ESCALA
PARTNERS

AGENDA 2023

Chief Investment Office

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Welcome

Welcome to the fourth edition of our annual investment publication, Agenda 2023. This publication is compiled by our investment team headed by our Chief Investment Officer, Tracey McNaughton.

There is no doubt, 2022 was a challenging year not just for investors, but for the environment and for humanity.

The world is currently witness to the largest number of violent conflicts since 1946. A quarter of the global population lives in conflict-affected countries with a record 100 million people forcibly displaced worldwide. Millions more were displaced due to pollution, extreme fire events, cyclones, hurricanes, unprecedented heatwaves, droughts, and devastating floods.

The social and environmental costs are large and they do affect investment returns. Even if you could exit, an investment in Gazprom has halved in value since the February 24 invasion of Ukraine. It has been estimated that the failure of institutional investors to address climate change risks can reduce the value of their portfolios by as much as 10 percent over the next 20 years (IFC).

From an investment perspective, there is not a single person alive who can remember a year that we have just had because we have never had a year like 2022. Bonds put in the worst performance in the history of the asset class. Thanks to decades-high inflation, the major central banks around the world raised interest rates at the fastest pace on record. There were few places to hide. The traditional 60/40 portfolio of Australian bonds and stocks underperformed dramatically.

If nothing else, 2022 was an exercise in humility when it comes to forecasting and guarding yourself against excessive hubris. What follows from Tracey and the team is not so much pinpoint estimates (although we do provide Bloomberg consensus forecasts for economic growth) but a narrative on the investment landscape, where we currently stand in it and how recent events may have affected where we go to from here. 2023 will undoubtedly continue to surprise on the global front. What we intend to do with the Agenda 2023 is outline a strategy for the year ahead.

The best investment strategy remains one that embraces diversification. The best diversification strategy is one that is soundly based on process and devoid of emotion. For many, 2022 was an emotional year. For investors, that should never be the case.

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Our Views in Brief

Global Growth

Global growth is expected to slow in 2023. That overall deceleration masks substantial differences within regions. Developed market economies are likely to struggle, while emerging economies will fare relatively better. India will overtake China to become the world's most populous country.

Inflation

Inflation is likely at, or close to, a peak for most of the major economies, with disinflation (slowing inflation) driving the narrative this year. Consumer goods prices have already started to fall on the back of supply chain normalisation and weaker demand; easing labour demand should temper elevated services inflation.

Interest Rates

For major developed market central banks, monetary policy is in restrictive territory and will likely stay that way throughout 2023. We expect to see a plateauing of interest rates from most major central banks by the second quarter with pressure building to ease monetary policy by the end of the year.

Fiscal Policy

Offsetting the drag from monetary policy will be stimulatory fiscal policy driven by the pivot to renewables, increased defence spending and energy assistance packages. This includes the Infrastructure Investment and Jobs Act and the Inflation Reduction Act in the US, and the Next Generation recovery plan in Europe.

Bond Yields

Slower economic growth and easing inflation pressure should coincide with lower bond yields making duration once again attractive. Higher short-term rates and generally good corporate fundamentals make high quality floating rate credit attractive.

Equities

High input costs and a growing reluctance from consumers to absorb higher prices will pressure margins and may mean equity investors are less insulated from the sting of inflation. Slowing demand will impact earnings in 2023, particularly for the more cyclical sectors of the market.

Currencies

We expect the US dollar to weaken in 2023 but mainly against the euro and Japanese yen. The Australian dollar will need to contend with slower growth in China and lower iron ore prices. Our preference for Australian-domiciled investors is to be 100% unhedged on their international equity position.

Alternatives

In general, alternatives offer the most attractive risk-adjusted returns for investors and will continue to do so in 2023. In particular we like private debt for yield and unlisted infrastructure for growth and a hedge against inflation. Direct property will be challenged by higher interest rates and slowing demand for space.

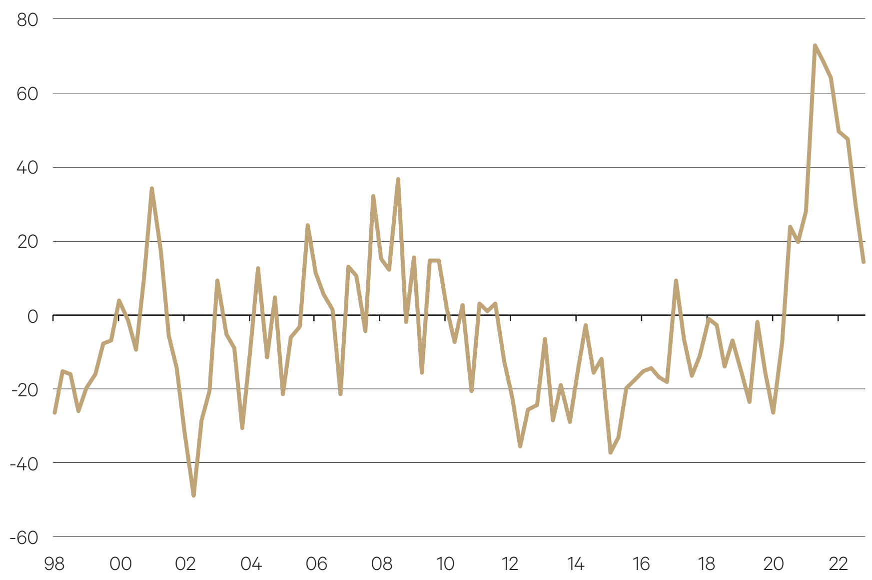
Exogeneity

Tracey McNaughton
Chief Investment Officer

2022 was a year like no other. Shocks ruled and fundamentals and market pricing became a passenger to what were exogenous, unforecastable, events. These events were not in the data and therefore not in the models or minds of investors or policymakers. And yet it was these events that ultimately drove financial market performance through the year.

No wonder economists, analysts and central bankers were so surprised. Coming into 2022, a Bloomberg survey of economists predicted the US economy would grow by 3.9% in 2022 (1.9% is more likely); inflation was expected to come in at 4.3% (more likely to come in around 6.5%); and the official interest rate was expected to be at 0.75% (it actually finished the year at 4.5%).

Citi US inflation surprise index



Source: Bloomberg

12%

The share of the world's semiconductors made by the US in 2022 compared to 37% made by the US in the 1990s.

