ESCALA PARTNERS

February 2022

MONTHLY AGENDA - RISK VERSUS UNCERTAINTY

Uncertainty levels are high currently

Uncertainty is at the heart of the stock market slump of recent weeks as investors face difficult questions - when, how fast and by how much will interest rates need to rise in the US? When will inflation ease? What are the consequences of Russia invading Ukraine? We see this uncertainty in our asset allocation dashboard (Chart 1). Sentiment is fearful and momentum has drained away despite positive indicators for valuation and macroeconomic fundamentals such as earnings, economic growth and employment.

Uncertainty differs from risk. Risks can be reduced to probabilities and quantified. The chances of living to a certain age can be calculated actuarially. Once estimated, the risk can be priced. The insurance industry is built upon the principle that it is possible to insure against the occurrence of a specific event.

Uncertainty cannot be priced. It is unquantifiable.

Uncertainty cannot be priced. It is unquantifiable. No one knows the outcome until the outcome presents itself which is why markets have only in the past few days reacted to the conflict in Ukraine. There was even a relief rally once the invasion began. This goes to the heart of the maxim: “Buy to the sound of cannons, sell to the sound of trumpets”. The sound of cannons signals the end of some of the uncertainty.

Not all the uncertainty has been resolved, however. Will NATO be dragged into a broader war? Are we on the cusp of a multipolar world and what would that mean for risk premiums? Questions around monetary policy and inflation remain as uncertain as ever (indeed more so now). How should you invest when visibility is so poor?

Chart 1: Escala Partners CIO Asset Allocation Scorecard

Asset Allocation Scorecard Overweight Neutral Underweight		Overall	Valuation	Macro	Sentiment	Momentum	Technical
Overall	Equities	1.8	2.1	2.3	1.2	1.6	1.9
	Duration	2.0	1.5	1.6	2.8	1.6	2.6
	Credit	2.1	3.0	2.4	1.5	1.7	2.0
	Alts	2.1	2.5	2.3	1.5	1.9	2.0
	Cash	2.0					
Equities	Aust	1.8	2.0	2.5	1.0	1.7	1.8
	US	1.9	2.0	2.4	1.4	1.5	2.3
	EU	2.0	2.3	2.7	1.0	1.7	2.3
	Japan	1.7	2.3	2.1	1.0	1.7	1.5
	China	1.7	2.0	1.7	1.5	1.7	1.5
Duration	Aust	1.9	1.0	1.5	2.8	1.7	2.5
	US	1.7	1.0	1.4	2.5	1.7	2.0
	EU	2.2	2.0	1.3	3.0	1.5	3.0
	Japan	2.4	2.0	2.3	3.0	1.5	3.0
Credit	IG	2.1	3.0	2.4	1.5	1.7	2.0
	HY	2.1	3.0	2.4	1.5	1.7	2.0
Alts	Infra	2.0	2.0	1.9	1.6	2.5	2.0
	PE	2.1	2.5	2.6	1.8	1.5	2.0
	HF	2.1	3.0	2.5	1.3	1.7	2.0
Date	25/02/2022		feb				

Source: Escala Partners, Bloomberg as at 25/02/22

Mentions of the word "uncertain" by the RBA at a peak

The level of uncertainty we are operating in currently feels very high and if the minutes from the Reserve Bank of Australia (RBA) monthly meeting are anything to go by we would be right. The chart below shows the number of mentions of the word "uncertain" in the monthly meeting minutes going back 12 years. Some of the peaks are worth pointing out:

1) June 2018: Political risk in Italy rose when President Sergio Mattarella blocked the formation of a government that would have been decidedly against the euro. The move raised the breakup risk of the euro.

