



ESCALA
PARTNERS

June 2022

MONTHLY AGENDA - HEALTH CHECK - GLOBAL EQUITIES

Late cycle investing presents more tactical opportunities

One of the observations that we have made since March 2020 is the speed of this business cycle. What is typically a seven-year cycle has been compressed into a cycle that is more likely three or four years in duration. At the time of our last global equities health check (July 2021) we believed we were transitioning from early to mid-cycle. Now, given the acceleration of the interest rate tightening cycle, we believe we are in late cycle. Late cycle is typically good for defensive sectors such as consumer staples, healthcare and utilities.

A number of characteristics are typical for late-cycle – economic growth begins to moderate, credit conditions tighten, corporate earnings come under pressure, inventories begin to grow, inflation and interest rates are rising. Directionality becomes clearer in the market making tactical asset allocation more profitable.

As can be seen in our Trade Tracker below, just three tactical trades were implemented last year when we were in mid-cycle and market directionality was less clear. Already this year, we have implemented three trades, with one already closed. More tactical opportunities should present themselves this year as we move further into late cycle.

Table 1: CIO Trade Tracker

Trade Tracker - Trade Summary											
Last updated	23/06/2022										
Position	Long	Short	Sponsor/Co-	Inception	End Date	Open/Closed	Time Horizon	Current level	Profit Review	Loss Review	Profit/Loss
L IE v AE	S&P Index	ASX 200 Index	TM/DB	28/01/2020	30/03/2020	Closed	34%	0.52	0.51	0.42	10.3%
S Duration	Cash	Jamison Coote / WAM AFI	TM/EB	16/03/2020	7/07/2021	Closed	106%	1.37	1.40	0.50	5.1%
L Hed v Unhed	MFS Hedged	MFS Unhedged Global Equi	TM / DK	17/03/2020	29/09/2020	Closed	75%	0.50	0.53	0.47	29.2%
L Alts	Alts model p	Cash	TM/DK	28/07/2020	25/12/2022	Open	79%	1093.97	1150.00	1000.00	11.6%
L AU Eq	VAS	Cash	TM / DB	6/10/2020	16/03/2021	Closed	91%	6778.10	6856.38	5365.86	13.7%
L EM Asia	Fidelity Asia	Cash	TM/EB	17/11/2020	21/04/2021	Closed	79%	884.06	850.00	750.00	11.9%
S EM v Sm Cap	Artisan Glob	RWC Global EM	TM/DB	21/06/2021	18/12/2021	Closed	119%	0.94	1.00	0.90	9.7%
L Liq v Duration	Realml HI	WAM ABF	TM/EB	7/07/2021	22/02/2022	Closed	88%	0.92	0.91	0.83	5.4%
S EM Asia	Cash	Fidelity Asia	TM/DB	28/07/2021	23/01/2022	Closed	74%	27.07	23.47	28.68	-3.8%
L Commod v EU e	MVR/QAU	WCM SIG	TM/DB	3/03/2022	14/06/2022	Closed	56%	4.47	5.00	4.00	15.9%
L Private v Public	HL	WCM QGG	TM/SD	24/03/2022	24/03/2023	Open	25%	1.06	1.05	0.85	11.4%
L Duration v credit	IAF ETF	Bentham/Perpetual	TM/EB	29/04/2022	28/04/2023	Open	15%	97.43	105.00	90.00	0.9%

Source: Escala Partners

Table 2: Asset Allocation

Cash	Capital Preservation			Capital Balanced			Capital Growth		
	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt
Cash	10%	10%	0%	8%	5%	3%	8%	5%	3%
Fixed Income									
- Liquidity	25%	25%	0%	17%	17%	0%	5%	5%	0%
- Duration	15%	10%	5%	10%	5%	5%	5%	0%	5%
- Credit	10%	15%	-5%	8%	13%	-5%	5%	10%	-5%
Fixed Income Total	50%	50%	0%	35%	35%	0%	15%	15%	0%
Equities - Domestic	15%	15%	0%	20%	20%	0%	20%	20%	0%
Equities - International	5%	15%	-10%	15%	25%	-10%	30%	40%	-10%
Equities Total	20%	30%	-10%	35%	45%	-10%	50%	60%	-10%
Alternatives	20%	10%	10%	22%	15%	7%	27%	20%	7%
Growth Assets	40%	40%	0%	57%	60%	-3%	77%	80%	-3%
Defensive Assets	60%	60%	0%	43%	40%	3%	23%	20%	3%
Cash + Fixed Income	100%	100%	0%	100%	100%	0%	100%	100%	0%
+ Equities + Alternatives									

Source: Escala Partners

To accommodate the transition in the cycle we have adjusted our global equities model. From a macro perspective, as the cycle ages, inflation and interest rates rise, and investors shift away from economically sensitive assets to defensives. Higher inflation typically weighs on the performance of longer duration assets.