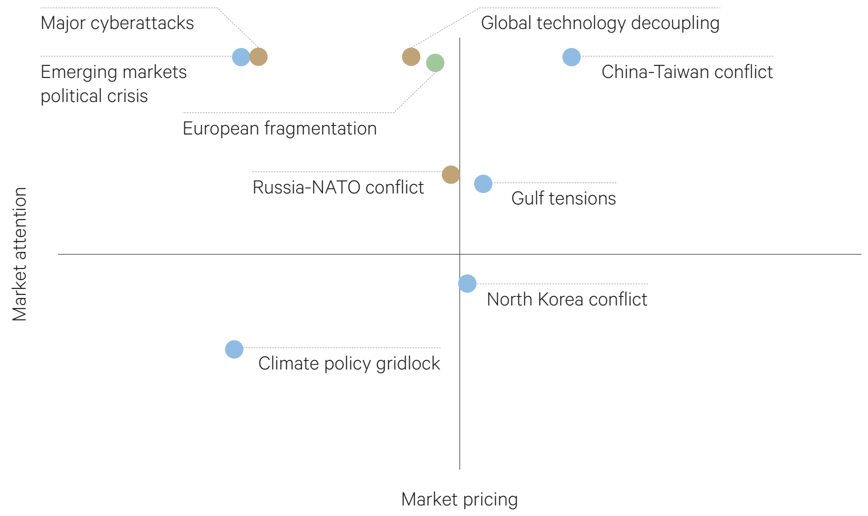
Shocks to economic, political, health and social systems have been pronounced and their after-effects are likely to be felt for some time. Behaviour is already changing. Workers are re-thinking their relationship with their employers. Consumers are becoming more conscious of their impact on the planet. Companies are re-structuring supply chains. Governments are investing in new security measures to protect against critical resources such as food, energy, pharmaceuticals, rare earths and data.

Global resource allocation is no longer premised solely on comparative advantage. Manufacturing is re-shoring and global trade is declining. When was the last time we had a multilateral free trade agreement? The Trans-Pacific Partnership (TPP) was never ratified due to the withdrawal of the United States in 2017 (it did evolve into a watered-down agreement which was ratified by the remaining 11 countries in 2018). Resilience, security and national interest are now challenging efficiency! David Ricardo would be shocked.

A costlier, more uncertain world

The world has taken a step away from a primary economic objective of efficient resource allocation. There are now multiple, sometimes conflicting, objectives. National interest is driving a rapid rise in fiscal spending on defence, food, energy, and data security. Any one of these could be the source of the next geopolitical event. For this reason, while we do believe fundamentals will play a greater role in 2023 than they did in 2022, geopolitical tensions will remain elevated for some time. This means uncertainty, whilst always and everywhere a feature of investing, seems to have taken a step up.

BlackRock geopolitical risk map



Liklihood: High Medium Low
Source: BlackRock

David Ricardo would be shocked.

Anytime there is a move away from efficient resource allocation, costs rise. This doesn't necessarily translate into inflation if it is just a one-off. Buying protection software against cyberattacks for your computer is a one-off cost. It won't add to inflation but it will mean an allocation of precious resource that will not add to your productivity. Higher government spending on security measures will have a similar impact on productivity.

Shifting your manufacturing base onshore in the name of security of supply chain will add to inflation because labour costs will be higher. This new, more uncertain, environment has the potential to lower growth in the economy (by reducing productivity) while at the same time adding to inflation pressure.

Fundamentals will likely start to matter more in 2023

Some of the exogenous events that we experienced in the past few years are now in the data. The impact of the invasion of Ukraine is in the commodity price data; the impact of covid on the supply of labour is in the wages data; the impact of climate change is making its way into the risk data for insurance companies (and subsequently insurance premiums).

We now know inflation isn't transitory. This understanding will make its way into company earnings reports and ultimately be reflected in stock prices. Until now, company earnings have largely been impervious to higher interest rates and higher inflation. This is largely because consumers have been cushioned by relief-swollen savings accounts. That won't continue. Those accounts are running down. Consumer sensitivity to prices will increase this year and this will be reflected in lower corporate earnings.

Money now has a cost and scarcity rather than abundance. There is now a cost to pay for future profitability. A return to focusing on cashflows and fundamentals will necessarily feature heavily this year. Focussing on companies with a high return on invested capital and avoiding those that don't will be key, regardless of size or style.

US$580bn

The amount raised for climate-friendly projects in 2022, more than that for fossil fuel projects.

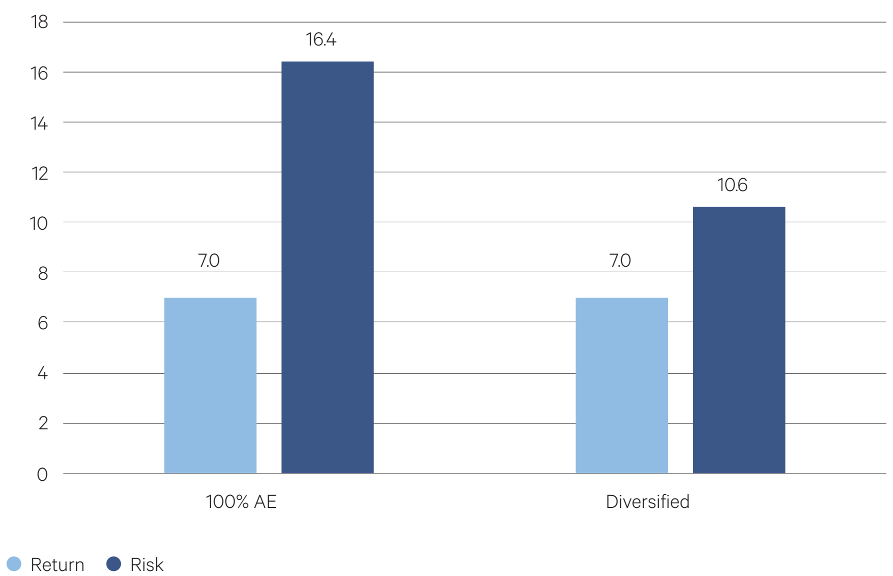
Exogeneity (contd.)

Shock proof portfolios

Risk can be priced into an asset price; uncertainty cannot. In the case of risk, the outcome is unknown, but the probability distribution governing that outcome is known. Investors can manage this by understanding how much risk they are willing to take given those probabilities. Uncertainty, on the other hand, is characterised by both an unknown outcome and an unknown probability distribution. For this reason, uncertainty is harder to price in the market. Investors can counter this by building shock-proof portfolios. This means having as many different levers embedded in the portfolio as possible – diversify by asset class, geography, size, and style.

