The 2022 Year in Review & the Outlook for 2023

Entrust
WEALTH MANAGEMENT

2022 Year in Review & the Outlook for 2023

2022 – Hello Inflation

As the world entered 2022, outside of bubble-like behaviour in some sectors (notably unprofitable tech companies and so-called "meme" stocks) there was a relative calmness across financial markets. Inflation increases in the US were considered to be "transitory" and while inflation had ticked up in Australia to slightly above 2%, the Reserve Bank of Australia (RBA) deemed that these pressures were more modest in Australia than many other countries and as such forecast inflation to reach 2.5% (the mid-point of the RBA's 2-3% target rate) by the end of 2023.

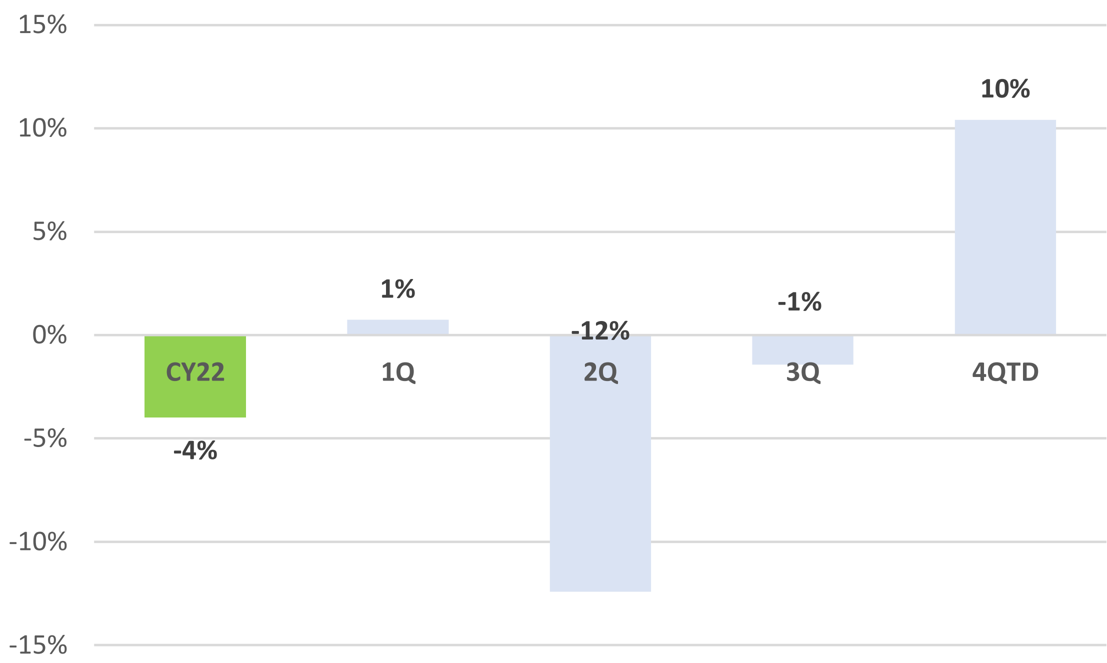
Based on this outlook, the cash rate in Australia sat at 0.10% with the RBA expecting it to remain at that level until 2024. In the US, the Federal funds rate was 0-0.25%, with projections for this rate to reach approximately 0.90% by the end of 2022. Things clearly have not turned out as expected.

Inflation has proven to be much higher and stickier, and as a result interest rates across much of the world have increased rapidly; with historically fast "tightening cycles" (i.e., rate increases) being seen in Australia and the US.

In combination with (and likely exacerbated by) these financial ructions, the global geopolitical situation has been, to put it mildly, less than ideal.

Financial markets do not like uncertainty and this was clearly evident in 2022. Over the year, as investor expectations around inflation and interest rates waxed and waned, equity market performance did the same. ***Chart 1*** shows that in 2022 the ASX200 is down 4%, yet the quarterly movements highlight the volatility apparent across the year.

Chart 1 – 2022 - ASX200 performance by quarter



Source: Iress, Entrust Wealth Management. Returns as at 16 December 2022.

