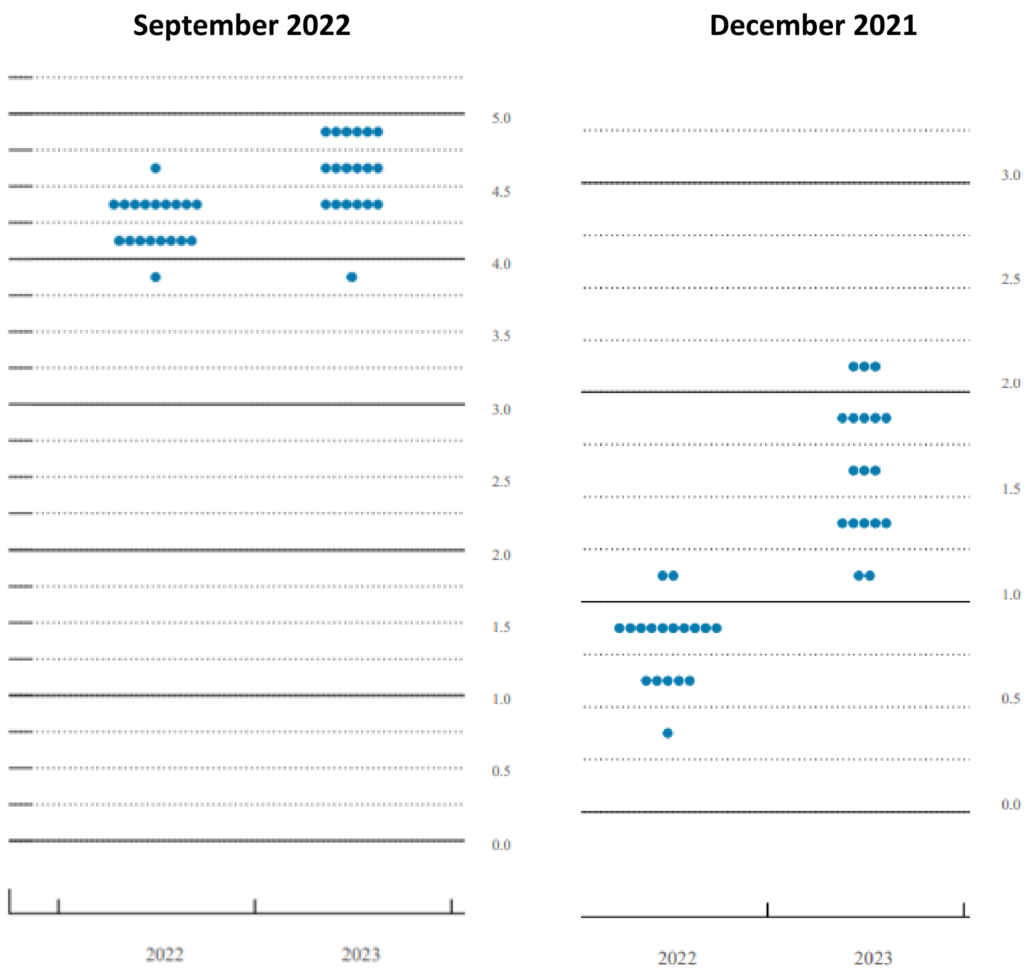
One of the more interesting and transparent quirks of the US Fed, as opposed to our own RBA, is that following each meeting the Fed releases its "Dot Plot" which shows the expectations of the Federal Open Market Committee (FOMC) members in regard to the future target federal funds rate (or in RBA speak "the cash rate").

As shown in ***Chart 3***, FOMC members now expect a federal funds rate of ~4.5% in 2023, up 3-fold from the expectation just nine months earlier that the 2023 federal funds rate would be ~1.5%. This change in expectations since December 2021 highlights two things:

1. how rapidly interest rate expectations have increased due to the significant rise in inflation, and

2. it pays to view economic forecasts with a large dose of scepticism, even (or maybe particularly) when they are made by smart people with all the available information.