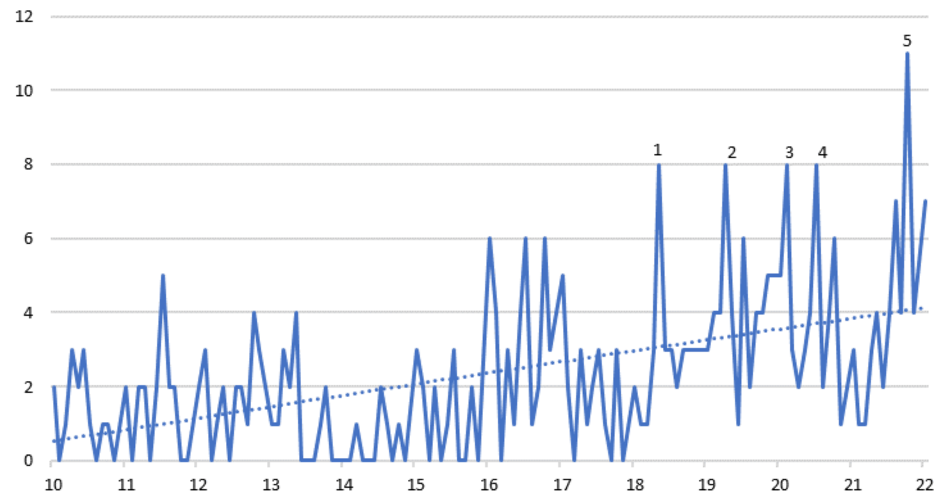
2) May 2019: Trade tensions between the US and China posed a risk to the global growth outlook. At the same time, low income growth domestically posed a risk to the outlook for consumption in Australia and hence economic growth.

3) March 2020: Actions taken by the Chinese authorities to limit the spread of COVID-19 severely restricted economic activity in China in the March 2020 quarter.

4) August 2020: The lengthening and tightening of restrictions in Melbourne, and the extension of restrictions to regional Victoria created uncertainty around how it would affect economic activity in the whole of Australia.

5) November 2021: Uncertainty around the labour market response in terms of the supply of workers and the impact on wages.

Chart 2: Reserve Bank meeting minutes mentions of the word "uncertainty"



Source: Reserve Bank of Australia

Monetary policy to be "flexible" given the uncertainty

The RBA acknowledges we are in a period of particularly high uncertainty. This makes forecasting economic outcomes very difficult and therefore requires the operation of monetary policy to be "flexible".

The current crisis in Russia adds to this uncertainty for policy makers. Do central banks raise interest rates because higher oil prices add to inflation pressure or do they delay rate hikes because of the impact higher energy prices will have on household budgets? Indeed, do they offer fiscal assistance packages as is the case in Italy?

Uncertainty is a fact of life for investors

The reality is that uncertainty is a fact of life for investors. It is always and everywhere a present feature lurking in the background. It is just that sometimes it moves to the foreground.

The chart below is a reminder of how uncertainty is a part of investing. Through each decade investors have been confronted with considerable uncertainty. Wars, terror attacks, political upheavals, pandemics, economic and financial collapses are part of the investing landscape.

Uncertainty is forever present

Uncertainty cannot be priced but can be managed through diversification

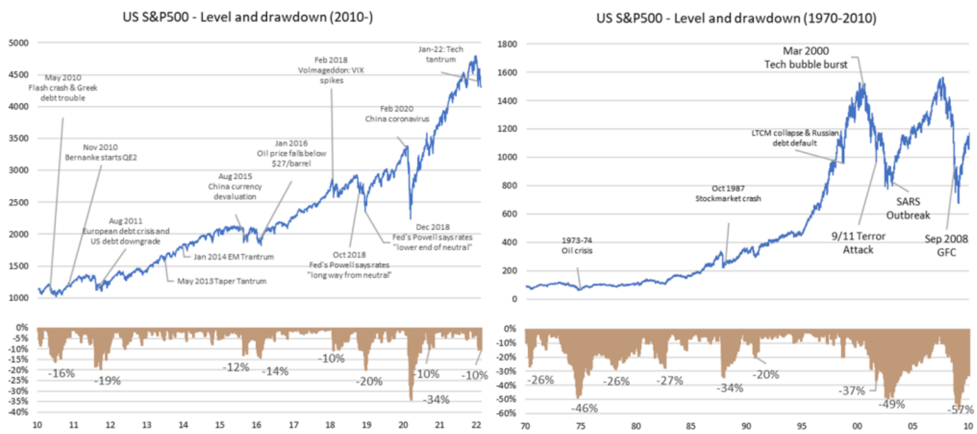
1970s	• Sharp rise in inflation, OPEC • Terrorism, Vietnam War, Watergate, Cold War, Iran hostage
1980s	• US S&L crisis, 1987 stock market crash, Iran/Iraq war • AIDS, Beirut bombing, IRA, Chernobyl, Pan Am, Tiananmen Square
1990s	• End of Cold War, European Union, Serbia / Croatia War, Gulf War • Japan property crash, LTCM, Asian crisis, Russian debt default
2000s	• 9/11 Attack, War in Iraq, Afghanistan, China WTO entry, climate change • TMT bubble burst, GFC, Greek crisis, EU debt crisis, SARS, deflation
2010s	• Quantitative Easing, Quantitative Tightening, Crimea • Arab Spring, ISIS, South China Sea, Brexit, Trump, populism
2020s	• COVID Pandemic, Russia/Ukraine conflict, China regulatory crackdown • Supply-chain crisis, inflation, Net Zero

