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*April 2022*

# MONTHLY AGENDA - ALTERNATIVES IN AN INFLATIONARY ENVIRONMENT

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## Alternative assets

The alternatives sector as a collective is diverse and includes such vehicles as hedge funds, private equity, venture capital, private debt and real assets. Over recent times, there have been some large performance dispersions across the different alternative strategies, which helps to highlight the heterogeneity of the asset class.

The alternative sector as a whole has not been immune to a range of unpredictable global and macro-economic events. Entering 2022, a combination of events has emerged including the Russian government's invasion of Ukraine, higher inflation and interest rates, with supply chain and labour challenges also increasing volatility in 2022.

Real assets are the tangible, essential building blocks of society.

Real assets are the tangible, essential building blocks of society. Real assets include real estate, infrastructure, natural resources, land, precious metals, and commodities. They are called 'real' as they can often provide an inflation adjusted level of return to investors through an income component. Alternative investments, especially real assets, have exhibited in the past low or negative correlation to equity and fixed income markets at times of increased volatility.

Over the past year, we have increased the allocation to alternatives. This reflects our view that this asset class offers greater risk-adjusted return potential providing investors can accommodate the illiquidity risk that this comes with. This month we assess how a number of the alternative asset classes are placed in these rapidly changing conditions, and how they are well placed versus other asset classes to combat the current inflationary environment.

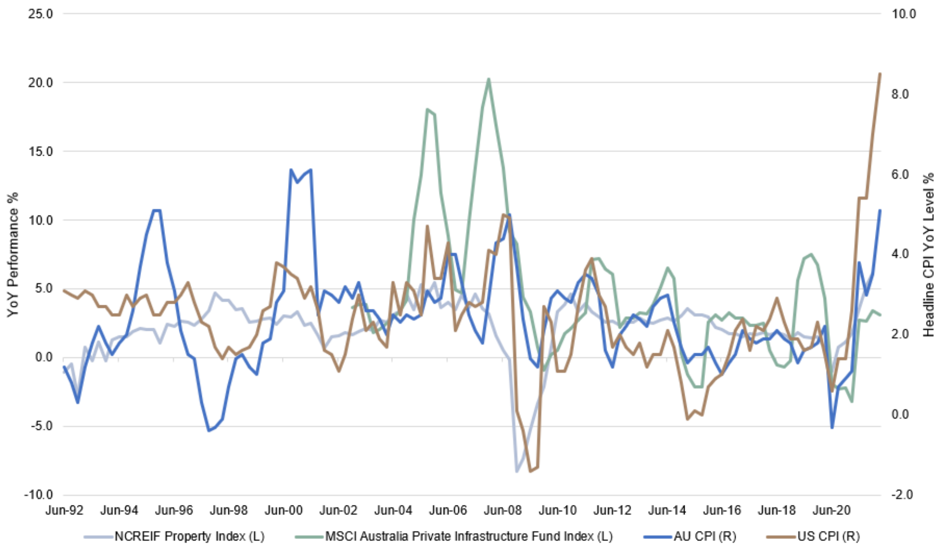
## What's driving inflation?

The start of 2022 brought strong economic tailwinds. Monetary and fiscal policy have been highly accommodative, while increasing vaccination rates are bringing back pre-pandemic activity levels. As COVID-19 restrictions have been lifted, production was unable to kick off as quickly as it had initially shut down. As it became increasingly apparent lockdowns would be more prolonged than initially hoped, consumer spending was reallocated across sectors, shifting towards goods and away from contact-intense services. This has seen bottlenecks in some places and spare capacity elsewhere. Strong consumer demand, particularly for goods, is accentuating supply chain disruptions. This has accelerated inflation that is now at the highest level since the early 1980s.

An economic landscape shaped by supply constraints will carry with it greater macro volatility. For example, where inflation is predominately demand-driven, stabilising inflation also stabilises growth. There is no trade-off. However, where supply constraints drive inflation, monetary policy cannot stabilise both inflation and growth – it must choose between them.