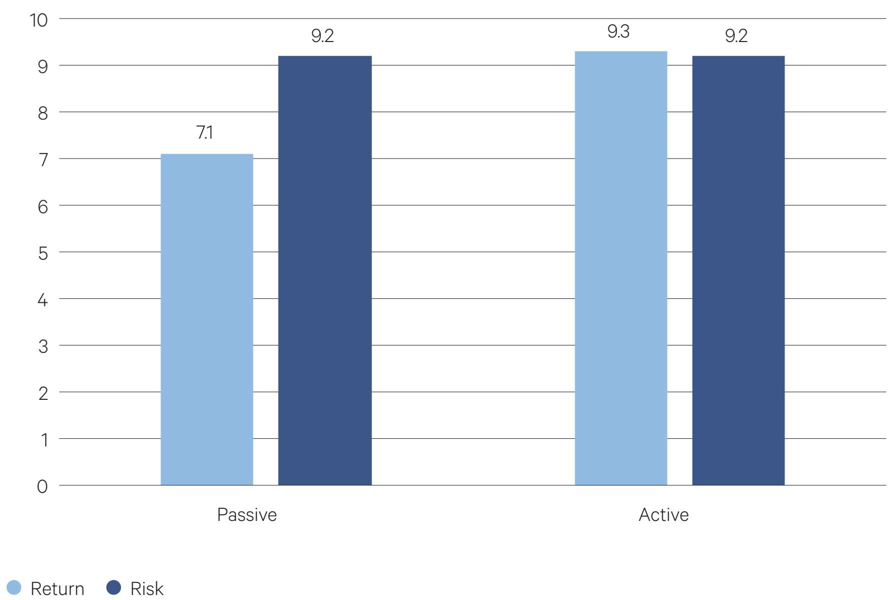
The charts below are based on actual performance over the past 5 years. The charts show that having a diversified portfolio reduces risk (relative to a portfolio that is 100% Australian equities) and having a portfolio of active funds increases returns compared to the passive equivalent.

Less risk being diversified (5yr)



Source: Morningstar, data as at 31/12/22

More return being active (5yr)



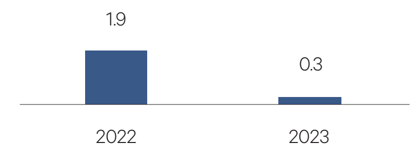
Source: Morningstar, data as at 31/12/22

Global Economy Breakdown

United States

The probability of recession is high in 2023 as tighter financial conditions (interest rates and the US dollar) lead to slower demand – consumption, capital expenditure and housing. Unemployment will likely rise as it has done in every US recession since 1949 pressuring already depleted household savings.

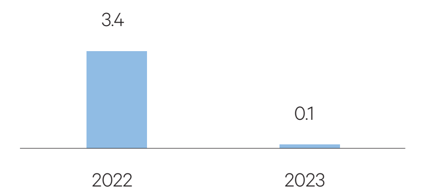
GDP %



Europe

The Eurozone is already likely in recession. Europe is facing an energy shock unlike anything the region has seen since the OPEC price increases in the 1970s. Fiscal support, high household savings and tight labour markets will provide some downside cushion.

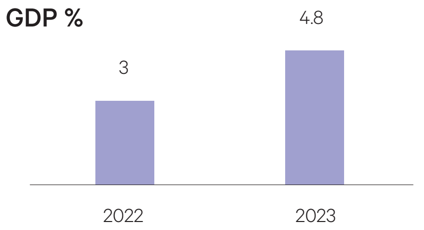
GDP %



China

Growth in China is expected to accelerate this year on the back of an easing in its zero-covid strategy. China has now opened borders that had been largely closed for nearly three years. Price growth is expected to be subdued as wages growth eases. The government is also stepping up efforts to bolster the economy.

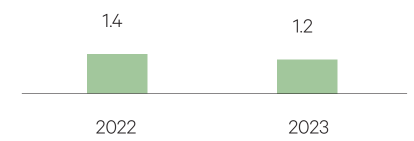
GDP %



Japan

The key change in the Japanese economy is the emergence of sustained inflation and its flow through to wages. Japan's inflation started as a cost-push phenomenon fueled by higher import prices but has spread to services. The Bank of Japan is expected to end yield curve control by the middle of the year.

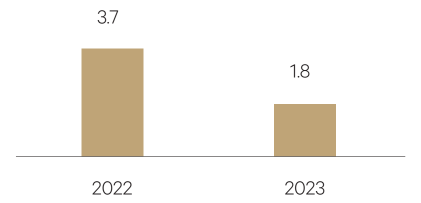
GDP %



Australia

Inflation is likely near its peak and should allow the RBA to pause its monetary tightening cycle in the first half of the year. Growth is expected to slow as highly leveraged households pullback on spending. Downside risk lies with a global slowdown and inflation pressures that fail to abate.

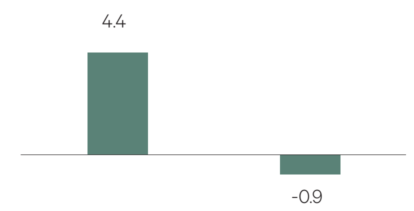
GDP %



United Kingdom

The UK entered a recession in Q3 2022 with the size of its economy still 0.8% below its pre-pandemic peak. Large fiscal support is keeping upward pressure on prices ensuring inflation falls only slowly through the year. Curbing price gains will require further tightening from the Bank of England.

GDP %



Source: Bloomberg, data as at 31/12/22

Theme 1:
Digging Deep into Net Zero

Over the past year there have been many eye-catching commitments to net zero but none more so than US President Biden's Inflation Reduction Act (IRA) which has been considered the single biggest piece of policy support globally in the fight to achieve net zero. The act sets out plans for US$369bn of spending over the next decade across renewables, electric vehicles (EVs), batteries and hydrogen.

The 2021 European Green Deal, later usurped by the REPowerEU initiative following the Russian invasion of Ukraine, plans to spend €210bn in the next five years to help accelerate the transition away from fossil fuels and dependence on Russian oil and gas. Under the deal the EU aims to double the amount of solar energy produced in Europe and increase the overall share of renewables to 45% by 2027.

Rolling out a fleet of zero emission vehicles across the world will result in over 145 million EV's manufactured by 2030 which will be powered by 105 million private charging points. Currently there are just 1.8 million charging points available across the world.

