Perpetual Private | Quarterly Market Update

Volatility rises, value emerges

March 2022

Trust is earned.

Contents

Snapshot

The three months to the end of March 2022 saw financial assets face renewed challenges, as China grapples with the Omicron variant of COVID-19 and conflict in the far east of Europe sees disruption and geopolitical tension rise.

Whilst markets have somewhat taken these headwinds in stride, the role of central banks in supporting economic health, whilst managing inflation has become significantly more difficult.

Although this presents investors with unwelcome levels of uncertainty, the increased levels of dispersion that the environment has encouraged, also provides opportunity to those who have a rigorous investment process and are empowered to respond to the changing conditions.

Asset class performance – March quarter

Australian equities

Australian shares continued to gain ground over the past quarter, with the S&P ASX 300 delivering 2.1%. This continues a trend of positive but slowing returns. Whilst this outcome would suggest an element of calm in markets, one only needs to look at sector returns to recognise that the reality is somewhat different. Benefiting from tightened supply in commodities markets, the Energy sector led in delivering 28.4% for the 3 months; whilst at the other end of the spectrum, Information Technology was down by 13.7%. Indeed, the changing atmosphere can best be recognised in the changing fortunes of Value[1] vs Growth[2] factors, gaining 11.7% and losing 4.0% respectively. When we consider that over the past 5 years, Growth has outperformed Value by an average of 3.9% per annum, it would appear that investors are positioning for a different market environment.

1 Measured by the MSCI Australia Value index
2 Measured by the MSCI Australia Growth index

International equities

Global stock markets[3] were challenged during the start of the year, softening by 8.37%. The conflict in Ukraine cast a shadow over European markets, as they underperformed other regions, with Germany returning -14.0%[4] and France close behind at -11.7%[5]. Japan also came under pressure, losing 9.6% in the quarter. Here it was the depreciation of the yen, (-8.8%) driving the majority of returns as tepid economic growth continues to restrain interest rate policy, in contrast to the US which initiated a 0.25% cash rate increase on March 16th; its first since 2018. As with Australia, the global Energy sector led, producing a gain of 17.31%[6]. Consumer Discretionary, Communication Services and Information Technology were the key laggards, with outcomes of -14.2%, -13.4% and -13.1% respectively[7]. On an international level, whilst Value lost 3.8%, this was a significantly better outcome than that of Growth which gave up 12.5%[8].

3 Measured by the MSCI All Countries World index in AUD (unhedged)
4 Measured by the German DAX index
5 Measured by the French CAC 40 index
6 Measured by the MSCI All Country World Energy index
7 Sector indices taken from MSCI All Country series
8 Growth and Value represented by MSCI World Index Growth and Value indices

Real estate

Australian Real Estate[9] gave up 6.7% over the period, with its global equivalent largely following suit at -6.6%[10]. Whilst the asset class, both domestic and global, retains a strong positive performance over 12 months (+19.2% and +13.0%), the portrayal of a sea-change reflects a growing consensus that interest rates are no longer tied to their lower bound. As with equities, Europe[11] was softer in Australian dollar terms, losing 10.2% of which 5.8% can be explained by a weakening Euro. Drilling down, the Hotel & Resort sector continued its strong rebound from COVID-19 induced lows, gaining 8.3% over the 3 months, in stark contrast to the Residential sector at -9.3%[12].

Fixed income

Echoing the common theme of a changing interest rate regime, fixed income assets lost ground. Australian bonds and credit gave up 5.9% and 4.6%, whilst floating rate securities depreciated by only 0.3%. The key take-away being that investors are not yet concerned with an economic impact on credit quality. Globally, US and international bond indexes (on a hedged basis), moved in almost perfect lock-step with their Australian counterparts, falling 5.9% and 5.0%. Global High Yield bonds (-5.2%) presented a parallel to that of floating rate securities, suggesting no material change to the credit worthiness of borrowers[13].

Alternatives

Despite market volatility in listed markets over the first quarter of 2022, private market assets have carried on with very limited fanfare. Operating performance was strong across most sectors and regions. Transaction volumes did slow over the quarter, fuelled by the volatility caused by Russia's invasion of Ukraine, rising and higher inflation and rising bond yields. Debt focused alternative assets did well over the quarter relative to fixed income assets which have underperformed.

Cash rate

The Reserve Bank of Australia (RBA) continues to hold its target cash rate at 0.1%, whilst acknowledging that inflationary forces are building. Whilst the Federal Reserve in the US has begun increasing rates, the local environment is more nuanced. The RBA notes that it wants to see "evidence that inflation is sustainably within the 2-3 percent target range", acknowledging that increases in wages remain below the level that would be consistent with persistent inflation increases. It will continue to be data dependent, seeking to avoid acting too early.

Aussie dollar

Benefiting from strengthening commodities prices, AUD gained against most major currency pairs. Against the US dollar, a 3.0% appreciation to 74.82 US cents was experienced. The Euro, weakened by Russia/Ukraine related risk aversion, saw AUD strengthen by 5.8%. Japan, a net resource importer, saw its currency suffer the brunt of the new environment, with the yen weakening against the Aussie dollar by 8.8%.

[9] Measured by the S&P ASX 300 / A-REIT index
[10] Measured by the FTSE EPRA Nareit Global index
[11] Measured by the FTSE EPRA Nareit Europe
[12] Sector indices taken from the MSCI World REIT Sector series

[13] In order, indices used in this paragraph are: Bloomberg AusBond Composite (0+Y), Bloomberg AusBond Credit (0+Y), Bloomberg AusBond Credit FRN (0+Y), Bloomberg US Aggregate (hedged), Bloomberg Global Aggregate (hedged), Bloomberg Global High Yield (hedged)

Global economic overview

"There are decades where nothing happens; and there are weeks where decades happen."

Vladimir Ilyich Lenin
(former Russian leader)

It's like déjà vu… all over again

At the time of writing, we are both shocked and horrified by reports of apparent war crimes committed by Russian soldiers, most recently in the Ukrainian city of Bucha. Whilst the attempted invasion by Russia caught many off guard except for, perhaps, British and US intelligence services, we should reflect that Russia is no stranger to conflict. Even putting aside their involvement in wars in Afghanistan and Syria, invasions of Chechnya and Georgia, and skirmishes scattered across various African countries; throughout history Russia has always had a tumultuous relationship with Europe. As The Economist notes, "during 300 years of imperialism, Russia has repeatedly been at war in Europe. Sometimes, as with Poland and Finland, it was the invader. Other times, as with Nazi Germany and Napoleonic France, it was seen as a lethal threat and itself fell victim to aggression." [14] We make this observation not to excuse or justify their unprovoked attack on their neighbour, but to demonstrate that discounting an invasion by Russia as 'unthinkable' or even 'improbable' was ignoring the lessons of history.