Despite experiencing the impact of supply chain disruptions, comparatively, Australia has been spared the worst. Supply chain bottlenecks have been milder in Australia and neighbouring Asia compared to the United States, who have borne the brunt of the supply chain issues. Despite this, Australia has recorded the largest annual increase in inflation since the introduction of the Goods and Services Tax (GST) in 2000. Consumer Price Index (or CPI) rose 5.1% annually as at March 2022.

## Chart 1: Real Estate and Infrastructure correlated with inflation




Source: Bloomberg

The impact of inflation varies across asset classes and investment types. Real assets remain a potent hedge against inflationary pressures, particularly where income is inflation linked.

### Direct Property

Commercial property can act as a hedge to inflation in a number of ways. For example, it is common for commercial real estate leases to have annual rent increases tied directly to increases in inflation (i.e. fixed rate plus CPI) - giving investors an income boost that offsets the effects of higher inflation. It is also common for annual rent increases to be set above the long-term inflationary outlook. This is why commercial property is regarded as an inflation hedge.

On the other hand, the sharp increase in building costs will likely constrain new supply in the near term, raw material prices have increased significantly whilst labour shortages and supply chain disruptions have also put upward pressure on costs. This will place a premium on existing high-quality assets in the property sector further supporting commercial real estate prices.

Complementing this inflation protection for the real estate sector is the structural tailwinds for many subsectors of commercial real estate including industrial, prime grade office and healthcare property which investors continue to have strong demand for given the defensive characteristics.

It is common for annual rent increases to be set above the long-term inflationary outlook.

In direct property, we recently introduced the Charter Hall Wholesale Property Securities No.2 (WPS No.2) which provides diversified property exposure including commercial, office, social and industrial exposure. Charter Hall's philosophy focuses on higher quality assets with lower levels of vacancy, often leased on long-term deals to government, listed and blue-chip tenants in prime CBD locations in the major cities across Australia. The aim is to provide investors with the defensive portfolio characteristics necessary at a time when parts of the market are coming under pressure and provides access to regular, reliable income through market ups and downs and act as a potential inflation hedge.

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## Infrastructure

The COVID-19 pandemic and recent climate events have underscored the importance of infrastructure, highlighted the inadequacy of certain pockets of existing infrastructure and significantly accelerated pre-existing trends, most notably a focus on renewables and energy transition, as well as the continued digitization of economies.

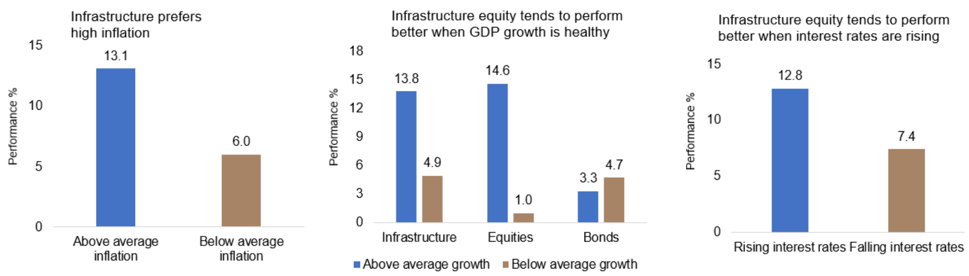
The first half of 2021 saw the global economy continue its recovery from the initial shock of COVID-19. The supportive environment for infrastructure was challenged in the latter half of the year as inflation showed itself to be more persistent than initially expected, and the market's expectations of interest rate hikes increased. This picture has now been further complicated by the conflict in Ukraine which continues to impact supply chains and energy prices, muddying the situation for policy makers as the fear of inflation is quickly becoming the fear of stagflation.

Infrastructure investors seek businesses with long-term contracts to provide income stability and certainty.

**Will infrastructure be a hedge against inflation?**

History suggests Infrastructure assets, on average, are less sensitive to inflation, and in many environments will perform ahead of other growth focused assets and display the resiliency and defensiveness that investors expect from assets that are generally uncorrelated to economic growth throughout the cycle.