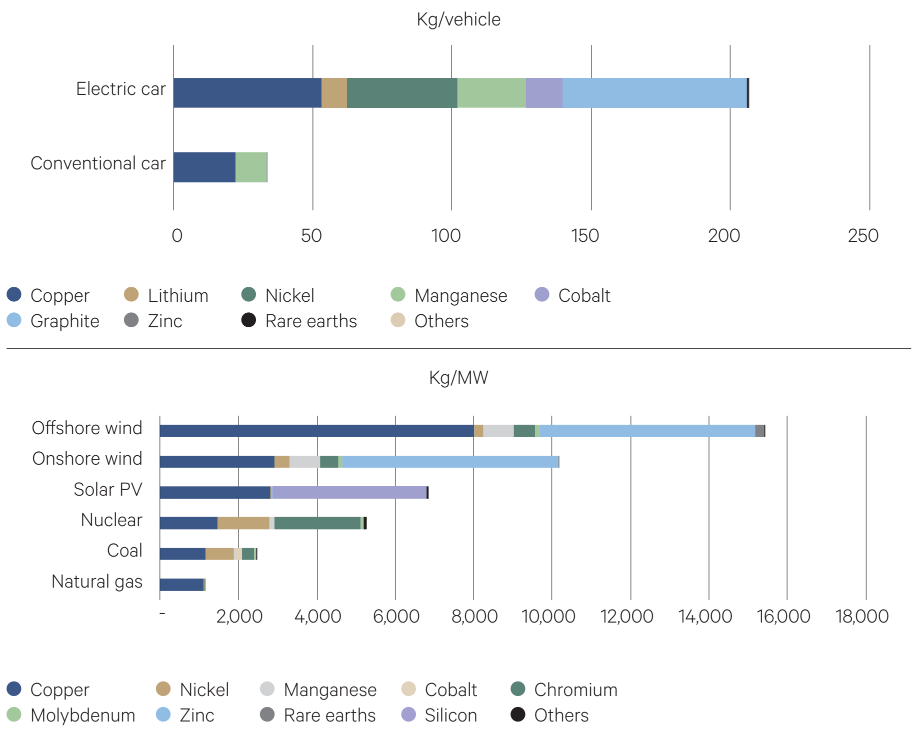
The ongoing energy crisis and the war in Ukraine has triggered unprecedented momentum behind renewables. The world is set to add as much renewable power over the next 5 years as it did in the whole of the past 20 years.

45%

Share to renewables planned by Europe by 2027.

All of these commitments will require an enormous amount of raw materials including copper, aluminium, graphite, cobalt, lithium, zinc, manganese, nickel and rare earth elements. Nickel and copper demand are forecast to grow by 3,300% and 3,000% respectively between 2020 and 2040 whilst Goldman Sachs predict supply deficits for critical materials such as cobalt, nickel and lithium by 2030.

Electric vehicles and renewable energy require significantly more raw materials

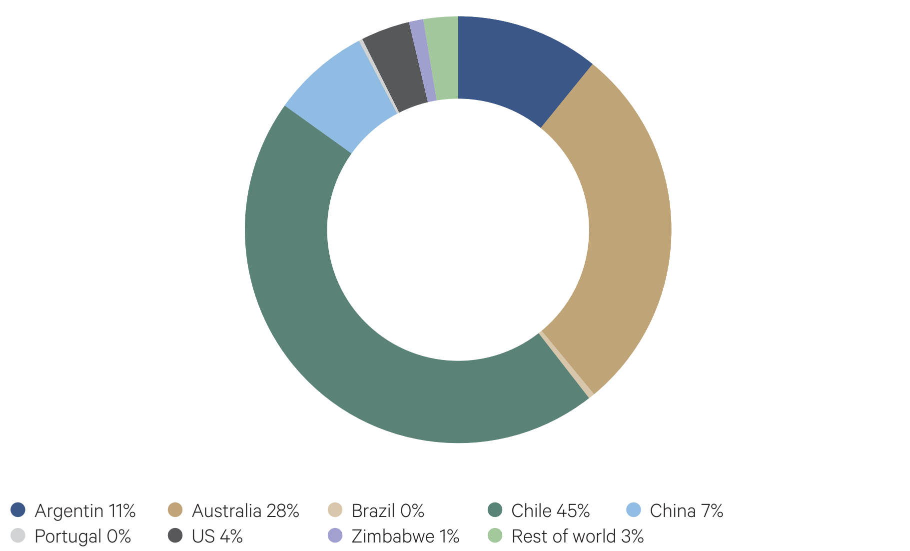


Source: IEA

Many resource abundant emerging market economies will play a crucial role in meeting this demand for critical materials. Copper is seen as the key industrial metal of the green wave and South American nations Chile, Peru and Brazil account for close to half of the world's current copper mining operations. Chile also has a critical role in lithium mining along with Argentina and Bolivia. The trio have become known as the 'lithium triangle', accounting for over two thirds of the world's reserves of the critical battery metal. Democratic Republic of Congo is responsible for 70% of the world's cobalt supply in 2021 and along with Russia and Cuba the trio hold over 62% of the world's reserves.

Hydrogen is seen as a key alternative to fossil fuels in zero emission steel and cement production in the future, replacing coking coal in the smelting process. It also has a critical role to play in long-distance, heavy duty transport as a key zero emission gas through hydrogen fuel-cells. Electrolysis, which is the process of splitting water into hydrogen and oxygen, relies heavily on the platinum group metals (PGMs); with 90% of the world's PGMs mined in South Africa.

Lithium reserves are concentrated in emerging markets

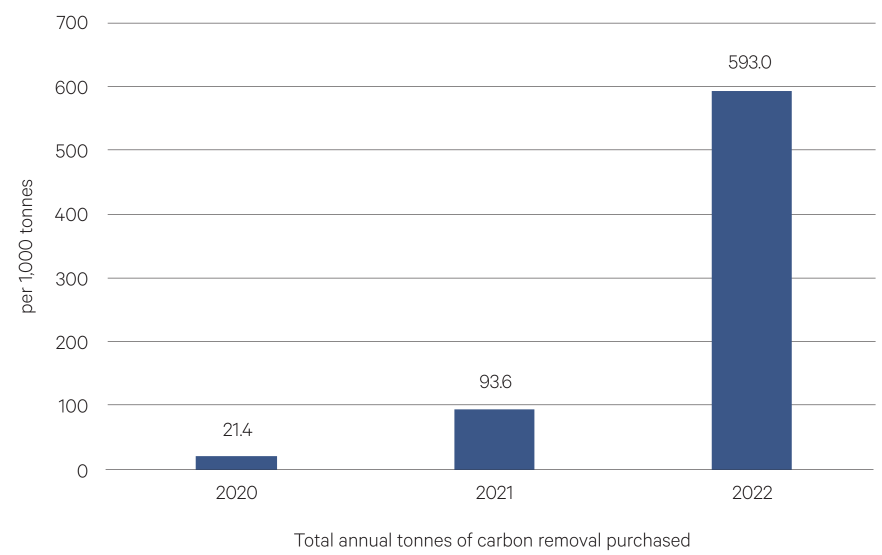


Source: BP Statistical Review of World Energy

66%

Chile, Argentina and Bolivia make up the 'lithium triangle' accounting for 2/3 of the world's reserves.