From a financial markets point of view, we have a sense of déjà vu. Almost exactly two years prior to the Russian military crossing into Ukraine, COVID-19 emerged as a global pandemic, shocking the world. Indeed, both 2020 and 2022 had similar beginnings with a demonstrable reduction of economic uncertainty, such as the US/China trade-deal and Brexit in 2020, and the diminished importance of the coronavirus in 2022. Similarly, 2022 has clear headwinds on the horizon, such as the US midterm elections, the normalisation of interest rate policy by central banks and growing Chinese assertiveness however despite these clear corollaries, the comparison begins to break down once you examine market reaction over these years.

From February 20th 2020 to March 23rd 2020, global equity markets[15] fell by 32.3%. Whilst the same period in 2022, which captures the beginning of the fighting in Ukraine, saw a 0.7% appreciation of international shares, using the same measure. What this demonstrates is, despite the visceral horror at the carnage inflicted on Ukraine, investments tend to be relatively immune to war (a notion that has played out numerous times over the past century or so).

That is not to dismiss or trivialise the impact of the conflict on the global economy, but to reflect a sober, market-based assessment of developments. While short-term volatility in markets was a result, the main driver of markets is ultimately the end of more than a decade of supportive economic and monetary conditions, resulting in slowing growth and increased volatility. In many regards, we anticipate an increase in "weeks where decades happen" over the coming year.

[14] The Economist, April 2nd 2022, "Why Ukraine must win"
[15] Measured by MSCI World All Countries Index

Despite headwinds the global economy shows signs of strength

In January, the International Monetary Fund (IMF) projected global growth of 4.4% in 2022. Off the back of developments in Ukraine, it now seems poised to cut this. Our central bank, the Reserve Bank of Australia (RBA), noted in minutes from their Monetary Policy Meeting on the 1st March that "before the invasion of Ukraine, the global economy had continued to recover from the COVID-19 pandemic". It's fair to say that economic growth seems likely to continue in many countries despite the challenges, albeit at a reduced rate.

One exception to the 'continuing economic growth' theme would be China, one of the few countries continuing to pursue a COVID-19 zero policy. At the time of writing some 26 million residents in China's most populous city, Shanghai, are in lockdown. Jarring policy details of the governments attempt to stamp out the spread of the virus, include a measure that "children whose parents are infected will be cared for by guardians or put in 'juvenile protection'"[16]. When we consider that the primary impact of the pandemic on economies was via lockdown, combined with China's importance to global supply chains and its status as the world's second largest economy, it is clear that we have some way to go before we can return to a sense of pre-pandemic normality.

On the positive side, unemployment levels in Australia and the US, amongst others are at historically low levels. In the words of the RBA, "Labour market conditions had tightened further in advanced economies. Labour demand was strong and unemployment rates were near or below pre-pandemic levels. Despite this, wages growth remained contained in most economies, with the United Kingdom and the United States two key exceptions. Stronger wages growth in these economies reflected reduced labour supply in the context of strong labour demand, increased job mobility and flexible wage-setting mechanisms."

The benefit of improved labour conditions is that they directly benefit the financial health of workers, particularly those who have the highest 'marginal propensity to consume'. In simple terms, people who will most likely spend their new wage increases. This in turn is likely to provide support to economies. It is for this reason, that many central banks justified delaying interest rate increases, citing a lack of wage price inflation.

[16] ABC, abc.net.au, April 4th 2022, "Shanghai asks entire city to self-test for COVID-19 as frustrations grow, infected parents anxious about care arrangements for their kids"

Inflation is no longer transitory

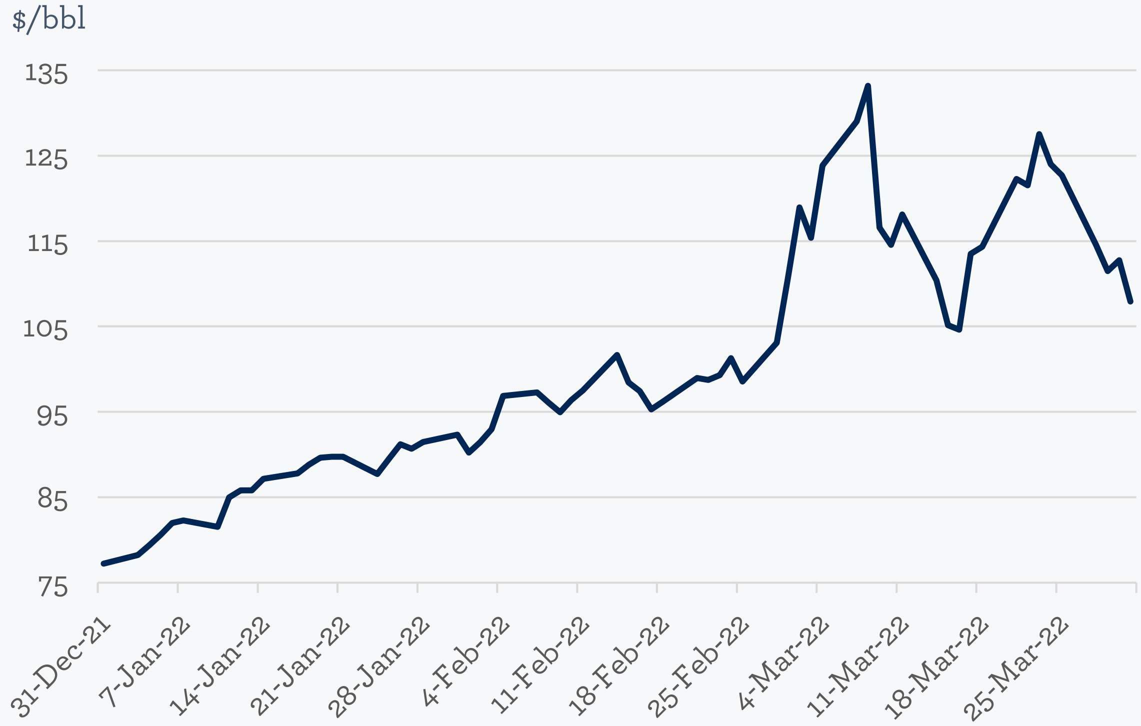
In our comments at the end of the third quarter of 2021, we paraphrased Federal Reserve chief Jerome Powell in that inflation will be "transitory until it ceases to be transitory". Unfortunately, measures of inflation expectations have begun to reflect such a cessation. When we contemplate supply disruptions which were born of the Great Lockdown it was hoped that as the world was moving forward from the pandemic and supply chain pressures would ease, reducing the influence of cost-push inflation.

Of course, the war in Ukraine and the impact of sanctions on Russia has led to spikes in energy and commodities prices, creating additional uncertainty about the inflation outlook. This is challenging as it has the dual impact of increasing risks to economic growth and driving up inflation. Whilst the former would broadly encourage holding or reducing interest rates, the latter demands a tighter monetary environment.