**Chart 2: The impact of inflation, GDP growth and interest rates**




Source: Macquarie Group

The extent of the inflation protection can vary dramatically based on several factors. Infrastructure investors often seek businesses with long-term contracts to provide income stability and certainty. Assets and essential services that have either explicit inflation linked pricing or those that have true inelastic demand will likely benefit from the inflation protecting attributes of infrastructure. However, if an asset's pricing does not reset with inflation or is unable to pass through any input cost inflation, the impact from a prolonged inflationary environment could significantly erode value.

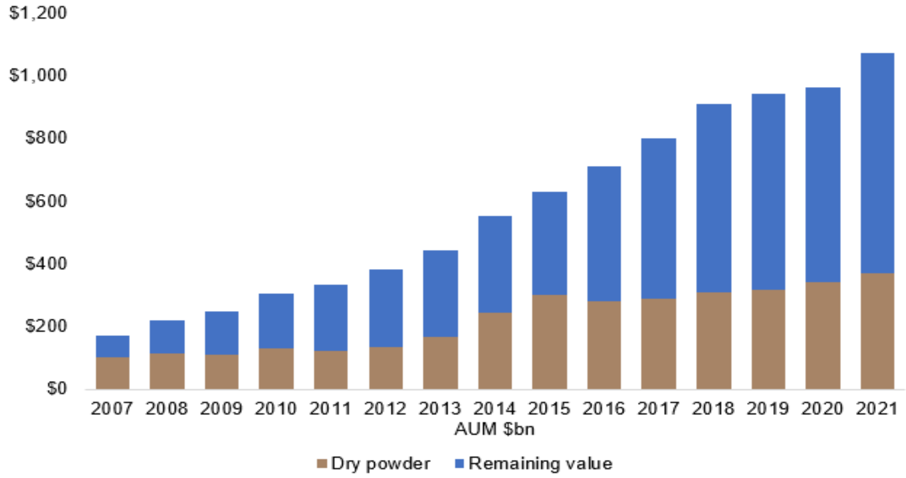
If inflation is being driven by energy prices, wage growth, and/or raw material prices, the impact on infrastructure businesses could be more pronounced. There are mitigants to this, but it is more pronounced in some assets versus others. Those assets with larger labour forces and those that are undergoing heavy capital expenditure (requiring raw materials) are more at risk if they are not able to generate proportional increases in revenue. Conversely, a number of the new-economy infrastructure assets have more structural protection from input inflation given lower exposure to energy prices and raw materials and tend to have proportionally smaller labour forces.

## What's the impact of rising rates on infrastructure?

The impact of historic low interest rates has seen infrastructure valuations in certain parts of the market move towards elevated valuations. There is however reason to believe that the "floor" to infrastructure valuations is likely to remain elevated - the key reason being the significant increase in the level of capital participating in infrastructure markets.

As infrastructure managers have raised more capital, and as a number of institutional sovereign and public entities have invested directly in infrastructure, the competition and prices for these assets has increased. Due to the sizable nature of many infrastructure investments, funds in the space tend to be massive – the average fund size in 2021 was $1.4 billion. These pools of capital are relatively stable and are expected to continue to participate in infrastructure markets.