Carbon removal purchases have accelerated



Source: CDR

Huge progress on the production of new clean energy sources won't however tackle the problem of existing emissions or hard to abate emissions. The EU recently recognised this and adopted a proposal aimed at promoting carbon removal technologies. Direct air capture (DAC) is one such technology, which works by using renewable energy to power big fans which collect CO2 by attaching it to a chemical compound which is then stored 500 metres underground. Investment in this early-stage space has gathered momentum in recent years with well over $1 billion invested in DAC companies. It's a space that is already attracting purchases from some of the world's biggest companies with Microsoft, Stripe, Square and UBS among the customers of some of the world's leading DAC companies.

Theme 2: Infrastructure

The COVID-19 pandemic and recent macro and climate events have underscored the importance of infrastructure highlighting the inadequacy of certain pockets of existing infrastructure and significantly accelerating pre-existing trends. Significant opportunities are also emerging for investment into next generation infrastructure such as renewable energy, decarbonisation and digitisation.

Underinvestment in infrastructure

The U.S. economy relies on a vast network of infrastructure however the systems currently in place were built decades ago. It's estimated that there is an 'infrastructure investment gap' of nearly $2.6 trillion this decade that, if unaddressed, could cost the United States $10 trillion in lost GDP by 2039 according to the to the American Society of Civil Engineers.

The state of the U.S. electrical grid highlights the ageing of infrastructure assets generally. 70% of electricity transmission and distributions assets are well into the second half of their lifespans. Likewise, nearly one in four bridges are deemed deficient, with 10% categorized as structurally deficient and 14% categorized as functionally obsolete.

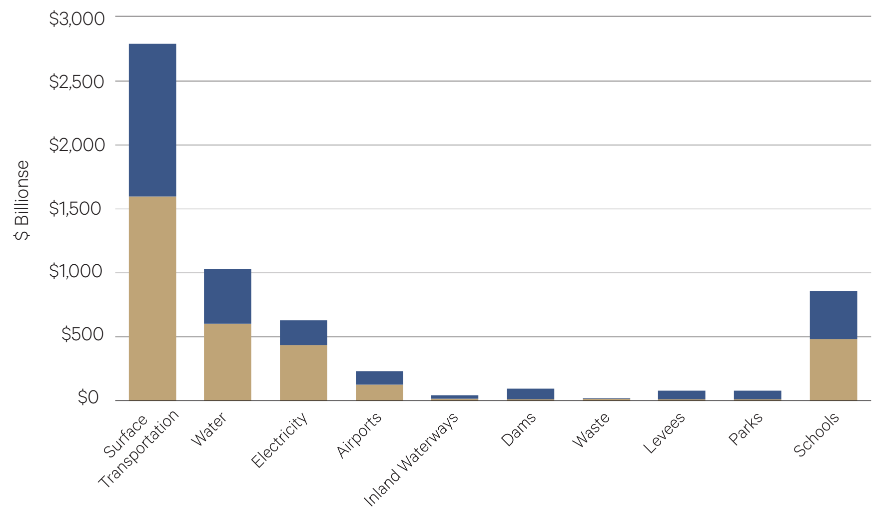
The European Union has identified significant infrastructure investment needs across the continent. The most recent European Investment Bank (EIB) estimates point to a combined €155bn annual infrastructure investment gap across the 27 countries.

Across the globe, government commitments to spending on infrastructure has picked up. In the US, the recent signing of the Inflation Reduction Act, alongside the earlier Infrastructure Investment and Jobs Act, provides a strong tailwind for unlisted infrastructure. In Europe, the war in Ukraine is spurring many governments to accelerate the transition to clean energy sources.

US$94trn

The world needs of infrastructure investment by 2040 to keep pace with economic growth.

US infrastructure assets will require over $2.5 trillion on investments from 2020–2029

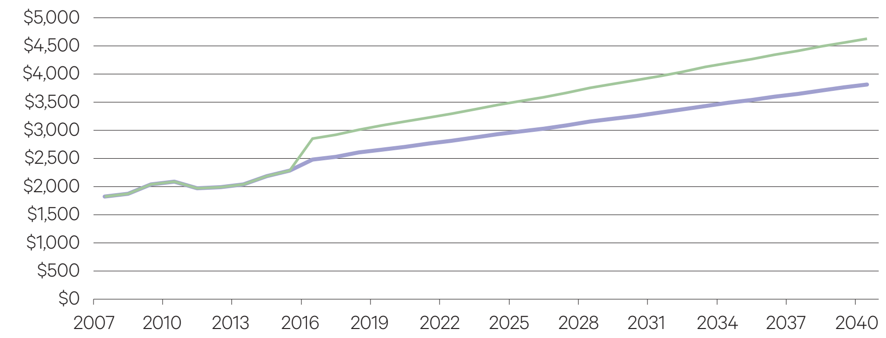


Funded Funding gap

Source: 2021 Infrastructure Report Card, American Society of Engineers

Whilst many governments have made infrastructure a core component of their post-pandemic recovery plans, 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.

Global infrastructure funding gap



Current trends $bn Investment need $bn

Source: Global Infrastructure Hub

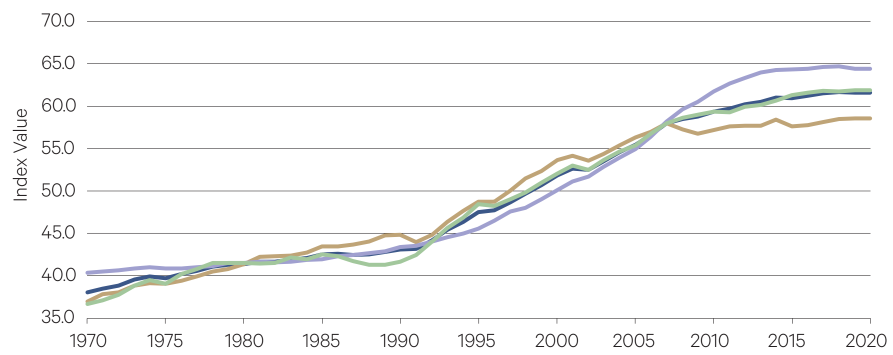
Deglobalisation: A reversal of the past 30 years?