We pay attention to macro forecasts to help us gauge what markets may or may not be pricing in. That said, we view any such forecasts with a large dose of scepticism, given i) how unknowable the future is, and ii) the generally poor track record of forecasters across financial spheres.

As we near the end of the year we are seeing many market prognosticators offering their views on what the next year and into the future holds. We keep in mind the sage words of former American baseballer Yogi Berra, that *"it's tough to make predictions, especially about the future".*

Bonds & Equities

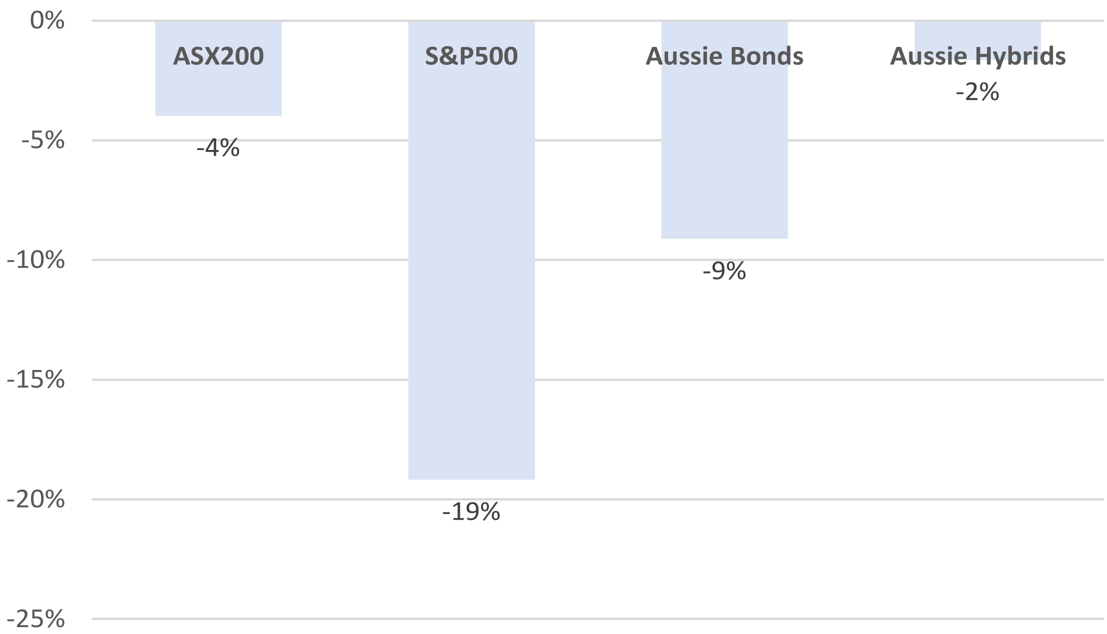
Making 2022 all the more unusual in an historical context have been negative bond returns at a time of negative equity market returns (***Chart 2***), something that has happened only a handful of times over the last 100 years.

To simplify, bonds and equities are usually seen to have an inverse relationship - when risk appetite is low, investors seek downside protection by selling equities and buying bonds. Conversely when risk appetite is high, investors tend to buy equities and sell bonds.

In the midst of rapidly rising interest rates and the associated economic uncertainty, the inverse nature of this relationship broke down during 2022.

While the current heightened volatility and uncertainty may continue to test the traditional bond / equity relationship, a slowing in the pace of interest rate rises combined with a reduction in general economic uncertainty would favour a return to this more "normal" relationship.