One of the key risks we've focused on over recent months is that of policy error by central banks. Given the application of quantitative easing (also known as QE) and record low interest rates, putting the monetary 'genie' back in the bottle, was always going to prove challenging. Developments over the past month have only added to the degree of difficulty. In the words of the IMF "While some effects may not fully come into focus for many years, there are already clear signs that the war and resulting jump in costs for essential commodities will make it harder for policymakers in some countries to strike the delicate balance between containing inflation and supporting the economic recovery from the pandemic."[17]

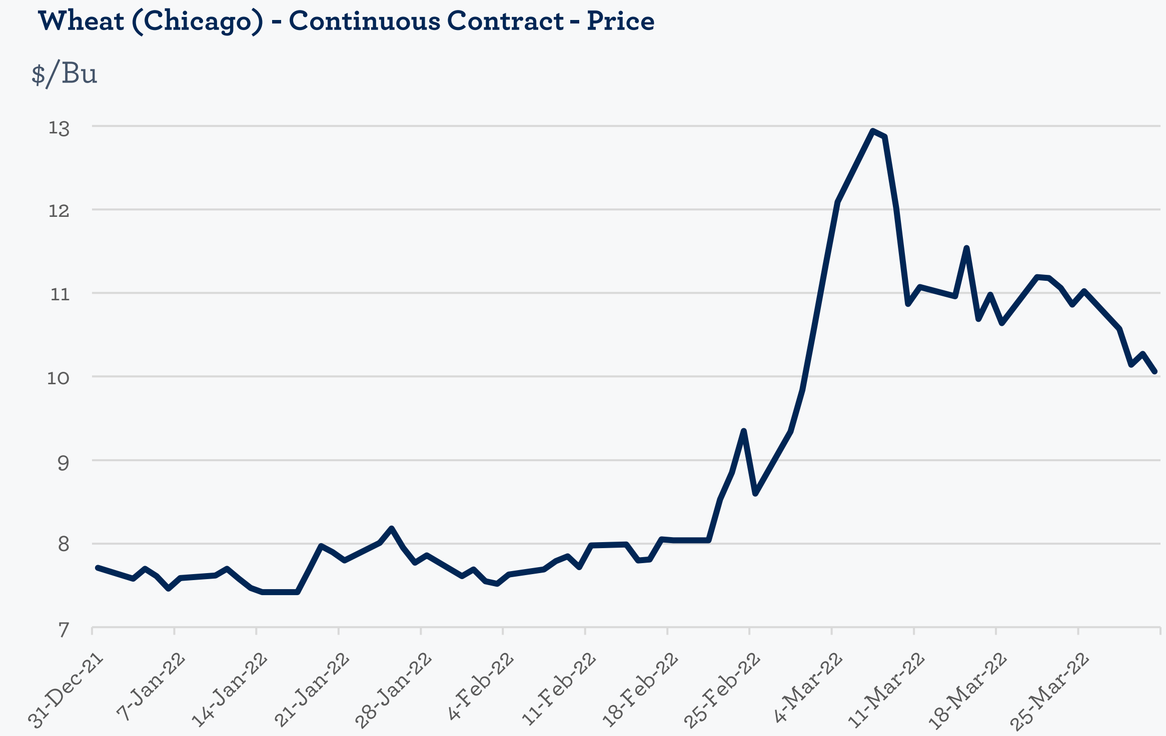
We include charts showing Oil, Wheat and Palladium as they, in turn, are key inputs into transportation, food and cars.

Crude Oil Brent - Price

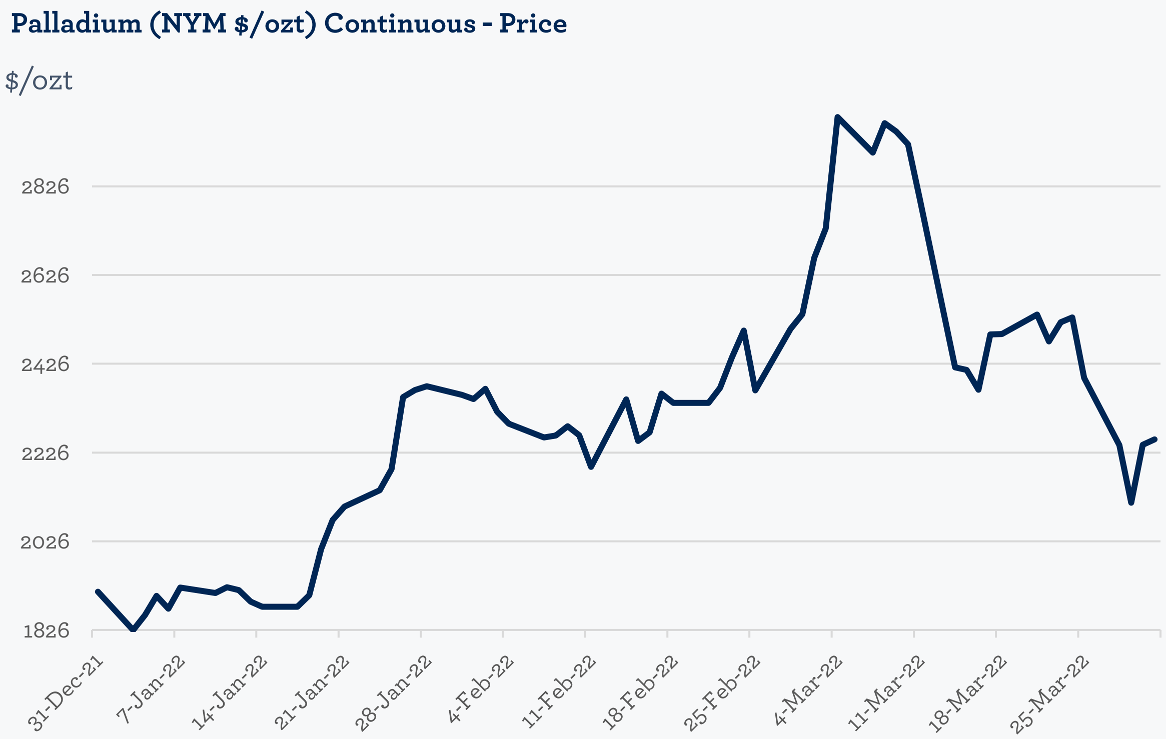


Source: FactSet, Perpetual Private

[17] IMF, March 31st 2022, "Tight Jobs Market Is a Boon for Workers But Could Add to Inflation"