We can see how this uncertainty has affected equity markets through time. The two charts below show the performance of the US S&P500 Index as well as the maximum drawdowns.

None of the many conflicts that marred the past five decades caused a bear market.

Note none of the many conflicts that marred the past five decades caused a bear market. Not the Iran/Iraq War. Not the first or second US wars in Iraq. Not the Balkan War. Not Israel's conflict with Hezbollah. Not the Syrian Civil War. Not the US involvement in Libya or Afghanistan. And not Russia's invasion and annexation of Crimea. In most of these instances, equities did decline as tensions escalated, but they began bouncing back shortly after fighting broke out. Not because armed combat is bullish, but because the fighting ended some of the uncertainty.

Chart 3: US S&P500 – Level and drawdown (2010-2022 and 1970-2010)



Source: Bloomberg as at 25/02/22

What is interesting to note from the above chart is that in the past 12 years (2010-2022) we have had as many episodes causing major market drawdowns as we did in the 40 years prior (1970-2010). The difference is the average drawdown in the last dozen years is significantly less than what we saw previously. The average major drawdown in the 1970-2010 period was 35.8%. In the 2010-22 period it was half that at 16.1%.

This can partly be explained by the actions of the US Federal Reserve. Since 2010, the US Federal Reserve has expanded its balance sheet by $US6.6 trillion taking it to almost $US9 trillion, more than quadrupling its size. Prior to 2010 the expansion of the balance was relatively minor in comparison.

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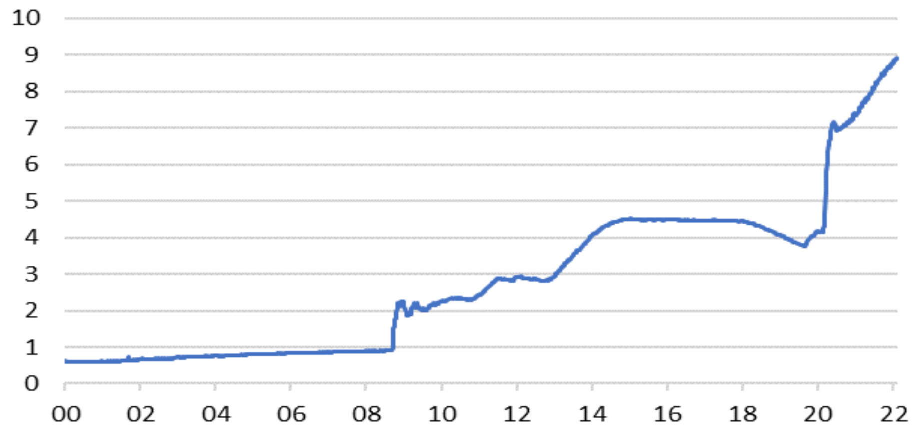
That injection of liquidity has suppressed the downturns in the market. Even a global pandemic that saw economies shut down and nearly 6 million people die "only" resulted in a drawdown of 34% - inline with the 1987 stock market crash and better than the GFC in 2008, the bursting of the tech bubble in March 2000 and 1973-74 oil crisis.