Chart 2 – Equities v Bonds & Fixed Interest



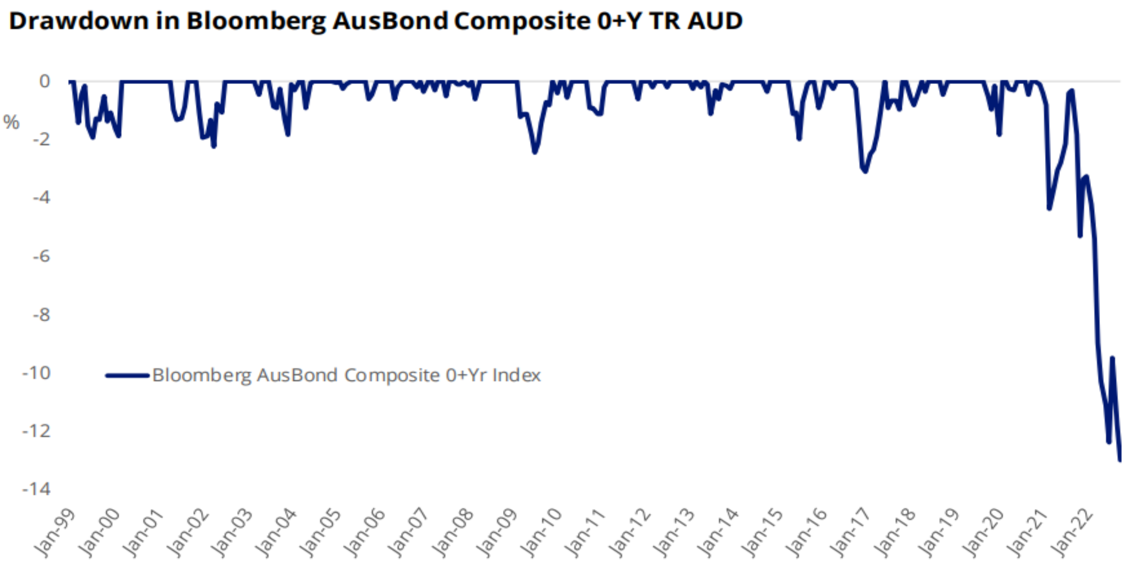
Source: Iress, Entrust Wealth Management. Returns as at 16 December 2022.

As interest rates and interest rate expectations rapidly escalated during 2022 the impact on Bond prices was pronounced, with the Australian Bond Index falling by as much as 13%, its biggest ever fall (***Chart 3***).

As discussed in our June and September Quarterly updates, portfolios were relatively well-protected from this Bond rout given the very low exposure we held based on the prevailing risk / return equation we saw.

Following this material sell-off, where appropriate based on individual client goals, we have recently added some portfolio exposure to $A Government Bonds, given the more attractive return profile, underpinned by the increased levels of income now available, combined with the potential for capital growth should interest rate reductions be seen at some stage.

Chart 3 – Aussie Bond Performance



Source: VanEck

Outlook – 2023 and Beyond

As a team we are constantly thinking about markets and how we can best position portfolios to meet the varying goals of our clients.

We have maintained a relatively cautious stance for much of 2022 and we enter 2023 in a similar frame of mind. We do however remain acutely aware that over time, equity markets have been a good place to be invested.

As ***Chart 4*** shows, despite many crises of various colours and resultant large (generally short-term) negative returns, over the long-term equity markets have ultimately always overcome the challenges of the time to move on to new highs.