Source: FactSet, Perpetual Private



Source: FactSet, Perpetual Private

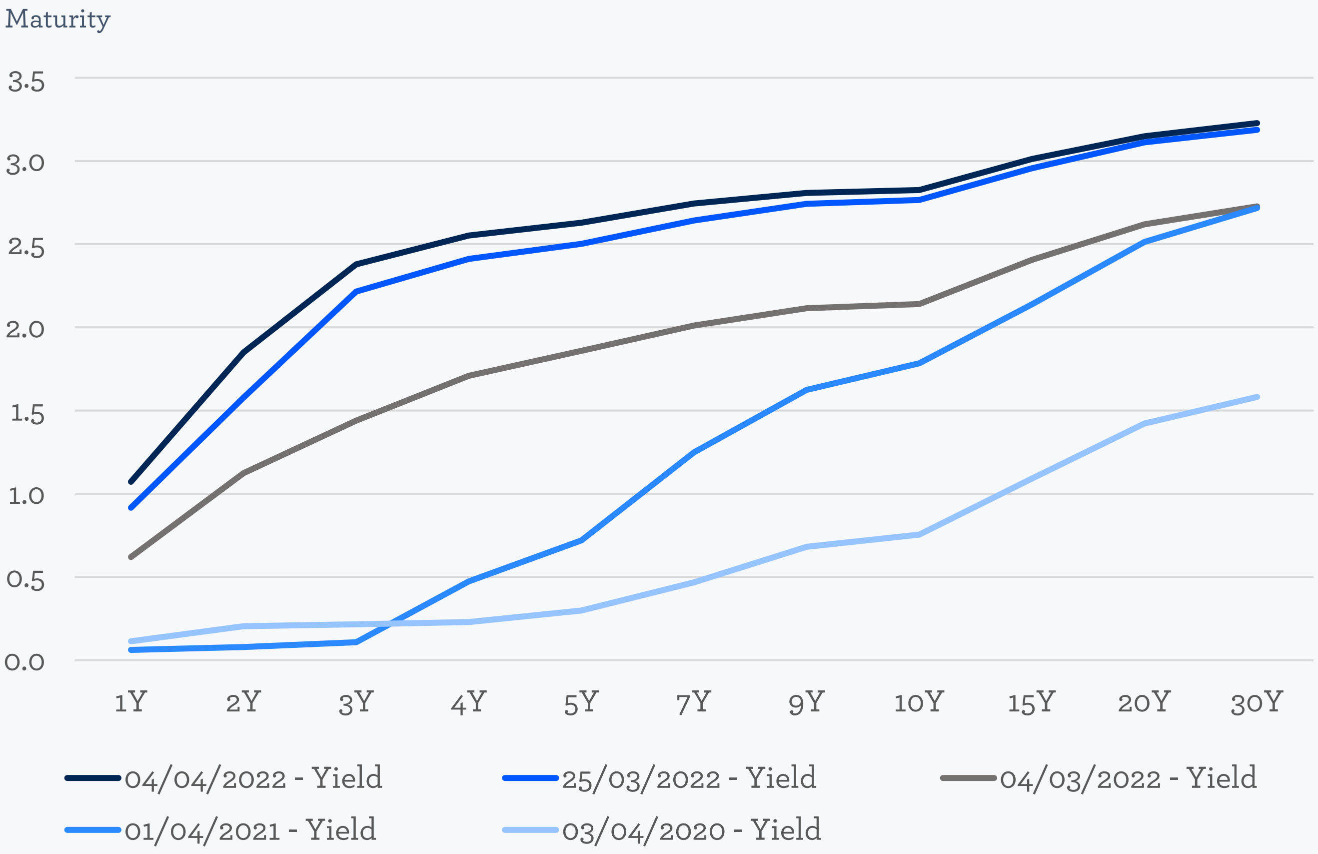
Interest rates: patience tested

Over the past year, even as inflation has continued to accelerate, central banks have continued to push the idea that they were willing to be 'patient' and look through near term price pressures. However, as price increases have proven to be persistent this point of view has become significantly challenged. From a US perspective, "For most of 2021 the central bank said that it had the tools to slow price rises, but saw no need to put them to use. Now investors are coming to terms with the fact that the Fed will have to deploy them at scale"[18]. Though pressures here in Australia are less acute than some of our trading partners, they are interrelated and no less serious.

Central banks face an increasingly difficult environment to navigate. Having put so much effort into softening the economic shock of COVID-19 and supporting economic growth, trying to withdraw support in an environment of slowing growth and heightened uncertainty makes the chances of a policy mistake, and resultant recession, more likely.

The chart below shows expected Australian interest rates based on bond yields. What we can determine from this data, is that interest rate expectations have rapidly been increasing over the past year, as the 'curves' move upwards.

Australian Treasury Yield Curve



Source: FactSet, Perpetual Private

[18] The Economist, April 2nd 2022, "Can the Fed pull off an 'immaculate disinflation'?"

Hope is on the horizon

As active investors, we find the uncertain environment compelling as market dislocation presents opportunities to add value to portfolios. Although we broadly expect lower returns and higher volatility compared to recent years, we see opportunity in the dispersion we are witnessing within asset classes. Prior to the pandemic, relatively benign market conditions were constructive for overall asset returns but did not provide opportunities for managers to outperform. The more nuanced environment is more conducive for managers who are able to identify trends and take active positions to outperform the broader market. Furthermore, the rising interest rate environment calls into question the valuation of long-duration equities (growth companies with most earnings in the distant future), in turn favouring those companies whose businesses are less likely to experience explosive growth, but are solidly profitable and cash flow positive today. Current conditions point to a change in regime, as indicated by the recent outperformance of Value vs Growth.

This of course does not mean we will rest on our laurels. Instead, we will continue to scan the horizon for opportunities and improve portfolio positioning where there are attractive prospects.

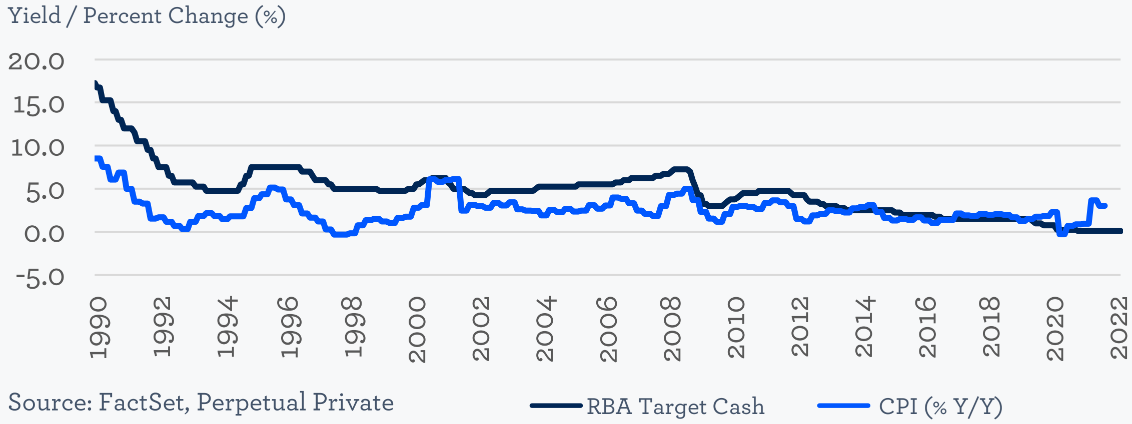
Australian cash rate and dollar

Australian Cash Rate

The Reserve Bank of Australia (RBA) continues to hold its target cash rate at 0.1%, whilst acknowledging that inflationary forces are building and broadening, with prices picking up for some parts of the services economy. Whilst the Federal Reserve in the US has begun increasing rates, the local environment is more nuanced. The RBA notes that it wants to see "evidence that inflation is sustainably within the 2-3% target range", acknowledging that increases in wages remain below the level that would be consistent with persistent inflation increases. However, wages growth has begun to rise modestly, returning to the rate observed in the years leading up to the COVID-19 pandemic, but has predominately been rising on those industries where there have been labour shortages induced by lower migration and closed borders.