**Chart 3: Real Asset AUM now above $1 trillion**

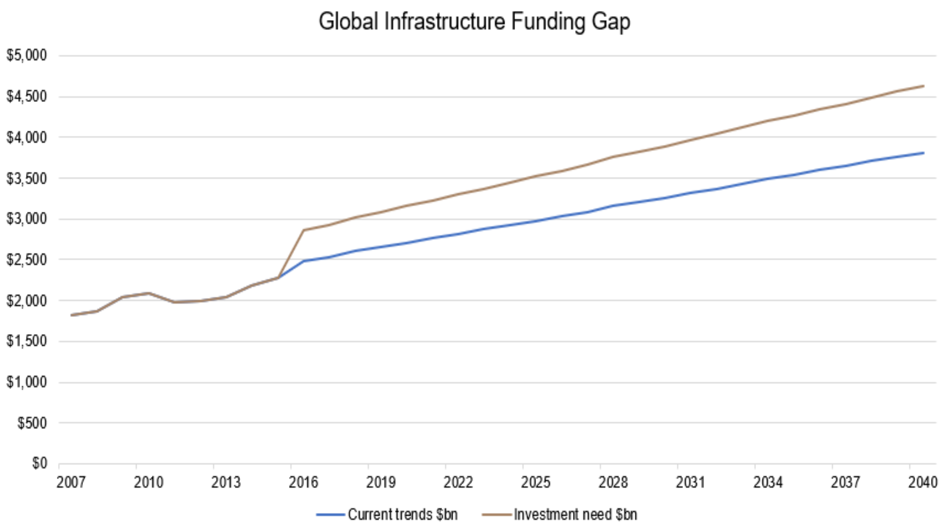



Source: Pitchbook

Post the pandemic, many of the structural changes infrastructure fund managers were focused on have accelerated. Significant opportunities are opening up for investment into next generation infrastructure such as renewable energy and key areas of digitization like fibre networks, towers and data centres. Whilst many governments have made infrastructure a core component of their post-pandemic recovery plans, the level of fiscal spending on infrastructure projects won't be enough to fill the gap for what is required, leaving a big opportunity for private sector investment in many of these strong growth sectors.

The Organisation for Economic Co-operation and Development (OECD) estimates that decarbonization efforts alone will require in excess of $6.9 trillion of investment annually by 2030 to meet interim targets while some estimates suggest telecommunication infrastructure upgrades will require in excess of $9 trillion by 2040.

**Chart 4: Global Infrastructure Funding Gap**




Source: Global Infrastructure Hub

Higher inflation and rising interest rates and the resulting impacts reminds us that not all infrastructure assets are created equally and also highlights the importance of manager selection. While rising inflation may aid those infrastructure businesses with inflation linked pricing, inelastic demand, and stable cost structures, while adversely affecting those that don't hold such attributes. Rising interest rates may put pressure on the recent premium pricing that we have seen in the largest core assets but should have less of an impact on value-add assets, which have less interest rate sensitivity.

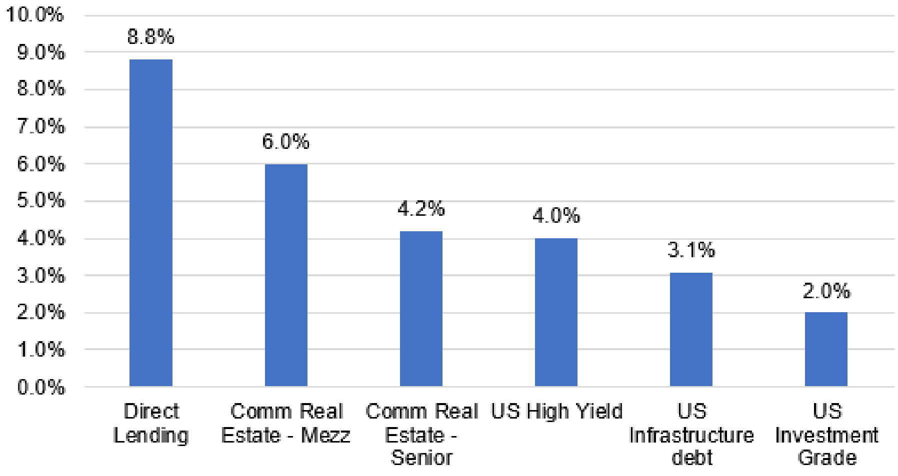
## Private Debt

Outside of real asset classes, other strategies across private markets, in particular private debt, are well equipped to deal with the ongoing market volatility and changes to interest rates.

In periods of higher inflation, private debt can offer investors a level of protection – being a floating rate asset class means the underlying yield increases as inflation and interest rates increase. Additionally, the long term, patient capital nature of private debt, and the ability to absorb and pass on rising costs mean these strategies can actually benefit from inflation, with investors still well-compensated for taking illiquidity and complexity risk.