One of the most important economic themes of the past three decades was the steady expansion of global supply chains. Firms in many countries came to rely on inputs produced hundreds or even thousands of kilometres away, delivered with high reliability and for modest costs.

The COVID-19 pandemic revealed that even modest hiccups in global supply chains could lead to big problems for downstream users. This accelerated an already existing trend towards slower, or less, globalisation.

Geopolitical tensions are likely to contribute to the slowing of globalisation. For example, the spill-over effect on the relationship between China and US will add to the momentum already building in onshoring manufacturing activity and shortening supply chains.

KOF globalisation index



Globalisation index Economic globalisation Social globalisation Political globalisation

Source: KOF Swiss Economic Institute 2021

Already, supply chain and geopolitical concerns have pushed certain industries back onshore. A notable example is the semiconductor industry, where the U.S. and Europe have announced programs totalling more than US$100 billion to expand onshore manufacturing.

US$100bn

US and Europe commitments to expand onshore semiconductor manufacturing.

Onshore manufacturing requires good, reliable infrastructure

Onshoring will not be immediate and will require years of sustained investment. To manufacture efficiently onshore you need good, reliable, infrastructure.

Likely beneficiaries of onshoring will be construction and engineering firms, railroads, and consumer discretionary firms as governments around the world remain focused on rolling out major transportation projects to both boost the economy's productive potential and drive the economic recovery as well as support the need to achieve net zero.

Abrupt changes to the global economy are widening the scope for infrastructure investment strategies in 2023 and beyond. From roads to airports and energy infrastructure, these assets are essential to industry and households alike, and can benefit from macro trends such as the energy crisis and digitalisation.

Theme 3: Deglobalisation

Globalisation was a key driver of economic growth over several decades post World War II. This was accelerated at the turn of the century as China joined the World Trade Organisation and countries became more connected due to advancements in technology. A combination of more open capital markets, increased trade and less regulation and government intervention helped to underpin a period of prolonged economic expansion and low and more stable inflation. Emerging market (EM) economies have been significant beneficiaries, with global poverty reduced materially.

The wheel is slowly turning against this previously well-entrenched trend. Global trade as a percentage of GDP peaked at 61% just as the global financial crisis (GFC) of 2008 hit and has been on a gradual retreat since. There are several reasons for this.

Firstly, the rise of more populist politics due to rising inequality following the GFC has led to outcomes such as Brexit, instability across the European Union, and the election of leaders such as Donald Trump in the US. Countries have become more inward-looking and protectionist as a result.

As China has risen to become a global economic power, the trade conflict with the US has migrated into higher value-add industries, such as technology. While China's growth has been transitioning from an export-led model to one more driven by consumption, the recent National Congress of the CCP also confirmed that maximising economic growth is falling in terms of the government's priorities. Instead, security is key, including the aim to become more self-sufficient in areas in which it had previously relied on international markets, such as food, energy and technology.

Lastly, two specific events in the last two years have had a large impact on the likely evolution of trade over the next decade and more – the Ukraine war and the COVID crisis. In the last 12 months, the Ukraine war has heightened the importance of food and energy security for many countries, particularly across Europe. An acceleration of the green transition to domestic renewables and away from foreign energy sources is a likely outcome in the wake of the war.

The COVID crisis exposed many global supply chains, causing significant disruption to numerous industries. Lockdowns drastically slowed the flow of goods, COVID infections left many businesses short of staff, and a spike in spending on goods led to demand that was unable to be fulfilled by just-in-time inventory management. The trade-off between minimising supply costs and optimising supply chain resilience and reliability had swung too far.

An emerging response for improved supply chain reliability is the reshoring or 'nearshoring' of manufacturing to countries that are closer geographically. In this fashion, trade would become less global and more regionalised. Adjacent countries to developed economies stand to benefit from this development, such as Mexico with the US.

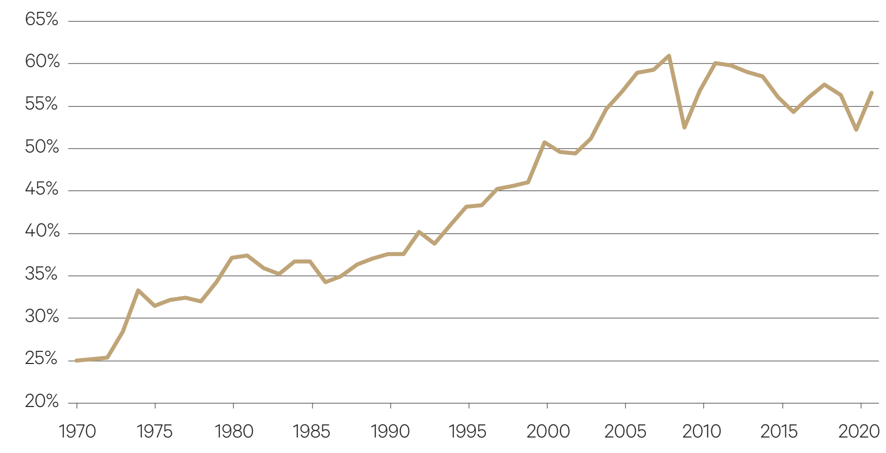
Global freight rates escalated through the COVID crisis, which has encouraged companies to either re-shore or near-shore their manufacturing base.

The investment implications of these developments

Deglobalisation inevitably leads to higher domestic production of goods, reduced profit margins for companies and higher competition for local employment, putting upward pressure on wages. In turn, this should result in higher inflation and hence higher central bank policy rates. Hence, the most important conclusion for investors is that globalisation can no longer be relied on as a permanent factor in helping to keep inflation (and consequently interest rates) low.