For now, macroeconomic policy settings remain supportive of growth and national income is being boosted by higher commodity prices. At the same time, rising pricings are putting pressure on household budgets. The consensus view has now shifted from a more patient approach by the RBA, to a rate hike as early as June 2022. Short term inflation expectations have increased further over recent months to around their highest level in many years, signalling the market believes that inflation will remain persistently high and the RBA will need to raise interests quicker and faster than anticipated.

Figure 1. Australian long-term interest rates
Long-Term Cash Rate VS Inflation



Source: FactSet, Perpetual Private

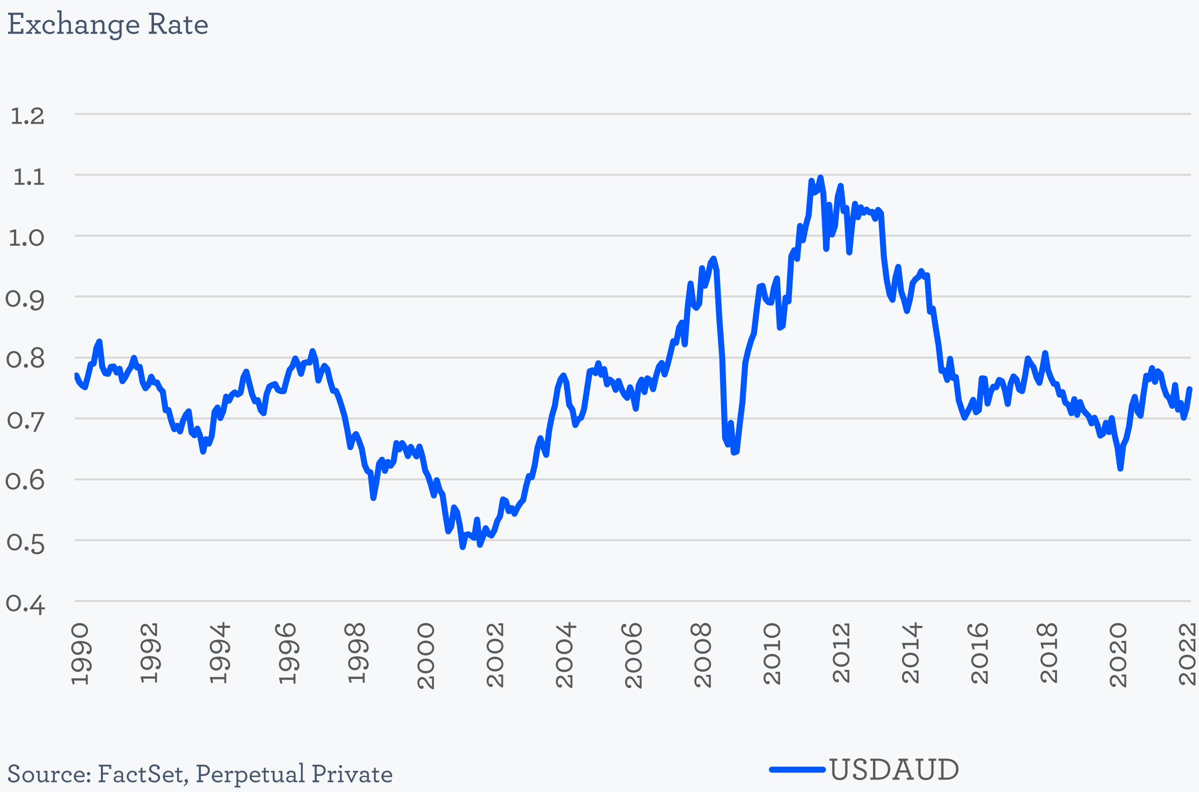
Australian Dollar

A clear beneficiary of tightened commodities markets, the Australian dollar has experienced near-term strength. Benefiting from strengthening commodities prices, AUD gained against most major currency pairs. Against the US dollar, a 3.0% appreciation to 74.82 US cents was experienced. The Euro, weakened by Russia/Ukraine related risk aversion, saw AUD strengthen by 5.8%. Japan, a net resource importer, saw its currency suffer the brunt of the new environment, with the yen weakening against the Aussie dollar by 8.8%.

Australian Dollar outlook

It has been a volatile quarter for the AUD, as the Fed began its tightening cycle, and the RBA continued their patient stance. Other global factors added to AUD appreciation, including rapidly rising commodity prices, especially oil after Russian sanctions were imposed, but deteriorated risk sentiment more broadly. As we move into the second quarter of 2022, the RBA has turned increasingly hawkish off the back of continually high inflation and so it is considerably likely that AUD will trend towards the upper end of the band over the rest of 2022.

Figure 2. Australian Dollar U.S. Dollar (Daily) Long Term
USD Per AUD Long-Term Exchange Rate



Source: FactSet, Perpetual Private

Australian and international equities

Australian equities

The Australian equity market climbed higher over the quarter, with the S&P/ASX 300 Accumulation Index delivering a return of +2.1%, considerably stronger than global equities with the MSCI All Country World Index (MSCI ACWI) returning -4.7% in AUD terms.

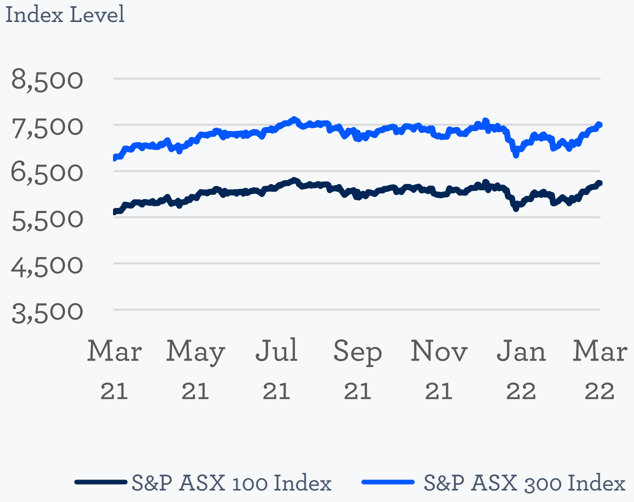
There was significant disparity in returns from growth stocks vs value stocks. With the threat of potential interest rate hikes looming and concerns around inflation, longer duration growth stocks that are more sensitive to rate changes were hit the hardest, returning -4% over the quarter, whilst value stocks delivered strong returns of +11.7%. It was also a more challenging quarter for smaller companies, with the Small Ordinaries index returning -4.2%, whereas the larger ASX100 index delivered +3.0%.