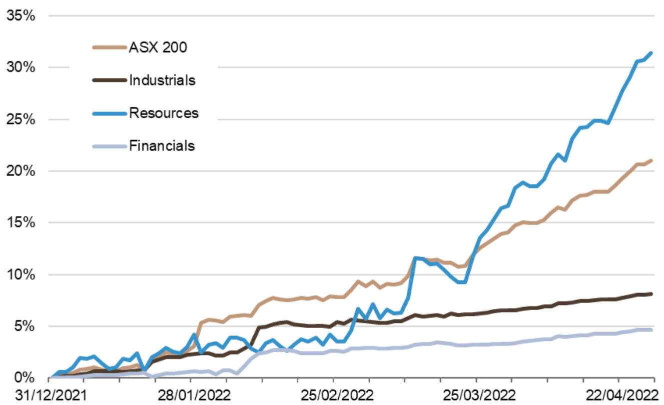
For example, we recently introduced the Partners Group Global Income. The fund is expected to be 95% invested floating rate debt securities, consequently duration risk is considered to be low. The fund is highly diverse across industry sector, country and position with exposures to in excess of 380 loans. Private debt is typically floating rate and therefore the pricing of private debt is not as sensitive as a typical bond investment.

**Chart 5: Private Credit spreads remain attractive**




Source: JPMorgan, Q3 2021

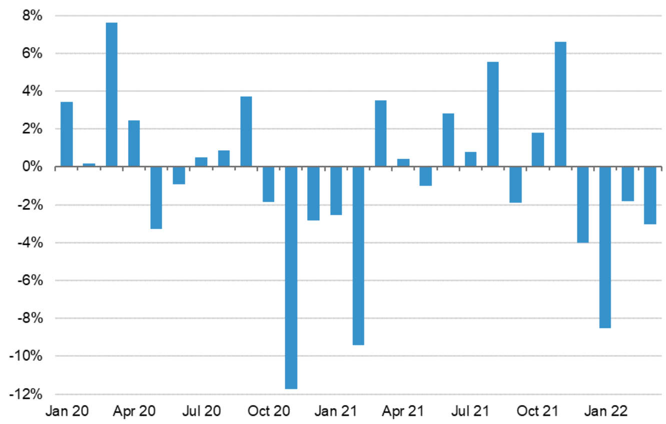
**Chart 6: Robust earnings: revisions since start of the year**




Source: Bloomberg

While many key global equity indices have struggled in the first few months of 2022, the Australian market has performed much better, with the benchmark ASX 200 only slightly lower than the beginning of the year despite the numerous headwinds that have emerged. An ongoing supportive earnings environment has underpinned this outcome, with earnings revisions continuing to trend higher. In particular, resources have led the way on the back of rising commodity prices, helping to lift the earnings of mining and energy companies by more than 30%.

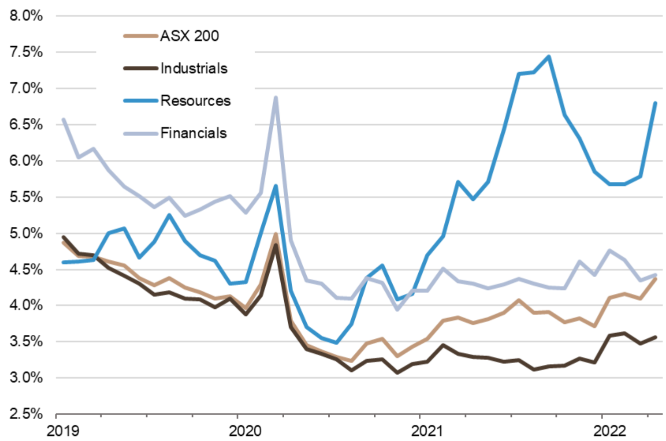
**Chart 7: Value outperformance continues over growth (MSCI Australia Value - Growth monthly returns)**




Source: Bloomberg

The market's recovery from the height of the COVID crisis has been marked by two distinct periods whereby cheaper 'value' stocks have outperformed their more expensive 'growth' counterparts. The first occurred around the announcement of the vaccines, with investors piling into companies that suffered the most impact from lockdowns. The second has played out through much of 2022 as an increasingly sharp monetary policy cycle is anticipated, leading to a surge in nominal and real interest rates. Consequently, cheaper stocks in the Australian market have now completed their fourth successive month of outperformance over growth.