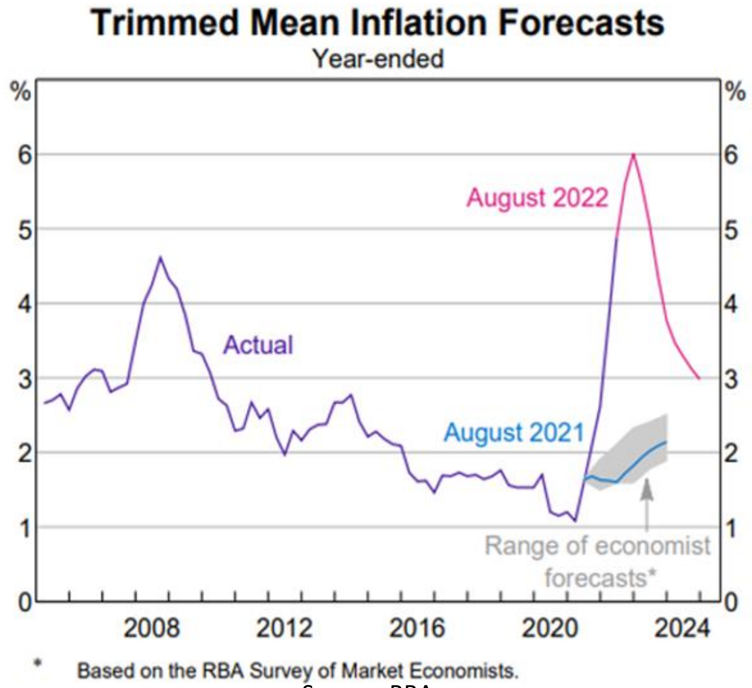
Chart 3 – US Federal Reserve Dot Plot – September 2022 v December 2021



Source: US Federal Reserve

As we are all too aware, US central bankers weren't the only ones to dramatically under-estimate inflation expectations and the resultant need to take action through increased interest rates. ***Chart 4*** shows that the RBA (and private sector economists) had significantly under-estimated inflationary expectations. This brings to mind renowned economist John Kenneth Galbraith's quip that *"the function of economic forecasting is to make astrology look respectable"*.

Chart 4 – RBA inflation expectations (August 2021 and August 2022)



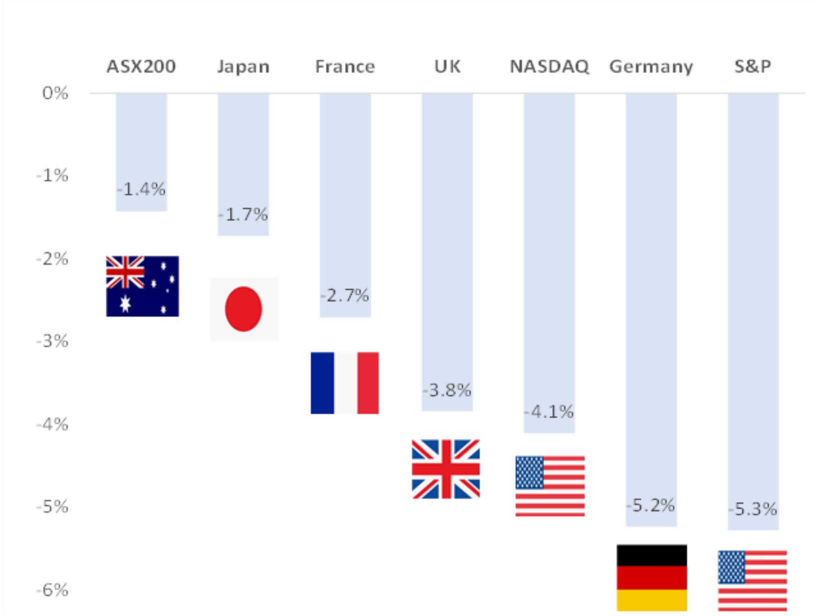
Source: RBA

ASX Performance

We have spent some time discussing the US and their inflation / interest rate outlook. Our attention here is due to the fact that from a macro perspective, given its size and importance, the US remains a key influence on markets globally.

The 1.4% decline in the ASX200 outperformed all major global equity markets (***Chart 5***).

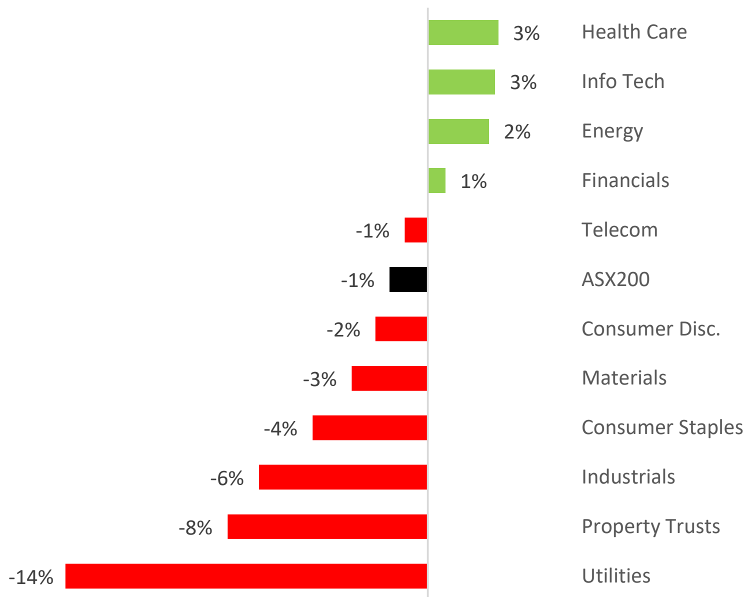
Chart 5 – Global Equity Market Performance – September Quarter