In a global sense, Australian Equities have been more resilient, largely thanks to higher commodity and energy prices. Whilst the market is closely following what transpires between Russia and Ukraine, the longer-term focus clearly remains on inflation and interest rates. In a global sense, the Australian economy has been quite far removed and relatively well protected from the impacts of the Russia/Ukraine war. As at the commencement of the war, our total exports to Russia accounted for < 0.1% of total GDP. Australian energy and key commodities have also helped to fill the supply gap left by the disruptions to Russian and Ukrainian exports, providing a boost to national income. The Australian economy is looking in better shape, with employment levels reaching all-time highs and household balance sheets in good shape (despite elevated mortgage debt). Inflation domestically has also been more contained and business confidence is building, with Australia delivering stronger GDP growth than most global peers. All eyes are now on the RBA and their rhetoric as to the pace and timing of future interest rate increases, which we expect to accelerate once we see more pronounced wages growth.

The relatively strong performance from Australian equities over the quarter has been largely driven by three key sectors – Energy (+28.4%), Materials (+15.2%) and Utilities (+14.1%). The war in Ukraine has prompted a spike in Oil prices as pressure mounts over the continued supply of Russian oil and gas to Western Europe, whilst a growing demand for commodities against the backdrop of continued supply disruptions as a result of the Russia/Ukraine war and the pandemic's lingering impact on world trade and a looming scarcity of key commodities due to underinvestment in new supply has pushed commodity and energy prices higher. Key sectors that detracted from performance over the quarter were Information Technology stocks (-13.7%), followed by Consumer Discretionary (-10.4%) and Healthcare (-10.1%).

Figure 3. Australian Shares

Australian Shares – Large Companies



Source: FactSet, Perpetual Private

Australian equities outlook

The Australian economy continues to rebound strongly from the pandemic, with GDP growth forecast to reach 3.5% this financial year and the domestic unemployment level expected to fall to 3.75% in the coming months, which will be its lowest level in close to 50 years. From a global perspective, the Australian economy also remains relatively sheltered from the flow on impacts of the Russia/Ukraine war.

The RBA has signalled that it could begin raising interest rates within months if wages and inflation data produce strong results. Whilst inflation is expected to continue and has been exacerbated by the Russia/Ukraine war and subsequent supply disruption, wages growth has been slower and has been lagging behind inflation, meaning most Australians will face little relief from higher living costs, let alone higher interest rates. The RBA is closely monitoring wages growth and we expect more supportive wage growth data to be the key catalyst determining future interest rate hikes.

Managers are targeting companies with pent-up demand that are set to benefit from the continued re-opening of the economy. The outlook for commodities appears stronger, with surging demand meeting constrained supply, which has been exacerbated by the situation in Ukraine, skills shortages and growing underinvestment in new mining projects. Against the backdrop of higher inflation, managers are also targeting those quality industry-leading companies that have greater pricing power to pass on higher input costs.

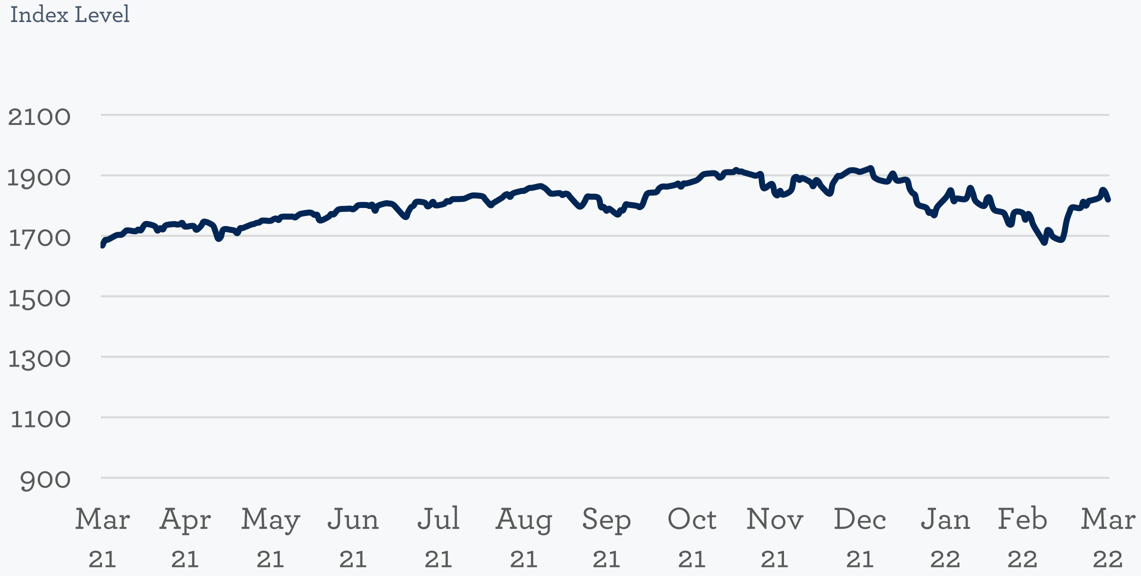
We expect markets going forward to be largely driven by macro events, in particular the Russia/Ukraine war, COVID-19 containment and the outlook around inflation and interest rates. Investors should expect continued volatility going forwards. Against the constantly evolving economic landscape, our preference is for a diversified portfolio of quality managers with complementary styles that follow a bottom up, fundamental investment approach, as we believe they together are best placed to navigate the uncertain market conditions and identify strong long term investment opportunities.

International equities

Global equities fell in Q1 2022 for just the second time in the last eight quarters. In local currency terms, the MSCI ACWI delivered -4.70% during the quarter. US equities declined for the quarter for just the second time since 2018 and underperformed developed ex US peers, but outperformed emerging markets counterparts. Value and large caps bested growth and small counterparts, respectively, Small caps and tech stocks briefly fell into bear market territory but finished well above intra-quarter lows. Meanwhile, large caps dipped into correction territory before regaining momentum in the second half of March to finish the quarter just 6.0% below the all-time highs. European equities fell and trailed broader developed markets in aggregate but returns diverged significantly between the United Kingdom and continental Europe.

Emerging market equities declined and trailed their developed markets peers for the fifth consecutive quarter. Chinese equities have declined 44% from their peak in mid-February 2021. Domestic China A-Shares held up better over that period, down only 23%, but are nonetheless in bear market territory. Three ongoing issues have pressured Chinese stocks—US delisting concerns, increasing COVID-19 cases and associated lockdowns, and risks surrounding potential sanctions stemming from China's support for Russia.

Figure 4. International Shares
(Local Currency Terms)



Source: FactSet, Perpetual Private

International equities outlook

Markets have seemingly been driven by the many macro issues in the first quarter of 2022, and with its high volatility and high uncertainty. This was stoked in large part by Russia and Ukraine: the economic repercussions of the war, the sanctions levied on Russia, and how the conflict could impact already-surging inflation. Several central banks responded to unrelenting inflation during March. The Federal Reserve raised its benchmark interest rate by 25 basis points (bps) for the first time since 2018. It also took a more hawkish tone than previously expected. Two years since the onset of the COVID-19 pandemic, portions of Europe, Southeast Asia, and Oceania are still struggling to contain the virus, and China is grappling with its highest case counts to date despite its "Zero-COVID" policy. We expect the macro to continue driving markets over the shorter term, which will take away from the fundamentals of underlying stock holdings in a global equity context. Investors should be braced for more volatility and potentially more stock market pain. That said, we are looking through the short-term noise, and continue to support active bottom-up stock picking managers. We feel they are best placed to navigate this volatility and take advantage of opportunities by looking through the lens of their patient, long term investment horizon.