Chart 4 – Equity Market Resilience Over the Long-Term

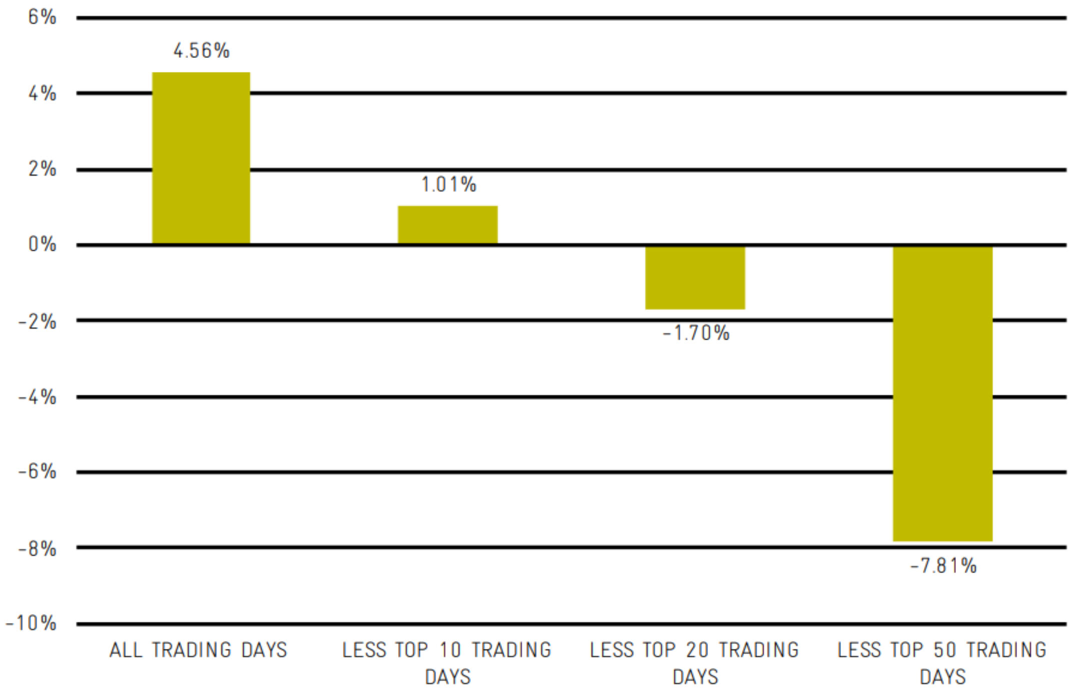
Source: BT

Trying to guess the wiggles of short-term market movements and profiting from continually buying and selling at the right time sounds appealing in concept and, in hindsight, might appear easy to implement. However, in reality it proves exceptionally difficult to successfully execute, particularly consistently.

In difficult or uncertain times, one may sell their investments, if markets then decline further, it would be understandable to feel good about one's decision. The problem generally turns out to be that most investors who have "successfully" sold in the short-term ultimately do not buy back into the market, missing the inevitable turnaround as the market's long-term upward path continues.

Missing a few days in the market can have a material impact on returns. Between June 2007 and June 2022, the ASX300 Accumulation Index (i.e., inclusive of dividends) generated a return of 4.56% p.a. ***Chart 5*** shows the impact that not being invested and missing a few positive days can have on portfolio returns. For example, if an investor missed the best 10 days over that 15-year period, returns would have declined to just 1.01% p.a.; a material reduction in comparison to being fully invested.

Chart 5 – Timing the Market – Careful You Don't Miss the Best Days



Source: Lonsec

To summarise our thoughts as we look to 2023 and beyond, there currently remains a heightened level of uncertainty and as such we are maintaining our generally cautious stance. We are cognisant however that markets are now starting to price in a reasonable degree of the more subdued outlook. From time to time this should provide investment opportunities, for which we remain ready to act on your behalf.

To borrow from J.P. Morgan, the one thing that we can be certain of is that *"markets will fluctuate"*.

What We're Thinking About

As we seek to best position portfolios for the prevailing environment, we spend a lot of time understanding as best as possible the market conditions in which we operate. Encompassed in this we also seek to understand what markets in general may be thinking, helping to provide us with a sense of what expectations may be factored in to market prices.

In this section we discuss some of the topics that we have been thinking about. The list is not exhaustive, but we hope it conveys some sense of what we are currently contemplating.

Market Psychology

Equity markets and particularly individual stocks or sectors within markets can be extremely volatile. While varying degrees of this volatility can be put down to economic reasons, a (sometimes much larger) share can be due to changes in investor psychology.

Oaktree Capital Management co-founder Howard Marks writes extensively on this market attribute, likening the swing of market sentiment from negative to positive and back again to a pendulum. Marks has recently contrasted the psychology of markets in the late 2020 bull market to how he sees it now (***Chart 6***).