Chart 4: US Federal Reserve Balance Sheet ($US trillion)



Source: Bloomberg

Risk can be priced, uncertainty can't – scenario analysis helps

Risk is randomness in which events have measurable probabilities, wrote economist Frank Knight in 1921. Risk, in other words, is quantifiable. Uncertainty, isn't. So how should investors navigate an uncertain environment?

One approach we like, and which has been adopted by the Reserve Bank currently, is scenario analysis.

For us, our base case scenario is that growth will ease from here taking the sting out of inflation. The US rate hike cycle will be sensitive to financial market indicators of recession risk. Bond yields will stabilise but remain at low levels in-line with lower inflation and growth biased assets will reassert themselves.

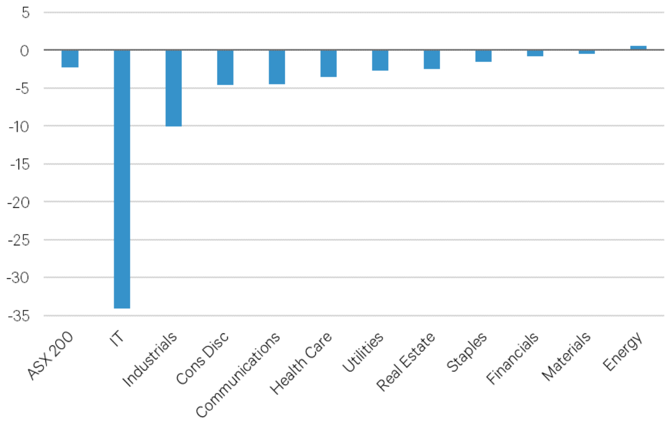
Our alternative scenario is inflation remains sticky and the Federal Reserve is forced to raise rates aggressively sending the economy into a recession. Higher energy prices in Europe leads to a recession there. We would call this the "what if we are wrong scenario".

We have constructed our portfolios to accommodate this alternative scenario. We have reduced our exposure to growth-biased funds, increased our exposure to inflation hedging funds such as infrastructure and other real assets. We are keeping our exposure to government bonds low and our exposure to floating rate credit high.

With visibility so poor we are keeping our tactical positions to a minimum, reserving our budget to only high conviction ideas such as our overweight to alternative assets.

The most important thing any investor can do in times of uncertainty is to have a process and be disciplined in keeping to it. It is also important to understand what you know and what you don't. When the later outweighs the former, good investors patiently sit on their hands and trust their strategic asset allocations.

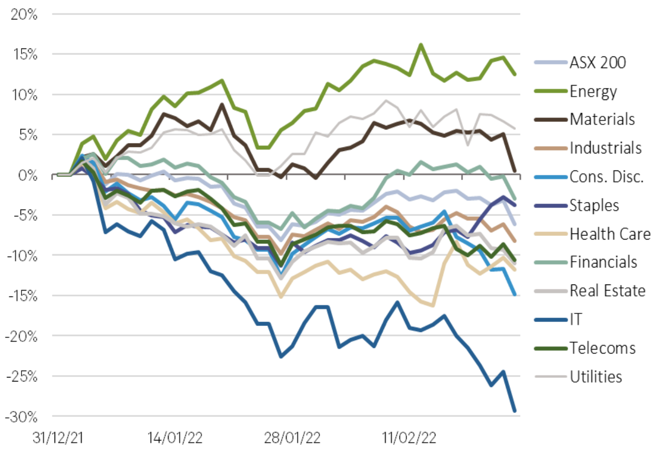
Chart 5: High growth sectors de-rate on Powell Pivot (PE change since start of year)



Source: Bloomberg

With earnings trends positive in the first two months of 2022, equity market weakness can be explained by a broad decline in valuations across nearly all sectors of the Australian market. Higher growth sectors, however, have suffered the largest valuation re-adjustment, with a greater impact as a result of the rise in interest rates that was triggered by a change in guidance from the Fed (the 'Powell Pivot'). This has been most visible in the domestic information technology sector where the forward PE ratio has fallen by 34 points.