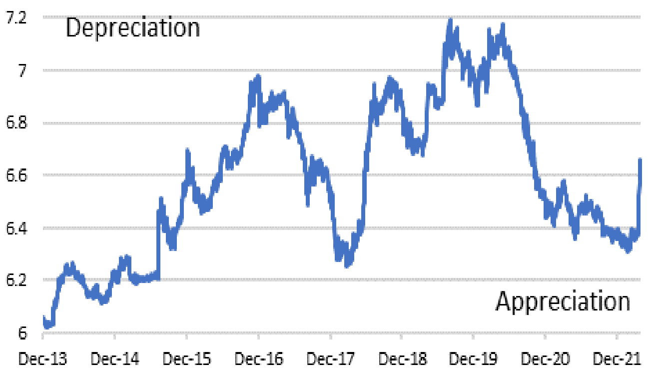
**Chart 8: Resources dividends supporting market's yield (Forward dividend yield)**




Source: Bloomberg

With earnings and dividends trending higher amidst more volatile equity markets, the forward dividend yield of the ASX 200 has also lifted back closer towards its pre-COVID level of 4.0-4.5%. However, the composition of the market's yield has changed significantly in the last two years. Industrials currently trade on a yield of around 1% lower than the ASX 200 and financials no longer offer a yield premium. Meanwhile, resources now trade on a yield of almost 7%, though are seen as a less sustainable source of dividends given their dependence on commodity prices.

**Chart 9: Chinese yuan surprise weakness against the USD – USDCNH – Chinese offshore exchange rate**

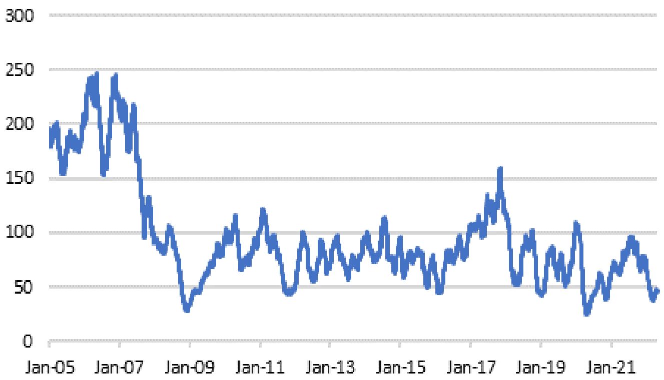



Source: Bloomberg

The yuan's recent fall is the largest seen since the August 2015 devaluation. There are several differences compared to then, but the key underlying imbalances of the Chinese economy that prompted the devaluation are little changed. China continues to repress the household sector to the benefit of the SOE and exports. This means China produces much more than the household sector can consume, and so China must export the surplus abroad.

Household consumption relative to GDP, after rising for a few years, is falling again. China is allowing the yuan to ease to alleviate pressure on employment from tighter credit and Covid-driven shortfalls in demand. However, an artificially weaker yuan leads to a larger trade surplus, further stoking imbalances. The risk with allowing the yuan to weaken is it can beget more capital outflow, putting further pressure on the currency. This was what happened in 2015.