Chart 6 – Investor Psychology

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Investor Psychology – From Flawless Toward Hopeless

	Late 2020	Now
Monetary Policy	Highly stimulative	Restrictive
Inflation	Below 2.0%	40-year high
Economic Outlook	Optimistic	Anticipating recession
Interest Rates	Ultra-low	Rising
Financing	Plentiful	Scarce
Buyers	Eager	Reticent
Holders	Complacent	Uncertain
Key Worry	FOMO[1]	Investment losses
Risk Aversion	Absent	Increasing
Credit Window	Wide open	Constricted
Credit Issuance	Robust	Challenged
Likelihood of Distress	Minimal	Rising
Yields	Low	Near historical norms
Yield Spreads	Narrow	Near historical norms
Prospective Returns	Ultra-low	Generous

1 FOMO: Fear of missing out. 35

Source: Oaktree Capital Management

The last line "Prospective Returns" is essentially the sum of all the categories above. Our summary of this is that in late 2020, the rosy outlook and positive sentiment was reflected in asset prices, making future return prospects weak. Today, the weak outlook and negative sentiment is also being reflected in asset prices, making prospective returns more appealing.

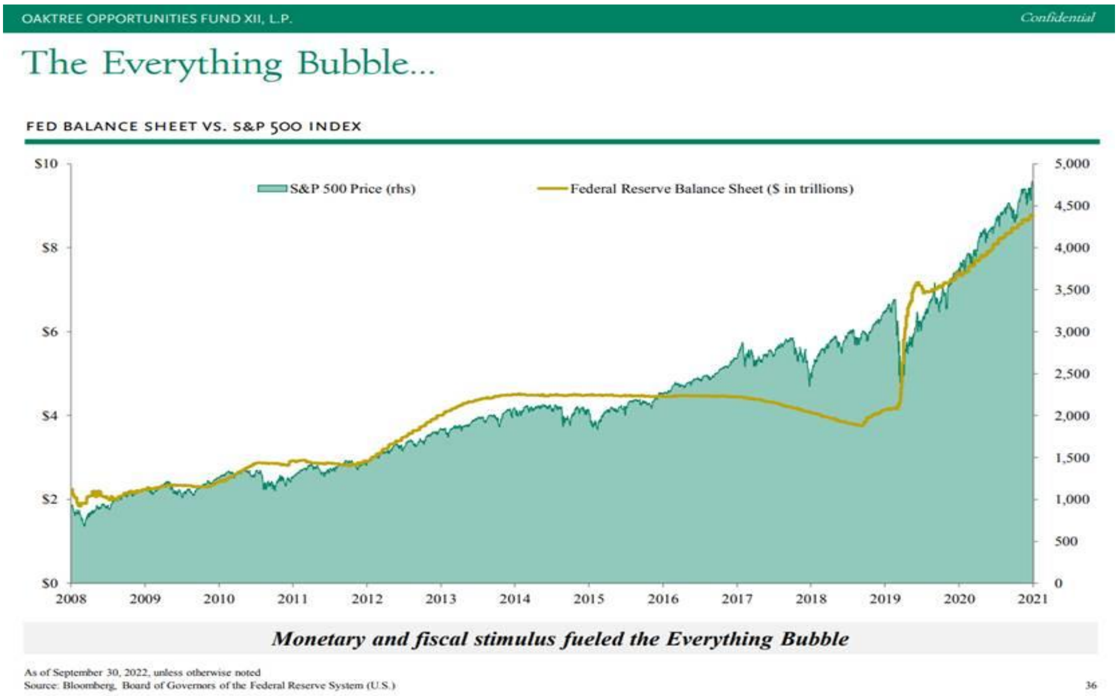
Fed Liquidity – QE becomes QT

Another major driver of equity markets in the US (which flows through to all other global markets) has been the liquidity (i.e., money) injected into the financial system by the US Fed, particularly since the onset of COVID.

This liquidity injection which occurred as the US Fed purchased US Government Bonds (amongst other assets) was known as "QE" or "Quantitative Easing". ***Chart 7*** shows that as liquidity was pumped into the system US equity markets enjoyed strong gains.

The US Fed is now gradually unwinding this balance sheet build up and therefore removing liquidity from the system (referred to as "QT" or "Quantitative Tightening"). All else being equal, this will act as a drag on equity and other asset prices.