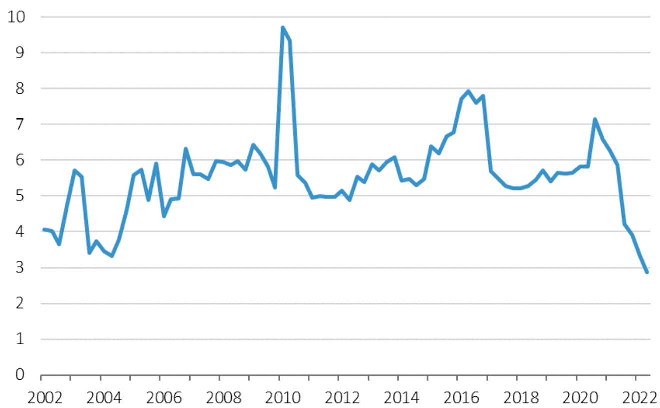
Chart 6: Australian equities: Sector dispersion in 2022



Source: Bloomberg

This has led to a significant level of dispersion in returns across the sectors of the Australian market in the first two months of 2022. The two resources sectors (energy and materials), along with utilities, have all managed positive performance year to date. Meanwhile, the key growth sectors of IT, health care and consumer discretionary have all recorded significant underperformance of the benchmark.

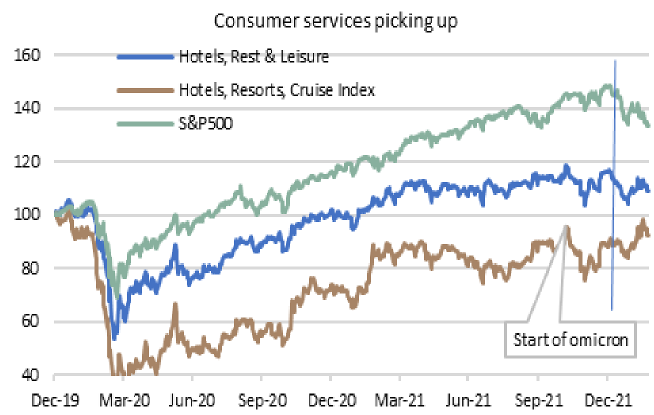
Chart 7: Corporate balance sheets in good shape (Net Debt/EBITDA)



Source: Bloomberg

While Australian households remain susceptible to tightening monetary policy with prevailing high debt levels, the opposite is true of large corporates. Companies have emerged from the COVID crisis in good shape, having built up cash balances with reduced or suspended dividends, cuts to capex spending and government support. The net debt to EBITDA ratio for the ASX 200 now stands at less than 3x, which is as low as any point in the last two decades.

Chart 8: S&P500 Hotels sub-indexes



Source: Bloomberg

We have the situation now where easing of restrictions is allowing the services side of the economy to open up. Disney reported its best quarter ever for revenue in its domestic parks and resorts for the 4th quarter. Revenue in its "theme parks, experiences and consumer products" division, doubled over the prior year to reach $7.2B and exceeded pre-pandemic levels. Profit margins interestingly rose in part because of lower spending on labour due to two new park navigation apps.

In other signs that the services sector is opening up, both Uber and Lyft said airport trips more than doubled from last year. These results are an important measure of how much demand there is for services as restrictions ease.

Chart 9: Chinese equities (CSI 300 Index) struggling

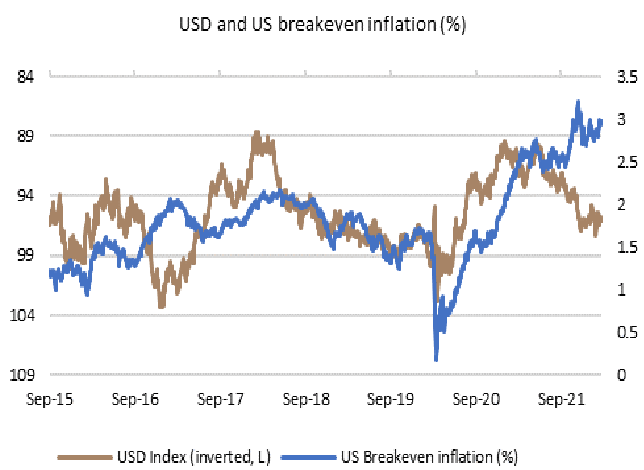
Source: Bloomberg

Chinese equities continue to be battered by regulatory risk. The latest comes as authorities told the nation's biggest state-owned firms and banks to start a fresh round of checks on their financial exposure and other links to Ant Group Co., renewing scrutiny of billionaire Jack Ma's financial empire.