**Chart 10: S&P500 Trading Liquidity**

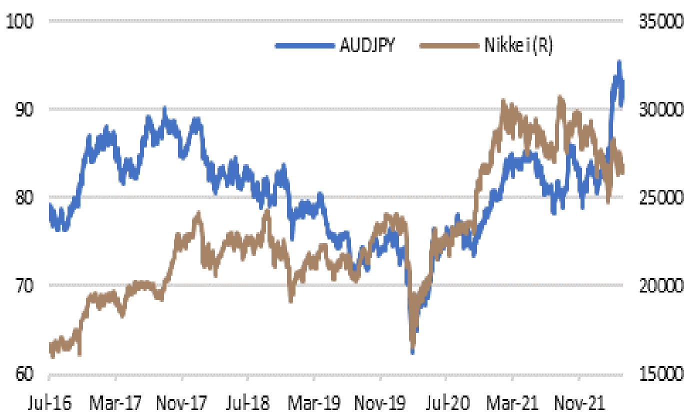



Source: Bloomberg

Increased tension with Russia is just the latest risk that's making stocks jumpy, adding to the perils of soaring bond yields and inflation forecasts that while receding, remain elevated.

All of that has made for a difficult April in what is historically the best month of the year for equities. For investors awash with liquidity, there aren't many good places to hide, with the exception of cash. Yet for those wanting to reduce risk, there's a catch: low trading liquidity largely explained by the absence of large institutional investors.

**Chart 11: Weaker yen not supporting Japanese equities**




Source: Bloomberg

The yen is heading for its worst month against the dollar since November 2016 - when Donald Trump won the Presidential election. The losses probably have further to go.

The BOJ is sticking to its powerful easing buying unlimited amounts of bonds to maintain the 0.25% yield target - quite a contrast to the rate hikes and quantitative tightening emerging elsewhere.

The relentless decline in the Japanese yen has failed to lift Japanese stocks – the close correlation has broken down recently. That suggests there's been limited benefits for corporate earnings from a weaker exchange rate so far.

**Chart 12: Number of RBA rate hikes priced by the bond market**


Source: Bloomberg

The Australian inflation data exceeded expectations in March coming in at 5.1% versus 4.6% expected for the March quarter. That leaves inflation at the highest level since June 2001 and opened up the possibility of the RBA raising rates by 15bps in May. This would be the first rate rise in over 10 years and would come crucially just before the May 21 Federal Election.

The Australian bond market now has 10 rate rises priced in by the Reserve Bank for 2022 taking the official cash rate to 2.5%.

**Chart 13: Mortgage rates rising in the US**


Source: Bloomberg

US housing is facing mounting headwinds from higher rates. The housing market in the US is beginning to look as overvalued as it was in 2005, prior to the housing crisis. The dynamics are different this time - this is a supply-led rise in prices rather than a credit-driven demand one - but once again rising rates are having a deadening impact.

The 30-year mortgage rate has risen to 5.4%. Rises in mortgage rates typically precede falls in building permits, an excellent leading indicator for the housing market overall. Annual growth in building permits has already collapsed from 35% a year ago to only 3% at the end of last year. The malaise in residential fixed investment is soon set to drag non-residential investment lower too. Both sectors together account for almost 20% of GDP.

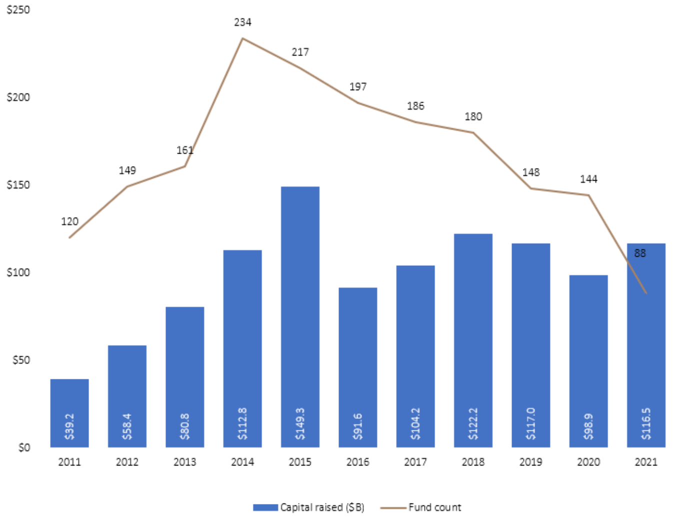
**Chart 14: Chinese 10-year bond yields (%)**


Source: Bloomberg

When lockdowns and Covid Zero crimp output from Beijing to Shanghai, China - being the factory to the world - imports weakness in its economy and starts to export inflation to the global markets. Already, anecdotal reports of how supplies due from the mainland to far-flung destinations have been stalled without any firm arrival date abound, and the latest scare will only make those bottlenecks worse.