Energy and utility stocks tend to do well as inflation rises and demand continues. Financials tend to underperform as the yield curve flattens reflecting the slowing growth outlook as do consumer discretionary stocks as inflation forces an adjustment in

household budgets toward consumer staples. Cash has also tended to outperform bonds in late cycle and bonds tend to outperform credit.

Table 3: The business cycle and sector performance

	Early Cycle	Mid-Cycle	Late Cycle	Recession
Financials	✓			
Real Estate	✓✓			xx
Cons Disc	✓✓	x	xx	
Inf Tech	✓	✓	xx	xx
Industrials	✓✓			xx
Materials	✓	xx	✓✓	
Cons Staples			✓✓	✓✓
Health Care	xx		✓✓	✓✓
Energy	xx		✓✓	
Comm Services		✓		x
Utilities	xx	x	✓	✓✓

Early Cycle: There is a clear divide between the winners and losers. Directional tactical asset allocation tends to perform well. The more cyclically sensitive sectors such as consumer discretionary, financials, materials, industrials and real estate tend to perform best. Defensive sectors such as health care, energy and utilities tend to perform worst.

Mid-Cycle: The divide between the winners and losers is less clear so fewer tactical asset allocation opportunities. The focus should be on making slight portfolio allocation changes to protect the downside and quality manager selection within active funds.

Late Cycle and Recession: Directionality returns as does opportunities to add value from tactical asset allocation. Defensive and inflation-protected sectors tend to do better.

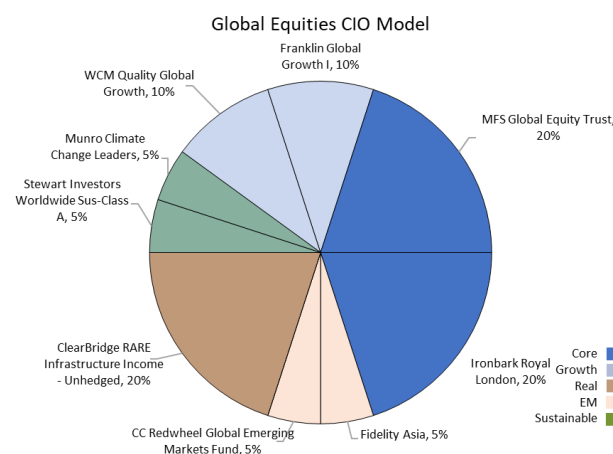
Source: Escala Partners

As we have moved from early to mid to late cycle we have progressively become more defensive in our manager selection. Since September last year we have:

- removed entirely from the model our allocation to small cap funds;
- we have increased the weight to real assets such as infrastructure to hedge against inflation; and
- we have reduced our growth style bias and increased the weight toward style agnostic or neutral funds.

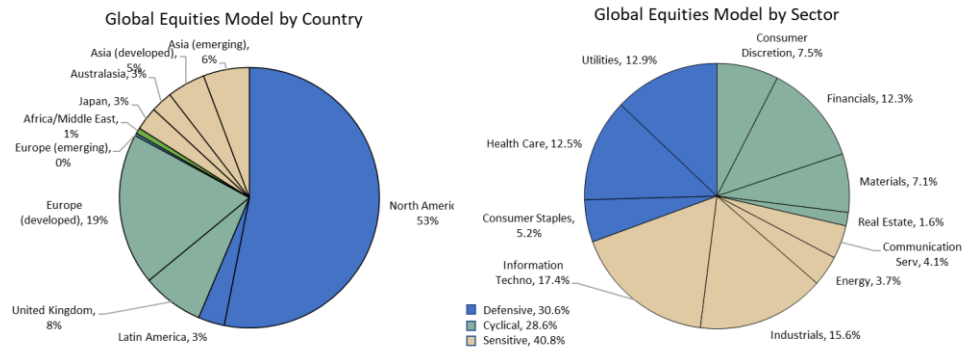
The current model is presented below.