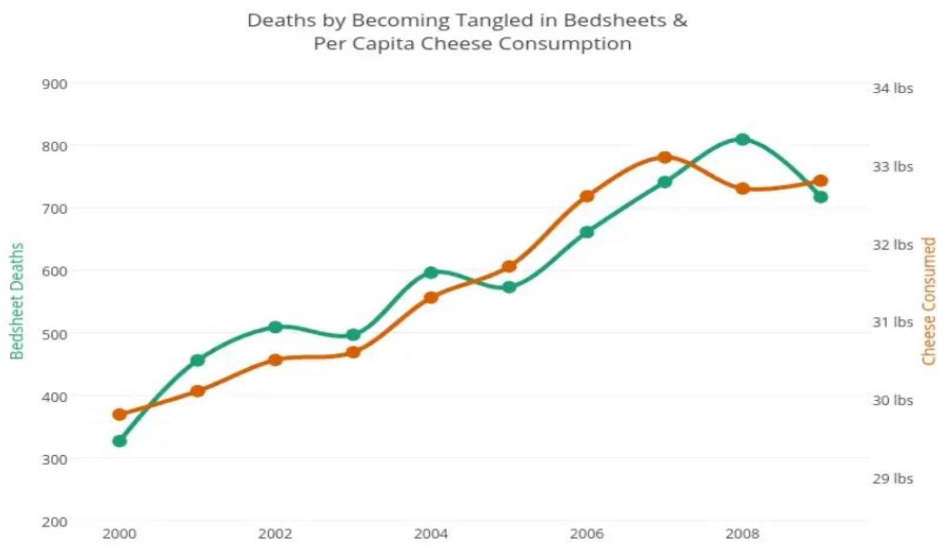
Chart 7 – US Federal Reserve Balance Sheet v S&P500



Source: Oaktree Capital Management

Chart 7 shows a strong (and real) correlation between market liquidity and equity market performance. Some charts we see claiming to show a relationship between various factors are less convincing, ***Chart 8*** helps us to maintain a questioning mind, when provided with data purporting to show a correlation.

Chart 8 – Not all Correlations are Correlated



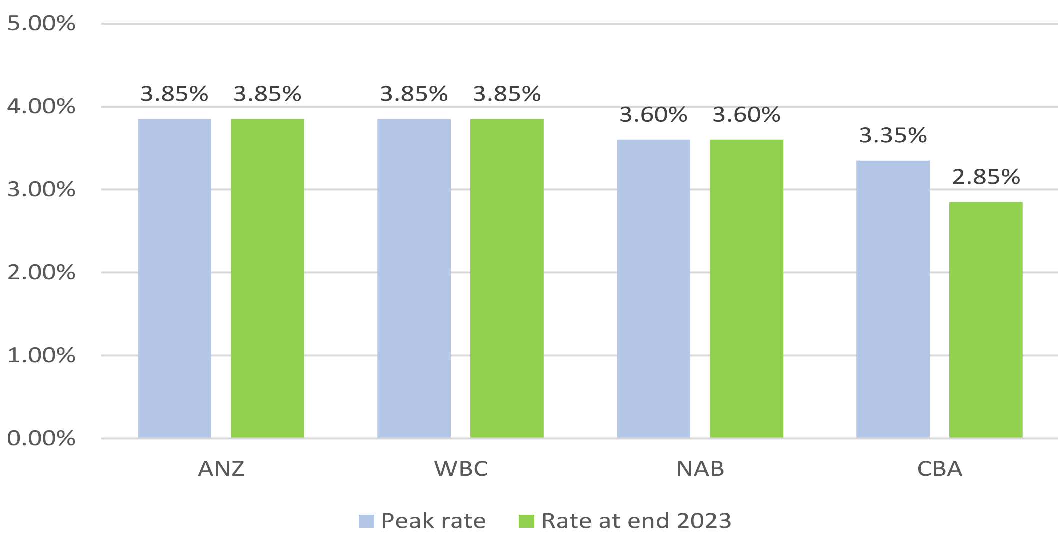
Source: Spurious Correlations

Inflation & Interest Rates

These words have been front of mind for financial markets over the last six months. Interestingly, despite the poor recent forecasting record of both the RBA and US Fed (discussed earlier) markets hang on their every word as they seek some macro direction. US inflation (7.1%) remains high and US Federal funds rate expectations continue to tick up, now expected to be approximately 5.1% at end of 2023, implying a further 0.60-0.85% of interest rate increases from the current rate of 4.25-4.50%.