For China this is showing up in weaker economic growth and lower bond yields.

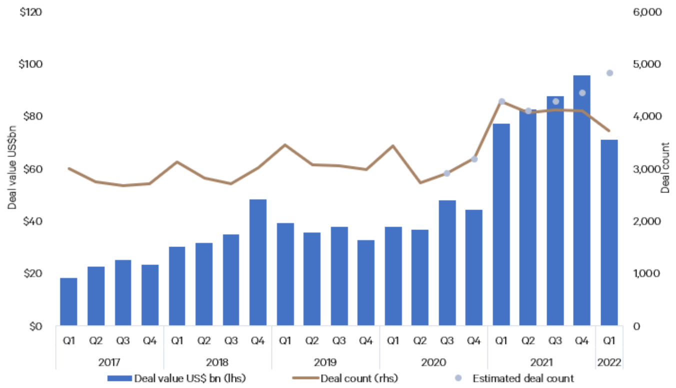
**Chart 15: Real assets fundraising activity**




Source: Pitchbook

Real assets funds had a solid 2021, with firms closing on $116.5 billion across 88 funds. This represents an uptick over the total capital raised in 2020 and is in line with the five-year average. The relatively flat fundraising sum disguises the underlying trend toward infrastructure funds. Just under 90% of the total capital raised was in infrastructure funds, a substantial rise from the approximately 55% of one decade prior. Due to the sizable nature of many infrastructure investments, funds in the space tend to be massive – the average fund size in 2021 was $1.4 billion.

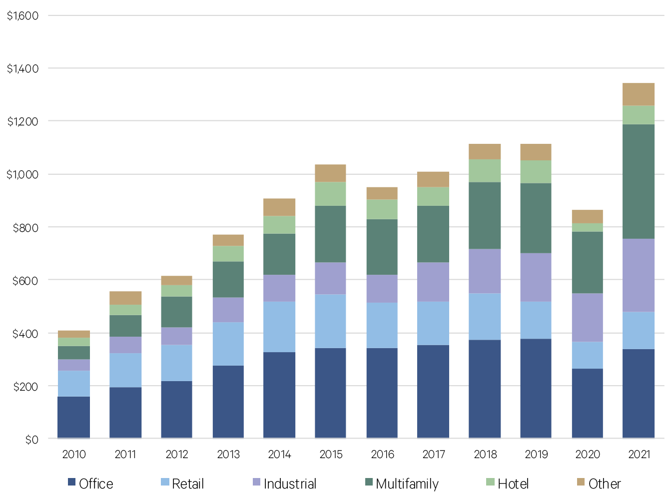
**Chart 16: US VC deal activity by quarter**




Source: Pitchbook

Fundraising has launched into 2022 with the momentum of recent record years of fundraising. US VC-backed companies raised $70.7 billion across an estimated total of 4,822 deals in Q1, marking the highest number of closed transactions in any quarter on record. Even though Q1 deal value was lower than every quarter in 2021, the number still exceeded pre-2021 quarterly totals dating back to 2010. The added dry powder should help further insulate the market from immediate, major disruption. VC deal activity will likely see a delayed reaction to the public market slowdown.

**Chart 17: Global real estate deal volume, $ billion**




Source: CBRE, McKinsey & Company

Global real estate deal volume reached an all-time high of over $1.3 trillion in 2021, after a dramatic slowdown in 2020, when markets effectively stopped transacting in the second quarter. The fourth quarter in 2021, when $498 billion of real estate changed hands, was the most active on record. By sector, multifamily and industrial reached record-breaking totals, which contributed more than half of total transaction value. Growth within these two sectors spiked, as pandemic-driven tailwinds became apparent to investors. Industrial deal volume grew for the fifth consecutive year.

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