Chart 1: Global equities CIO model of managed funds



Source: Escala Partners

Chart 2: Global equity model health check



Source: Escala Partners

We are happy with our 53% weight to North America. In our view, the regions most at risk of a recession over the coming 12-18 months are Europe and the UK. Where we do have exposure to these regions it is mainly in materials, such as Anglo American, or utilities, such as National Grid and Iberdrola. Both sectors tend to do well in late cycle. Since the start of the year the US S&P500 is down 20% versus -4.5% for Iberdrola, -1.5% for National Grid and +13% for Anglo American.

From a geographic perspective, one of the largest changes over the past 12 months is the reduction in emerging markets exposure, particularly to emerging Asia (from 11.9% to 6%). We are happy with this given the impact the strength in the US dollar tends to have on emerging markets. Emerging markets also tend to struggle in late cycle as growth eases.

This decline in weight to emerging markets is mostly due to our reduced weighting to the Franklin Global Growth Fund and WCM Global Growth. This has had the effect of reducing our top ten exposure to emerging market risk. In particular, HDFC Bank (a financial stock in India) and Mercado Libre have fallen out of the top ten. TSMC, the Taiwan semiconductor manufacturer, is still the number one holding for Fidelity Asia but has also fallen out of the top ten holdings.

In the past 12 months we have made some significant changes in our manager line-up to build in resiliency into the model to navigate a late cycle environment. This is best reflected in the changes in our sector weights.

Our exposure has increased to:

- Utilities, (from 0.3% to 12.9%),
- Consumer Staples (from 4.8% to 5.2%),
- Materials (from 4.1% to 7.1%), and
- Energy (from 0.5% to 3.7%).

Our exposure has decreased to:

- Information Technology (from 22.4% to 17.4%), and
- Consumer Discretionary (from 11.2% to 7.5%).

The total weight to technology stocks in our top ten is now just 1.7% in a single stock (Microsoft) compared to 3.5% across three stocks (Shopify, TSCM, Synopsys) 12 months ago.

Though being challenged in the current climate, Microsoft has a very strong balance sheet with \$105 billion in cash and equivalents. Its cloud unit, Azure, is growing by more 40% annually and it is expanding its margins. Azure generates \$19 billion in revenue (responsible for 38% of Microsoft's total revenue). Azure has several tailwinds given the heightened need for cybersecurity protocols and the increasing prevalence of remote work. Azure is growing across every industry, region, and type of customer.





nationalgrid

Microsoft has knocked Visa from its number one position in our top 10 holdings despite it being the stock most widely held by our model fund managers.

Visa derives its revenue from client services, data processing, cross-border transactions and value-added services, such as licensing fees. It does not issue credit cards and does not bear risk tied to the interest or fees paid by cardholders. The key tailwinds supporting Visa is the opening up of economies and the resurgence in travel and the intensification of the shift to digital payments. Visa is also disrupting the payments industry with its Visa Acceptance Cloud (VAC). VAC expands its "Tap to Phone" payment solution, allowing almost any device to be transformed into a cloud-connected payment terminal.

New to our top ten is National Grid – a UK utility stock held by our newly appointed Royal London Global Equities fund. With a yield of around 5%, the stock is seen as a safe hedge against inflation given its revenues (which are up by 16%) are tied to inflation. The shift to electricity should also mean faster growth in the future, as electric consumption replaces gas usage. This should translate into faster earnings growth, supporting higher dividends.

Table 4: Top 10 positions

Stock	% Holding	Sector	Country	CIO Model Funds
Microsoft Corp	1.7%	Technology	US	Royal London, WCM
Visa Inc	1.3%	Financial Services	US	MFS, WCM, Franklin
National Grid	1.1%	Utilities	UK	Royal London
Thermo Fisher	1.1%	Healthcare	US	MFS, WCM
Anglo American	1.1%	Materials	UK	Royal London
Amazon	1.1%	Consumer Disc	US	Royal London
Iberdrola	1.0%	Utilities	Spain	ClearBridge RARE
Suncor Energy	0.9%	Energy	Canada	Royal London
Reliance Steel	0.9%	Materials	US	Royal London
Steel Dynamics	0.9%	Materials	US	Royal London

Source: Morningstar

Table 5: Top holding in each sector

Sector	Top Holding	% Weight	Country	CIO Model Funds
Consumer Disc	Amazon	1.1%	US	Royal London
Financials	Visa	1.3%	US	MFS, WCM, Franklin
Materials	Anglo American	1.1%	UK	Royal London
Real Estate	Crown Castle Int	0.6%	US	ClearBridge RARE
Communication Serv	Alphabet	0.8%	US	Royal London
Industrials	Atlas Arteria	0.9%	Aust	ClearBridge RARE
Information Tech	Microsoft	1.7%	US	Royal London, WCM
Consumer Defensive	Pernod Ricard	0.5%	Fra	MFS, WCM
Health Care	Thermo Fisher	1.1%	US	MFS, WCM