Source: Iress, Entrust Wealth Management

The performance of the ASX200 by sector (***Chart 6***) shows that the defensive Health Care sector continued to perform well as did Energy and Financials. A number of sectors more sensitive to interest rate movements (e.g. Property Trusts) were negatively impacted. Interestingly, the Utilities sector which is generally seen as defensive performed poorly; however, this is more a reflection of the fact that the ASX200 Utilities sector only comprises three companies, two of which performed poorly over the period.

Chart 6 – ASX200 Sector Performance



Source: Iress, Entrust Wealth Management

On the back of the Jackson Hole commentary (discussed above) and the expectation of higher US interest rates, the US Dollar strengthened against all major currencies including the $A, which declined 7% over the period. ***Chart 7*** shows that the $A had strengthened slightly against the US Dollar prior to Powell's Jackson Hole comments (depicted in grey), from which time the $A fell 8% to finish the period at 0.6401.

Chart 7 – AUD USD

Source: Iress, Entrust Wealth Management

Outlook

In our June Quarter 2022 report we noted a number of uncertainties facing markets and investors. These included, but were 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?

Three months down the track and we see that these uncertainties largely remain.

Underlining the continued uncertainty, famed US billionaire investor Stanley Druckenmiller recently commented *"I make a living supposedly forecasting changes in the economic environment and in the financial markets. And with the caveat that I've been doing this for 45 years, and between the pandemic, and the war, and the crazy policy response in the United States and worldwide; this is the hardest environment I've ever encountered to try and have any confidence in a forecast 6-12 months ahead. There are brewing issues when you get the price of oil doing what it's doing historically, and you get interest rates doing what they're doing historically. And it becomes a global phenomenon with tightening of liquidity and you've got war. The odds of a global recession and a change in the macro economy are about as high and severe as I've seen them in decades."*

Added to the above uncertainties, which are generally known, we are also mindful that (to borrow from Donald Rumsfeld) there may be "unknown unknowns" lurking in the shadows.

An example of this in recent weeks was the rapid rise in UK 30-year Gilts (i.e. UK Government Bonds), which required the Bank of England (BoE) to intervene in the market in order to restore financial stability to their system. Without going into detail, market illiquidity in the UK resulted in a number of Pension Funds needing to sell / liquidate their UK Gilts. This selling pressure resulted in yields increasing rapidly; prior to the BoE intervening, on one day the intraday move in the yield on Gilts was 127 basis points (1.27%). The BoE notes that prior to this, the largest daily move in history had been 29 basis points (0.29%).

Positioning

In managing our client portfolios, we are cognisant that over time equity markets have a heavy bias toward delivering positive returns. Historically positive annual returns are delivered in approximately 70% of all years.

As US investor Bill Miller notes *"odds much less favourable than that have made casino owners very rich, yet most investors try to guess the 30% of the time stocks decline".*

In managing our client portfolios, we are certainly not trying to guess short-term market movements. At present, we do however maintain our overall cautious stance, currently holding lower than target weightings to growth assets.

We remain alert to opportunities to increase these weightings back to target levels where circumstances dictate. For example, opportunities may arise:

- Were the US Fed to change its tune in regard to future interest rate expectations, or;
- Should a market capitulation occur, resulting in a large increase in the margin of safety available in growth assets.

In this regard, ***Chart 8*** shows that large market declines have historically pre-empted strong market returns over the following years

Chart 8 – Bull markets follow bear markets

Bull markets follow bear markets

When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		-37.6%	21.6%	36.9%	83.3%	213.7%

Source: Chester Asset Management

Where appropriate, subject to individual client circumstances, we have undertaken the following actions during the period:

- Added some exposure to $A Government Bonds given the more attractive return profile now available (see our June Quarter 2022 report for further commentary in this regard).

- We have redeemed some unlisted property exposures. In this regard we note that unlisted property valuations have to date remained largely unimpacted by increased interest rates, however we expect valuation impacts will occur over coming periods as investors demand a greater return on these assets, relative to the improved returns now available in other (lower risk) asset classes (e.g. Bonds).

- Conversely, one area that we believe is potentially providing good opportunities is in the ASX-listed property space, where equity prices have been materially impacted in recent periods. This now sees a number of these assets trading at significant discounts to the value of the assets on their balance sheet while also offering attractive distribution yields.

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