More than a year after the Chinese government cancelled the biggest initial public offering in history by Ant, Beijing has showed no letup in a crackdown that has hit the tech sector hard. Officials have handed out billions of dollars in antitrust fines to end the domination of a few heavyweights as President Xi Jinping pushes for more "common prosperity."

Chinese technology shares are down 52% since peaking this time last year.

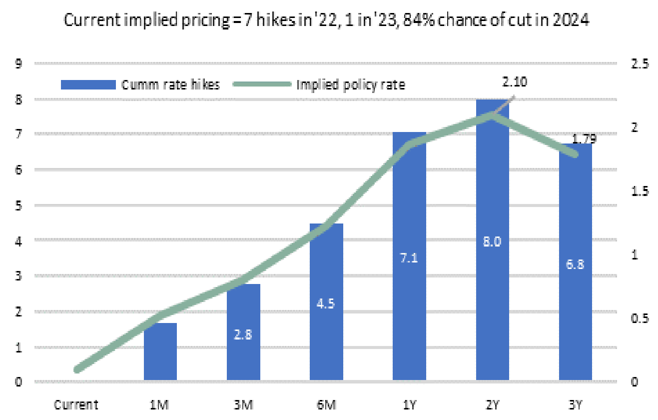
Chart 10: Somethings gotta give



Source: Bloomberg

Something has gotta give. The normally very close relationship between the US dollar and market expectations of inflation seems to have broken down recently. This wouldn't be the first time but it does suggest either inflation expectations need to fall or the US dollar needs to (note the USD is on an inverted axis so a move up implies a fall). Historically it has been the USD that has corrected in which case a lower dollar may be on the cards. That would bode well for emerging market equities.

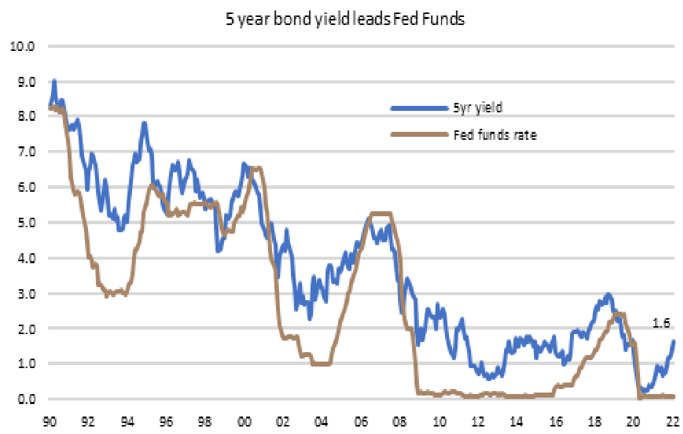
Chart 11: A rate cut priced in for the US



Source: Bloomberg

Expectations for rate hikes have become ever more front-loaded in the US, with seven seen for this year. But markets now suggest just one hike is on the cards in 2023. There is now an 84% probability of a rate cut priced in for 2024. That's a big change from just the beginning of this month when they suggested zero chance of a rate cut all the way through 2025. The thinking behind the move is around how aggressive the US Federal Reserve may need to be to combat inflation with the likely consequence it could push the U.S. economy into recession.

Chart 12: How many rate hikes in the US?



Source: Bloomberg

Just how many rate hikes should we expect from the US Federal Reserve? History has shown the rate hike cycle tends to end when the target rate, the Fed Funds rate, reaches the yield on offer on the 5-year Treasury bond. While that yield is currently sitting at 1.6%, we should expect it to rise further once the central begins to tighten policy. A re-alignment of the two yields historically signalled an end to further rate hikes.