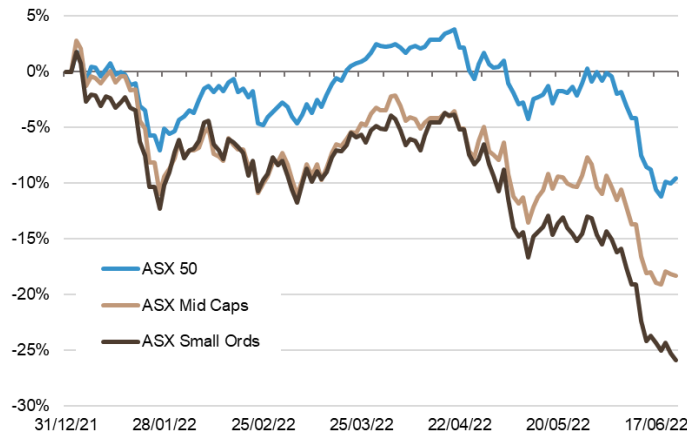
Source: Morningstar



Asset Class View

Australian Equities

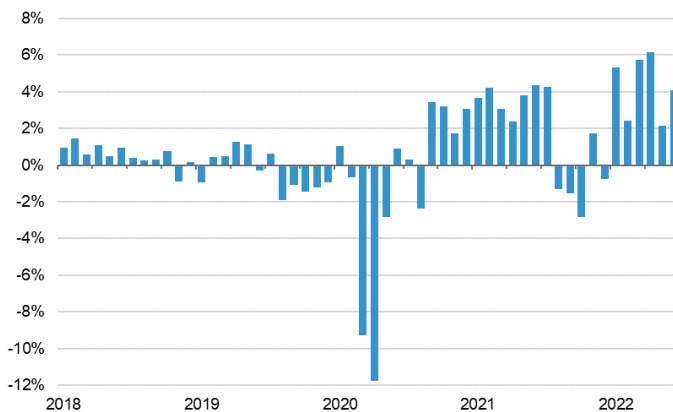
Chart 3: Bigger is better: Australian large caps limit losses in 2022



Source: Bloomberg

Bigger has been better for the Australian market in 2022. The 50 largest companies on the ASX have experienced more limited losses compared with their mid (ASX 51-100) and small cap counterparts though this year. Domestic large cap companies are, on aggregate, more mature, generate strong cashflows and hold dominant market positions than smaller companies, all characteristics which have been favoured by investors in 2022. Additionally, large caps have been helped by the solid performance of large cap resources stocks.

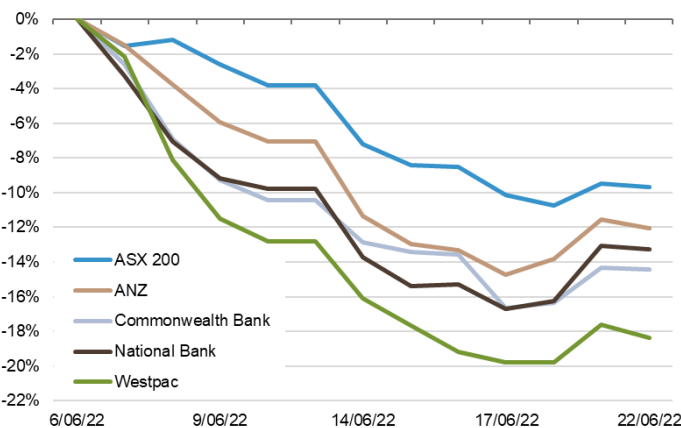
Chart 4: Earnings trends robust, defying rising recessionary risks



Source: Bloomberg

While the economic cycle is maturing and the RBA has now signalled a strong intent to combat inflation with sharp increases in interest rates, the earnings environment for the ASX 200 is yet to reflect any heightened recessionary risk over the next 12 months. In fact, earnings estimates for the ASX 200 have been revised higher in every month so far in 2022, underpinned by broad-based strength in commodity prices flowing through to the earnings of the resources sector.