A-REITS and G-REITS
(Listed property securities)

In AUD terms, Global Real Estate Investment Trusts (G-REITs) fell 7.0% over the quarter to the end of March 2022 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index fell by 3.5%, with both indices reversing much of gains achieved in the prior quarter. In Australia, A-REITs fell 6.7% over the quarter. Increasing real yields in bond markets were the main driver of REIT underperformance during the quarter.

In Australia, after a flurry of capital raising activity in the domestic market during Q4 2021, activity slowed in Q1, although asset level transaction volume remained buoyant. The domestic earnings season generally delivered results in line with expectations, with funds management platforms generally beating expectations. In offshore markets, earnings season broadly confirmed reasonable operating conditions from self-storage, data centres and life science REITs.

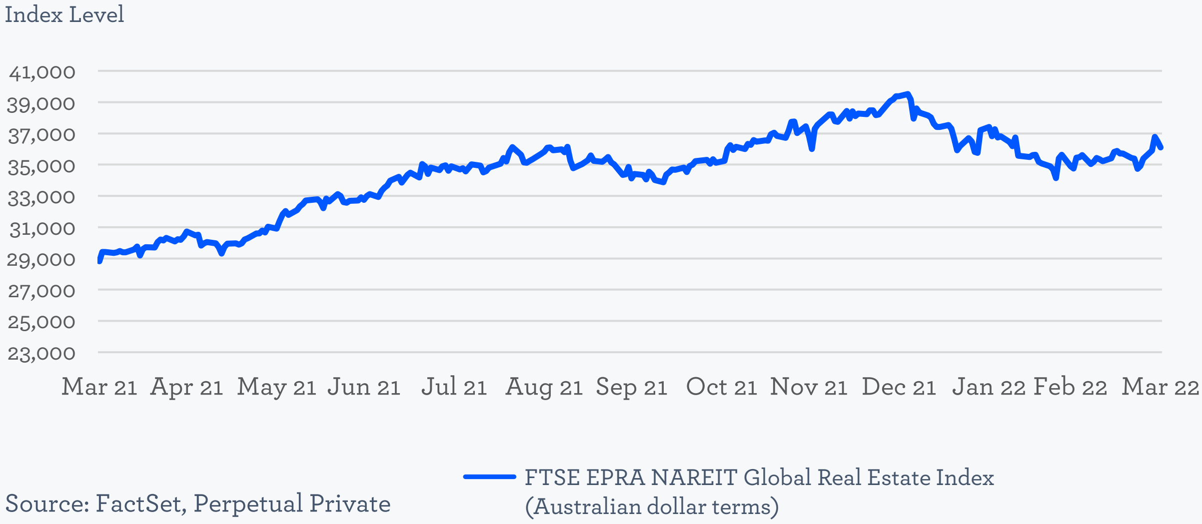
Figure 5. Australian Real Estate Investment Trusts (A-REITs)
Property

Index Level

Source: FactSet, Perpetual Private

S&P ASX 300 AREITs

Figure 6. Global Real Estate Investment Trusts (G-REITs)
Property



Source: FactSet, Perpetual Private

REITs outlook

Over the quarter, we saw a shift in the market's focus away from the COVID-19 pandemic, towards the outlook for inflation and the path of interest rates, namely in the US. Despite this, COVID-19 continues to result in significant disruption; many corporates are still 'working from home', retail foot traffic remains below pre-COVID-19 levels, and hotel vacancy rates while improving remain below pre-COVID-19 levels.

Operating conditions have changed meaningfully for sectors like Hotels, Retail and Office, with the operating and earnings environment unclear. The themes we outlined across real estate markets remain intact:

- 'Right sizing' of 'shop front' real estate. We are now beginning to see 'private capital vehicles' being raised to acquire 'distressed' retail assets.
- Many corporates have embraced 'working from home' for their staff, and this will lead to a shift in thinking around office space requirements (right sizing, collaborative space, etc.). We expect strong demand for CBD real estate, while fringe and suburban office assets may suffer from lower demand.
- For Hotels, while domestic travel may pick up in some regions, those hotels which are heavily reliant on business or international leisure travel will likely remain under pressure for the foreseeable future.

We expect the accommodative monetary policy to remain a feature of markets for some time, particularly in Europe and the US, which will support real estate valuations. However, the market is now beginning to incorporate a scenario where central bank interest rates rise over the course of the next 12 – 24 months. This may cause some volatility in markets. Those REITs with the ability grow rental earnings or maintain development margins will likely be best placed to weather any rate rise. Sector and geographic allocation remain important with valuations and growth prospects differing across markets and segments.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned -5.9% during the March 2022 quarter. The poor performance comes off the back of some very large moves in the yield curve. At the end of March, the Australian 10-year bond yield was 2.77% versus 1.67% the previous quarter. The Australian 5-year bond yield moved aggressively, jumping to 2.50% versus 1.33% from the previous quarter.

In February 2022, the Australian unemployment rate was 4.0%, down from 4.2% the month prior. The December reading for CPI was very high, rising 3.5% for the 12-months ending December 2021, due to strong demand and supply disruptions leading to rises in goods like furniture and motor vehicles. The trimmed mean, the preference inflation measure for the RBA was 2.6% for the year ending December, the highest it has been since 2014 and toward the higher end of the 2%-3% RBA inflation target.

The RBA held their target cash rate at a historical low of 0.10%. In Philip Lowe's April statement, the RBA noted that their Board wanted to more evidence that inflation was sustainably within the 2-3% band before it increases rates. They also noted that the improving labour market contributed to Australia's strong economic growth. Wages growth has improved but is only back the "relatively low rates" before the pandemic.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned -5.0%. Credit underperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning -5.9% over the quarter. High yield debt as measured by the ICE Bank of America High Yield Index (Hedged) fared slightly better, returning -5.2% for the period.