In Australia inflation sits at 6.9% and interest rates 3.1%. Expectations for Australian interest rates amongst the Big 4 Banks diverge (**Chart 9**) with CBA being the outlier, expecting rates to peak at a lower level (3.35%) and then starting to reduce sooner.

Chart 9 – Big 4 Banks – Interest Rate Expectations



Source: Canstar

Market Hopes of a "Pivot" Continue to be Challenged

One narrative that markets have been holding on to has been a "Fed Pivot" – the expectation (hope) that the US Fed will cease its interest rate rises and indeed start to ease rates. While this is a possibility, taking US Fed commentary at face value, would suggest that the likelihood of a "pivot" is at this stage low.

Not only have Fed forecasts around the peak or terminal level of interest rates continued to creep up over the course of 2022, we believe that Fed Chairman, Jerome Powell, has been unequivocal in his commentary that more work needs to be done to tame inflation. Of note, Powell has declared that *"history cautions strongly against prematurely loosening policy* (i.e., reducing interest rates). *We will stay the course until the job is done."*

Continued Volatility Upon Data Releases

The level of interest rates is an important input into the assessment of asset values and as such interest rate movements will continue to be keenly watched with any unexpected movements (up or down) likely to have a reasonably material impact.

In today's quick-moving environment with a constant stream of financial information confronting investors, we note that currently there is an intense focus on inflation readings and interest rate commentary.

While these developments, as they unfold over time, will undoubtedly have some impact on longer-term economic conditions and financial market asset values, we have noticed recently that equity (and other) markets have been reacting violently to some of these short-term data points. For example, market consensus expectations for US inflation in October 2022 was 7.9%, upon release of the actual inflation reading of 7.7% in early November, a whole 0.2% below expectations, the US S&P500 index jumped 5.5%. While we find it difficult to reconcile such movements upon release of a single data point (which will likely fade into irrelevance in a reasonably short period of time), we need to acknowledge that these are the markets in which we operate.

With that background, we expect that further sharp bouts of market volatility, both positive and negative, will continue to be a feature. While these short sharp moves can cause heightened uncertainty for investors, we seek to ignore the (vast quantities of) noise and remain focussed on positioning portfolios as best as possible to meet their long-term goals.