Chart 5: Banks underperform on hawkish Reserve Bank of Australia



Source: Bloomberg

The shift in tone by the RBA at its most recent monetary policy meeting to signal a sharper hiking cycle in coming months has been reflected in the share prices of the major banks. With more economists now forecasting a sharper slowdown in the housing market, this has led to much weaker performance across the banking sector. Westpac and Commonwealth Bank, the two banks with the highest exposure to residential mortgages, have underperformed the market the most in the last few weeks.



Asset Class View

International Equities

Chart 6: Housing stocks feeling the pinch (S&P500 Home Builders sub-index)



Source: Bloomberg

The Mortgage Bankers Association's weekly gauge of mortgage applications showed that applications for a loan to purchase a home were 16% below last year's level.

Factors like rising rates and home prices have weighed on builder sentiment. The National Association of Home Builders' index gauging builder confidence declined for the sixth month in a row in June to its lowest reading since the same month in 2020.

No wonder housing stocks are falling. Two gauges of residential home building, housing starts and permits, fell further than expected in May. Starts fell 14.4% month over month while permits dropped 7%.

Chart 7: Chinese equities rebounding? (CSI 300 Index)



Source: Bloomberg

The rebound in Chinese credit supply last month has resulted in idle money sneaking back into equities. Last month's jump in loans was dominated by short-term lending, an indication that companies and households remain reluctant to borrow. Amid a housing slump, where do you think some of these funds are going?

At the same time, the stock rally enjoys little support from economic fundamentals. Industrial production is growing only slightly and consumer spending is contracting.

You could argue that the gains are on shaky foundation but since when have Chinese stocks traded on economic fundamentals? Liquidity and sentiment has always been a key driver in a market dominated by speculative retail investors.

Chart 8: US hotel and cruise line stocks getting belted



Source: Bloomberg

Royal Caribbean, Carnival and Norwegian Cruise are the three biggest S&P 500 decliners this month, each down well over 30%. Airlines also are among some of June's worst performers. The 7-member S&P 500 Hotels Resorts & Cruise Lines index is trading at the lowest since November 2020 and over 35% below its Feb. 2022 peak.

Travel and leisure are among the first luxuries to go as soaring fuel and food costs erode the cost of living. Plus, fuel is a big cost for cruise ships and airlines, which weigh on profits.

Signs are emerging that the consumer is slowing down. Retail spending growth slowed in May for the first time in five months.



Asset Class View

Fixed Income

Chart 9: US 30-year fixed mortgage rate (%)



Source: Bloomberg

Mortgage rates have jumped dramatically.

The average rate on a fixed 30-year loan rose 6%, the highest since November 2008.

The higher rates are the result of a shift in expectations about inflation and the course of monetary policy. Higher mortgage rates will lead to a moderation from the blistering pace of housing activity that we have experienced coming out of the pandemic.

Rates have climbed at a historic pace this year, making it more difficult for buyers to afford a home. The rate on a 30-year loan has doubled in the past six months, the biggest jump in the history.

Chart 10: Number of rate hikes priced in for Australia



Source: Bloomberg

The Reserve Bank of Australia will do what's necessary to bring inflation down to its 2-3% target according to Governor Philip Lowe in a rare interview with ABC TV. He warned inflation could hit 7% by year end and is unlikely to slow until the first quarter of 2023.

A day after those comments, Australia's industrial relations umpire raised the minimum wage by 5.2%, the largest increase in 16 years.

The combination of Lowe's signal, the wage ruling and the Federal Reserve setting the tone for aggressive rate hikes, led the market in Australia to price in 12 rate hikes over the remainder of this year taking the official cash rate to 3.8%. Whether we actually get there is another matter.

Chart 11: European corporate credit spreads (OAS)



Source: Bloomberg

As the European Central Bank and the Federal Reserve both focus on combating inflation this year, credit markets are bracing for impact.

Companies in Germany, the UK, France, Spain and Italy are the most distressed since August 2020, according to the Weil European Distress Index. The study aggregates data from more than 3,750 listed European firms.