Chart 13: Australian 3-year bond yield (%)

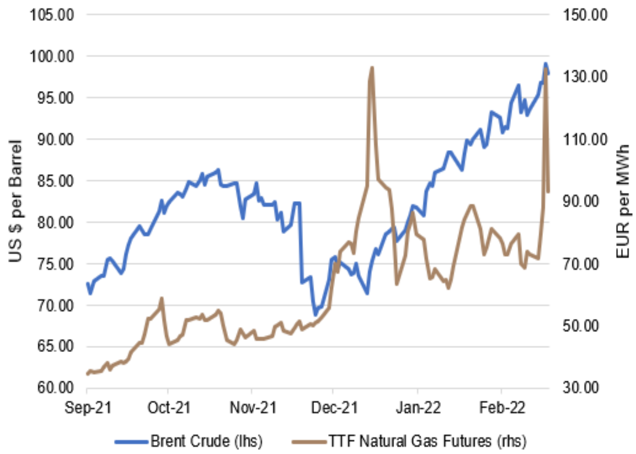
Source: Bloomberg

Australian bond yields are likely to retain an upside bias despite a weaker than expected reading on wages growth for the December quarter. RBA Governor Phil Lowe has admitted it was plausible the RBA would have to hike this year. He also stressed the central bank can take its time because inflation in Australia is nowhere near as hot as in the U.S.

Despite this, the bond market is pricing in an aggressive rate hike cycle for Australia with 2-year yields rising sharply.

Alternatives

Chart 14: Energy markets spike on uncertainty



Source: Bloomberg

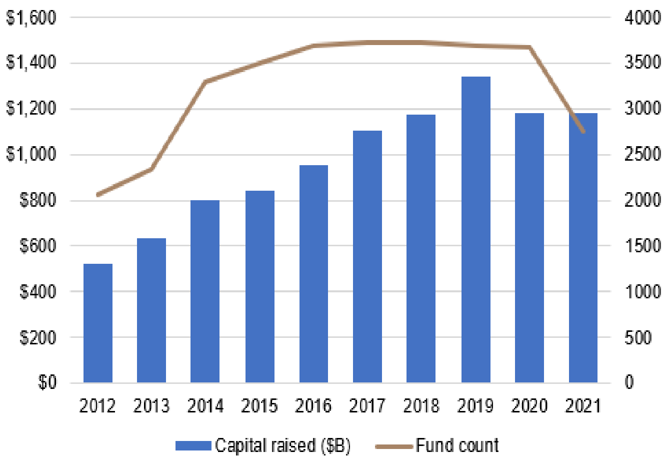
Energy markets were thrown into turmoil late in February as markets began to brace for and then react to Russia's invasion of Ukraine and the uncertainty it would mean for oil and gas prices across a European market already dealing with shortages. The western world has reacted by announcing a raft of sanctions on Russia and it remains to be seen whether this will ratchet up to include Russian oil and gas companies which would further reduce the supply to Europe. Volatility will remain high as the uncertain situation unfolds meaning short term moves will be harder to predict.

Chart 15: Wheat hits highest price since 2009

Source: Bloomberg

Wheat prices rose by more than 5% at the end of February as world begins to unravel where the impact will be most felt from the war in Ukraine. Russia and Ukraine combined account for over a quarter of the worlds wheat supply and are responsible for more than 80% of global sunflower oil supplies. Wheat futures in the US traded at their highest levels since 2009 as closures to ports and rail networks in Ukraine bring a sudden halt to agriculture exports which may persist for some time.

Chart 16: Private capital raises fewer but larger funds



Source: Pitchbook

Private capital fundraising activity across all private market strategies raised $1.2 trillion during 2021. Traditionally, private equity (PE) has led fundraising in terms of capital raised at the strategy level, which was again the case in 2021, as PE took in 38.6% of commitments. The number two strategy, venture capital (VC), raised only 18.1% of the year's total. Whilst the level of private capital raised during 2021 is in line with 2020, the number of funds is significantly lower as record fund sizes get more attention than the vast majority of funds that are much smaller.

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