Interest Rate Rises – It's not all Negative

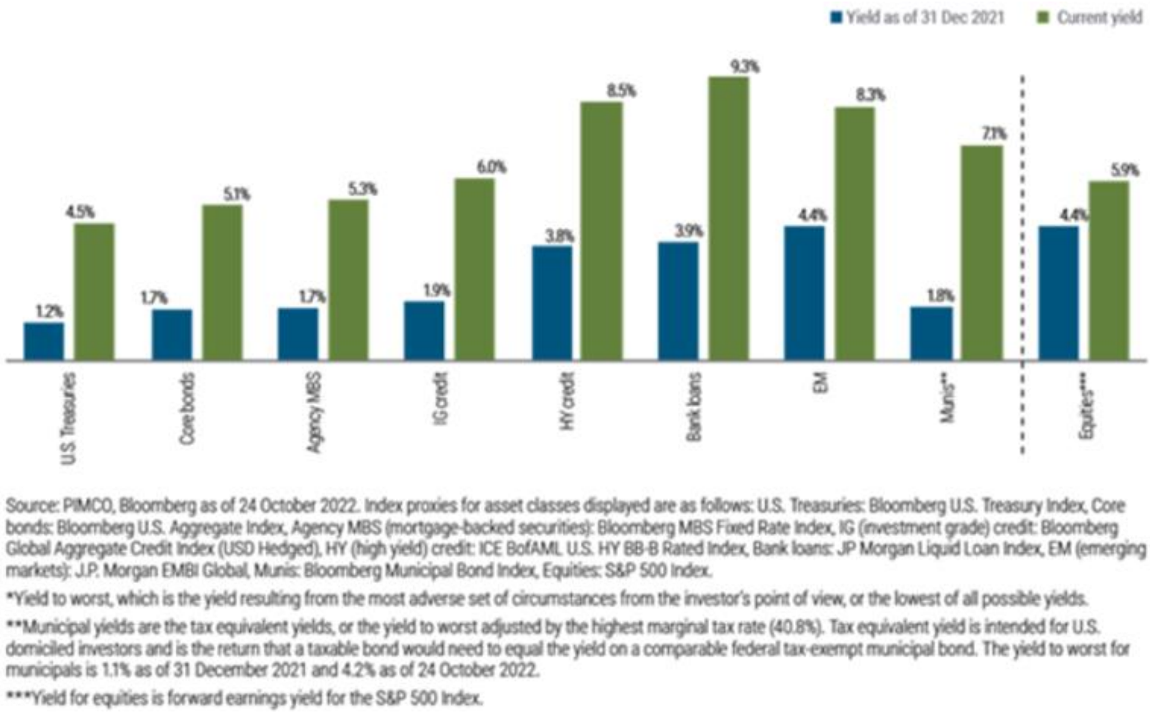
As we have touched on in recent updates, one of the main positives from the increasing interest rate environment is that we are now seeing reasonable levels of returns available from income producing assets such as Bonds, Hybrids and Credit-based products.

Chart 10 shows the significantly higher yields (i.e., income) now available from a range of assets. In a recent memo, Howard Marks characterised the period from 2009-2021 as a "long slog" for income investors given the very low interest rate environment.

With the rapid change seen over the course of 2022, Marks notes that investors in these asset classes now face much better prospects in this changed environment than they did in the 2009-2021 period as they can now potentially achieve solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments in an effort to achieve their overall return targets.

As the return environment has improved over recent months, we have been adding some portfolio exposure to credit-based investments.

Chart 10 – Yield Improvements Across 2022



Source: PIMCO

Energy Transition

Climate change and its impacts have quickly become a key focus for the world and by extension for equity markets. Further evidence that Australia is indeed the lucky country arises from the fact that Australia, as with many minerals, is very well endowed with lithium, a key commodity in the transition from fossil fuels.

Lithium prices have been so strong in recent times that it is easy to forget that it is less than two years ago that some operating assets were sitting in "care and maintenance" as the costs of production exceeded the price at which the end product could be sold.

Given the relative immaturity of the lithium market and opaqueness of prices, further volatility can be expected. Lithium price forecasts from major investment banks vary wildly, hence the cash flows and share prices of lithium producers will likely also remain volatile.

One stock in which a potentially material lithium business is hidden is Wesfarmers (WES). Wesfarmers owns 50% of the Mt Holland lithium deposit which is currently under development along with a lithium hydroxide refinery in Kwinana.

First production is expected in late calendar 2024 (i.e., 2yrs away) and based on current ("spot") lithium prices we estimate that the project would deliver additional Net Profit to Wesfarmers of around $1.7bn.

We believe this asset is somewhat under-appreciated given that most analysts that provide research coverage on Wesfarmers are professional Retail sector analysts, which makes sense given Wesfarmers is the owner of major retailers such as Bunnings, Kmart and Target. These analysts (understandably) have limited knowledge of lithium hence we believe that the market appreciation for this asset is low.

We see that Wesfarmers budding lithium business is essentially a "free option" as we believe that there is little to no upside factored into the share price for this asset. If lithium prices remain strong, in 2yrs time it will be a material contributor to the business (which will ultimately be recognised in the share price), if lithium prices fall materially and Wesfarmers lithium business is a negligible contributor, we see limited downside share price risk.

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