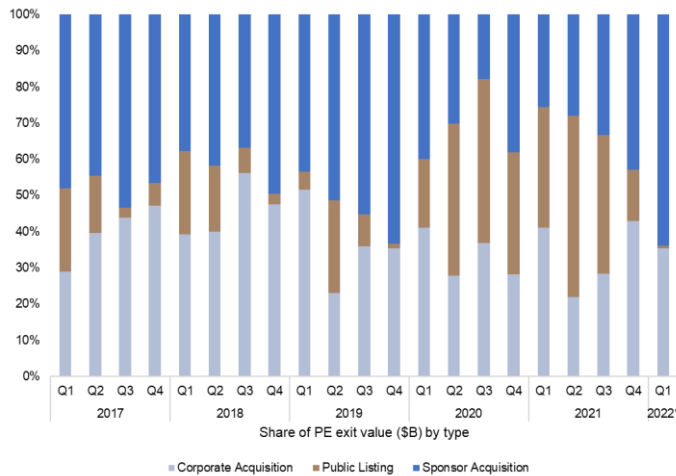
Businesses in Europe are struggling with rampant inflation, with firms forced to pay more for everything from fuel to labour. The resulting tightening of monetary policy by the Bank of England and the European Central Bank is also making it more expensive for companies to refinance their outstanding debt.



Asset Class View

Alternatives

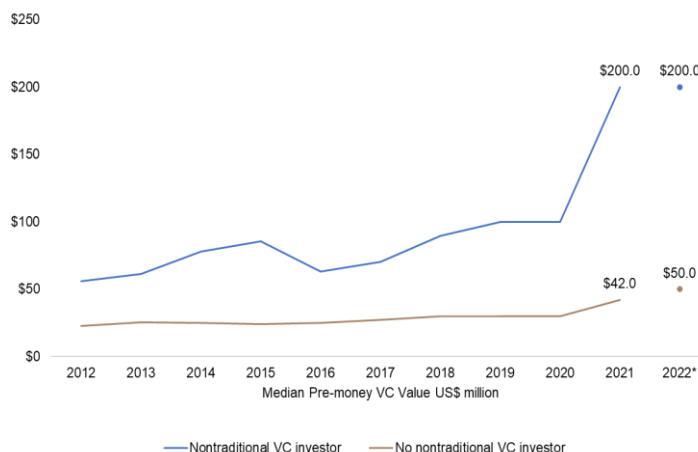
Chart 12: IPO market closed for business



Source: Pitchbook

Private Equity (PE) exit activity slowed drastically in Q1 2022 as exit count and value dropped by 57.2% and 57.5% respectively from Q4 2021. High inflation, rising interest rates and war in Ukraine have caused heightened uncertainty causing many PE firms to hold onto the portfolio companies instead of listing them in a struggling public market environment. Initial public offerings (IPOs) which accounted for an outsized share of exit activity throughout 2020 and 2021 came to a halt in the first quarter, accounting for less than 1.0% of all exits as public market valuations fell sharply.

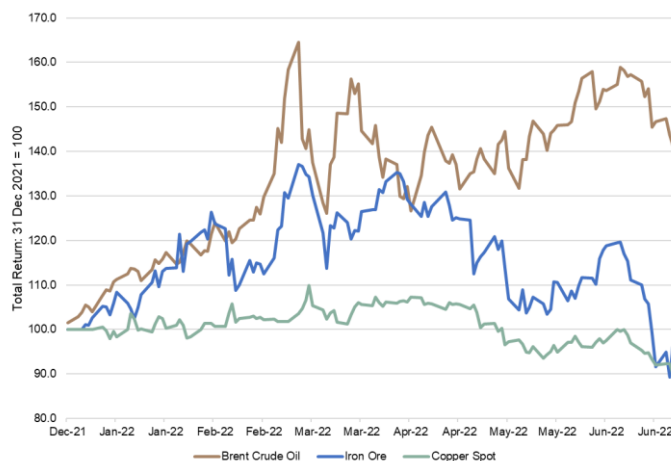
Chart 13: Venture capital non-traditional investors



Source: Pitchbook

Venture capital (VC) market activity reached multi-year highs in 2021 and although it slowed from the record pace set in 2021 it still remained above the long term average in Q1 2022. The number of deals which took place with non-traditional investors surged throughout 2021 and into Q1 2022 as institutional investors searched for access to high growing parts of the VC industry. Many traditional venture capital fund managers attribute some of the lofty valuations in VC markets to non-traditional investors willing to pay-up to get access to some of the most sought-after early stage companies. The valuations of deals including non-traditional VC investors were four times the valuation of deals that only included traditional VC investors.

Chart 14: Commodities soften on weaker growth prospects



Source: Bloomberg

Commodities across the energy and industrial metals sectors have fallen sharply in recent weeks on heightened fears of a recession in many regions across the world. The price of oil is set to fall in June, the first monthly decline since November 2021, as investors fear a global slowdown will materially impact demand for energy. Copper and iron ore which are closely tied to economic growth prospects have fallen 12% and 15% respectively in June whilst reports of excess stockpiles in China for both metals have added to weakness.

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