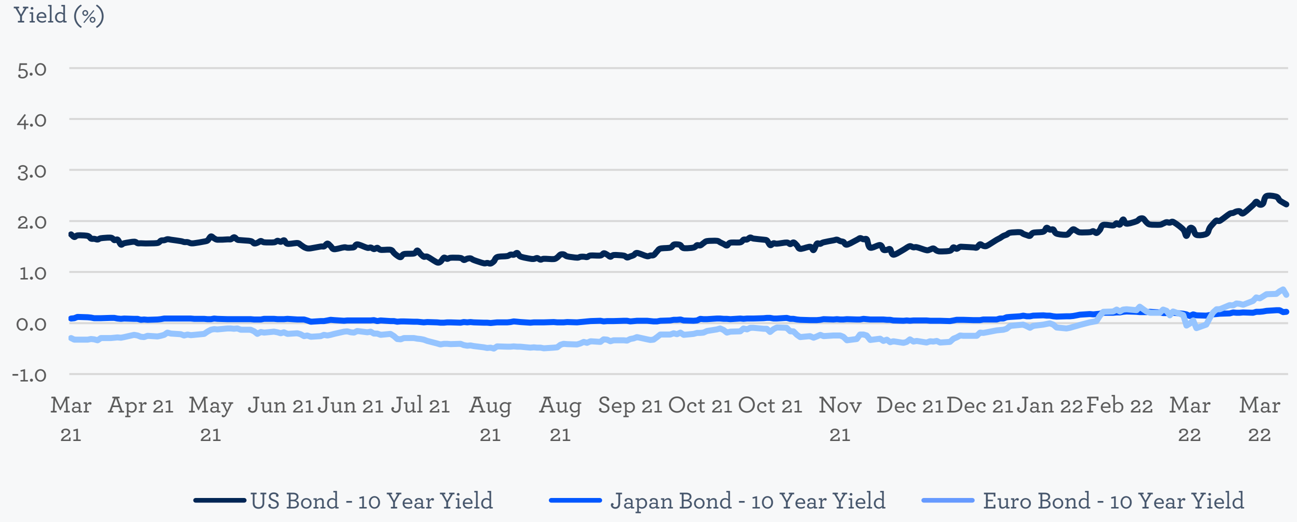
The US Yield curve has flattened, with the US 2yr yield rising to 2.29% from 0.73% 3 months prior and the US 10yr rising to 2.49% from 1.51% over the same period. The sharp move in the near-term part of the curve has contributed to the losses in the Bloomberg Barclays Global Aggregate Bond Index (Hedged) and in the corporate bond indices.

US inflation has been running hot for the last few months with CPI up 7.9% for the 12 months to the end of February 2022. The Personal Consumption Index (PCE), the Federal Reserve's preferred inflation gauge was up 6.4% over the same period. On March 16th 2022, the Federal Reserve increased it's range for the federal funds rate to 0.50% from 0.25%. In their statement, there was an expectation that inflation would return to 2% and that the labour market would remain strong.

Figure 7. Australian Government Bonds

Source: FactSet, Perpetual Private * Note: Bond prices are inversely correlated with bond yields

Figure 8. Global Government Bonds



Source: FactSet, Perpetual Private * Note: Bond prices are inversely correlated with bond yields

Figure 9. Global Credit Markets

Difference VS. US Govt Bonds

Source: FactSet, Perpetual Private. * Note: Bond prices are inversely correlated with bond yields

Fixed Income Outlook

Inflation was already running high in the US and Europe at the end of last year. The unprovoked attack on Ukraine by Russia has contributed to those inflation pressures. Russia supplies Europe with much of its energy and Ukraine is a major grain supplier and exporter of urea. These pressures have led the US Fed Reserve to begin its tightening cycle and for the market to price in a series of rate hikes. Given the uncertainty around the war and the ongoing supply constraints, we expect inflation expectations to remain volatile.

US credit spreads rose over the last few months until the Fed Reserve meeting in March, at which point, spreads rallied. However, both the investment grade and non-investment grade corporate bond market are sensitive to moves in the US treasury rates and both posted strongly negative returns over the period. Surprisingly, non-investment grade bonds outperformed investment grade bonds in a period of poor equity returns. We remain positive on credit versus government bonds while defaults remain low. At some point, higher government bond yields will make them more attractive than corporate bonds.

Perpetual's alternatives funds

Growth alternatives

Despite market volatility in listed and tradable markets during Q1 2022, private markets have carried on with limited fanfare. Operating performance remains strong across most sectors and regions. After a very strong 2021, we saw transaction volumes soften somewhat in Q1 2022 on the back of market volatility caused by Russia's invasion of Ukraine, rising and high inflation and rising yields. Despite the drawdown in equity markets, the partial rebound late in the quarter suggests that Q1 2022 valuations will be broadly unchanged (short of any company specific issues coming to the fore).

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. Regulated and contracted assets remain well bid.

Within Private Equity, Leveraged Buyout (LBO) returns were strong through 2021, with 'mega funds' outperforming mid-market funds. Pleasingly, we saw an increase in the pace of realisations through the course of 2021, although given the changing environment in 2022, we expect the pace to moderate. While we are not hearing of meaningful shifts in borrowing costs for private equity sponsored transactions, we are watching for any change in debt markets which could impact transaction volumes or multiples.

Sector dispersion remains wide within Real Estate markets, with Industrial and Logistics assets continuing to be well bid, while valuations for Retail and Hotel/Hospitality assets remain uncertain. Office assets in Australia remain well bid, particularly by foreign investors. Dynamics continue to support East Coast markets, with CBD office being the most attractive on a relative value basis. We are beginning to see large, high quality retail centres transact. However, office assets in markets where labour is more mobile has not fared as well. Our focus remains on the nexus between availability of capital and valuations. Of note, we are seeing the cost of debt rise in the US which is slowing transaction volumes, and dampening prices.

Market dynamics have changed meaningfully during the quarter (inflation, interest rates and Russia's invasion of Ukraine), which in our mind warrants a shift in thinking and outlook. We continue to focus on policy decisions made by central banks, but have incorporated a deeper focus on the health of the 'real economy'. We are responding to what we expect to a market environment more akin to that of the environment prior to the GFC (interest rate cycles, and greater focus on fundamentals) by adding hedge fund strategies which can navigate such environments.

Income alternatives

Debt focused alternatives strategies have performed in line with our expectations for the year. The Fund's bias to private debt has contributed to the relative performance versus traditional fixed income markets which have performed poorly over the last 18 months.

The Income Opportunities Fund's (IOF) exposure to private debt, broadly syndicated loans, CLOs and Healthcare Royalties have performed strongly over the year. Over the medium term, the Fund is performing in line with expectations, despite the increased volatility in rates and credit spreads. We expect that US CLOs, Loans and Private Debt will do reasonably well versus their European counterparts. The impact of rising rates on consumer and business spending is a risk that the team is monitoring.

Over the last six months, the Fund has experienced a high level of capital calls, reducing its liquid allocation significantly. The largest capital calls are associated with the investments in IOF's newer strategies. These are CLOs, through Blackstone and core property, through Nuveen. Nuveen will improve IOF's yield characteristics by diversifying away from corporate credit.

The Fund is close to being fully deployed. Over time, the Fund will reduce its exposure to 1st lien unlevered private debt in favour of more liquid securities. This will help the Fund meet its hedging and distribution requirements. Potential investments may include convertibles, investment grade structured product, high yield or more broadly syndicated loans. The Fund will maintain its watch on interesting private strategies that can produce an uncorrelated high yield. Potential private strategies include Insurance and Asset Backed Debt.

More Information

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