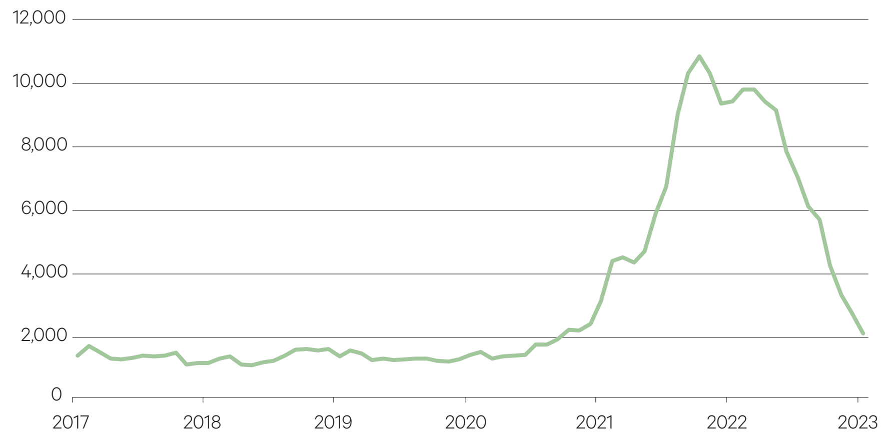
A second key takeaway is that China is becoming less attractive for allocating capital within a portfolio. The combination of increased geopolitical and regulatory risk, and a normalisation of long-term economic growth rates as social goals rise in priority for the CCP, all amount to a challenging outlook over the next decade. With China accounting for nearly a third of EM equity indices, portfolios should hence be constructed with particular regard to this growing risk.

Global trade as a percentage of GDP peaked in 2008 and has trended slightly down ever since



Source: The World Bank

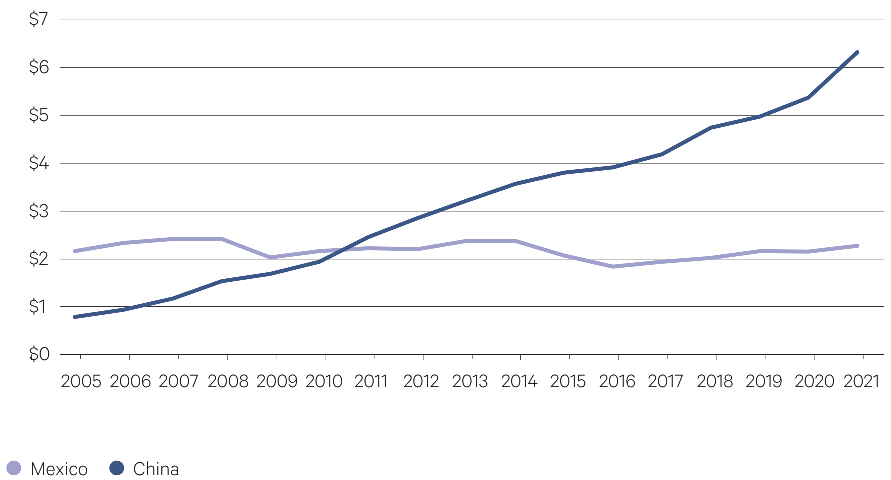
Freightos Baltic Index (global container freight index)



Source: Bloomberg, Freightos Data

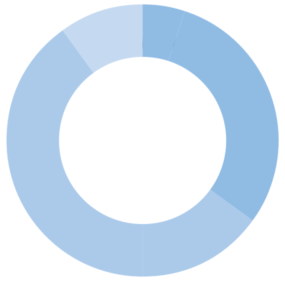
Stagnant wage growth in Mexico compared with China now means that manufacturing labour costs are now much lower in Mexico, giving further incentive for US companies to relocate or diversify their manufacturing base to their neighbour.

Manufacturing labour costs per hour – China and Mexico ($US)



Source: OECD, Bank of America

Fixed Income



Tracey McNaughton
Chief Investment Officer

The Australian fixed income asset class recorded its second consecutive year of negative returns for the first time ever (as measured by the Bloomberg AusBond Composite Index). Bond prices fell (yields rose) substantially over the year in response to the fastest pace of inflation in over two decades. Global bond investors suffered a worse fate with the negative returns this year even greater. There are three reasons to expect a more positive outcome for the asset class in 2023.

First, the global sell-off in bonds means substantially higher starting yields (three-times higher in fact for global investment grade credit). This provides the most attractive yield cushion for fixed income investors since 2009.

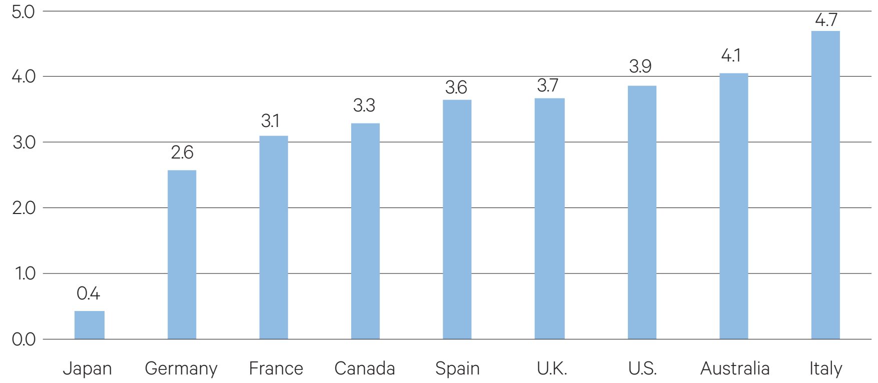
Yield on global investment grade bonds (%)

Source: Bloomberg

US$24trn

The size of the US bond market.

Starting yields matter for bond investors (%)



Source: Bloomberg, data as at 31/12/22

Starting yields matter for bond investors because just as a dividend yield can provide a cushion for an equity investor in the event of a decline in the stock price, the starting yield provides a cushion for a fixed income investor that can protect against further bond price declines. The chart to the left shows current 10-year bond yields for a range of government bond securities. Higher government bond yields in part reflect the fiscal health of the issuing government. Government debt levels in Italy, for example, are one of the highest in the world which is why it has one of the highest bond yields among its peers.

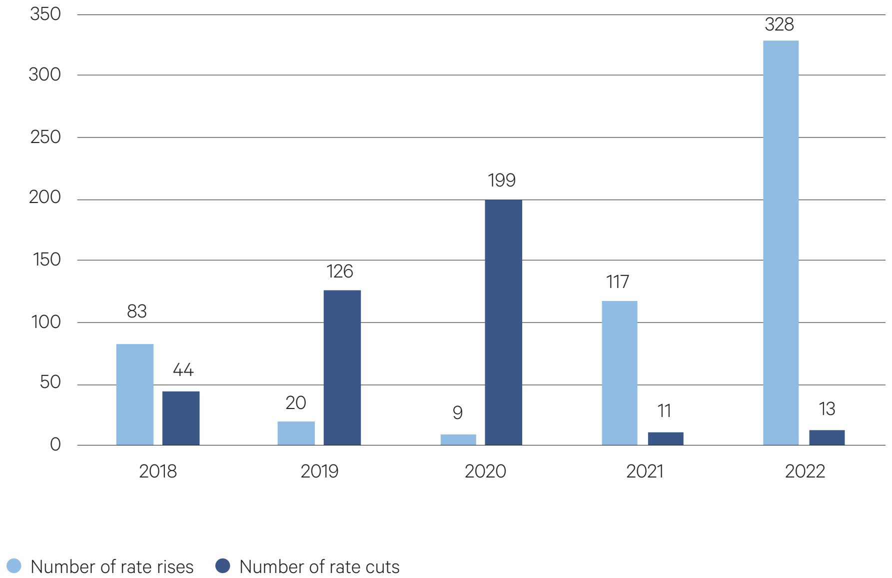
UN food and ag world price index (yoy%)

Source: Bloomberg

Bond yields around the world have risen over the past year as central banks worked to contain inflation. Inflation may remain higher than the average of the past decade this year (thanks to sticky service sector inflation) but there is every reason to believe it has peaked. Slowing consumer demand, an easing of supply chain blockages and a shift away from China's zero-covid policy have resulted in a pullback in many goods prices. Even the spike in food prices following the invasion of Ukraine by Russia on 24 February has eased. This will help cap bond yields.

A second reason for feeling more optimistic about fixed income is the outlook for monetary policy. 2022 saw the most aggressive rate tightening cycle in the US in four decades. This resulted in long term bond yields rising from 1.8% at the start of the year to 3.9% by the end. The expectation for 2023 is an easing and eventual pausing in the interest rate tightening cycle as inflation eases. The market is pricing in a peak US official interest rate of nearly 5% and interest rate cuts in late 2023. This expectation hinges on how fast and to what level inflation falls and how significantly the unemployment rate rises.

2022 – The most aggressive rate hike cycle in decades



Source: Bank of America

Finally, still-robust corporate fundamentals will provide some protection for credit investors. Many companies were able to term out their debt, extending the time to maturity and raising money at low rates in recent years.

Corporate balance sheets are healthy and cash levels are high so while we do expect to see some rise in defaults, the overall level should be contained. What is more likely is a downgrade cycle as the expected decline in earnings causes leverage ratios (net debt/EBITDA) to rise. This may result in some investment grade names being downgraded into high yield.

Even cash looks more attractive. 2023 will be the first time in seven years the rate on a one-year term deposit exceeds 3% in Australia. Income seeking investors can now afford to take less risk in their portfolio in order to achieve their target return.

Australian Equities

David Bruty
Investment Analyst

Australian shares stood out from the pack in what was a challenging year in 2022. That said, portfolio composition mattered; the resources sector was the beneficiary of favourable supply and demand dynamics (a factor that was augmented by Russia's invasion of Ukraine), while companies and sectors with a higher growth orientation suffered following a sharp rise in bond yields. Macro factors were the key determinant of stock returns over the year.

With inflation stickier than initially anticipated, the Reserve Bank of Australia (RBA) followed other central banks in one of the sharpest monetary policy tightening cycles in history. In a similar fashion to overseas equities, Australian shares have experienced a contraction in valuations, with the forward price-earnings ratio of the market dropping from 18.4x (or slightly expensive) to 13.8x (or slightly cheap).

Resources face contrasting forces in the year ahead.

In 2023, we believe that the path of earnings will matter most and this represents the greater risk of near-term downside to the market. Presently, forward estimates of earnings are elevated despite the prospect of weaker global economic growth as the full impact of monetary policy tightening is realised. While Australia enters the year in better health than many countries overseas who stand on the brink of recession, a downdraft in earnings would still be felt here should this materialise.

Consumer driven businesses are most at risk, which to date have been buffeted by high household savings built through the COVID crisis, mortgages that were fixed through this period and sustained strength in the labour market. The lagged impact of rate increases and the roll-off of fixed rates, however, is likely to be realised through 2023, providing downside to these sectors. House price declines have already begun feeding into the wealth effect and sentiment has peeled off sharply.

The large domestic financials sector has already been the beneficiary of an earnings tailwind as higher interest rates are incorporated into estimates. A more severe housing downturn, however, would raise the spectre of an escalation in bad debts for the mortgage-heavy banks.

Resources face contrasting forces in the year ahead. A global economic slowdown creates a headwind for short-term demand. However, this is balanced with the uplift from China's reopening, market tightness from long-term underinvestment and the opportunities created by the green energy transition. While commodity prices have retreated from the mid-year high of 2022, shareholders still stand to benefit from healthy dividends in 2023.

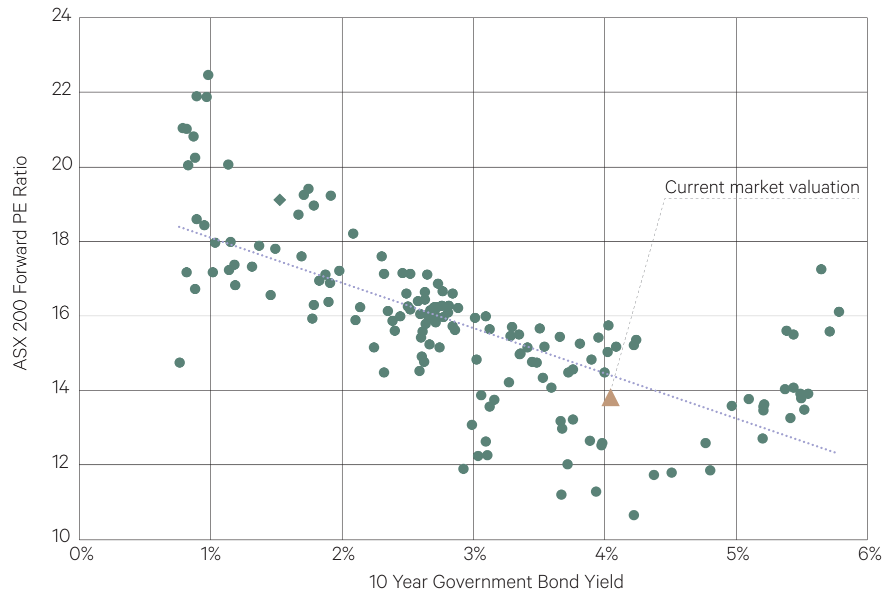
Wage inflation is less problematic in Australia.

While earnings risk is key, we note that wage inflation is less problematic in Australia (with the RBA correspondingly less hawkish), balance sheets are healthy, the market is still providing an attractive dividend yield and we should be cushioned by one of the last 'COVID re-opening' trades in China.

We believe that the outlook is evenly balanced and we have a neutral view on the asset class.

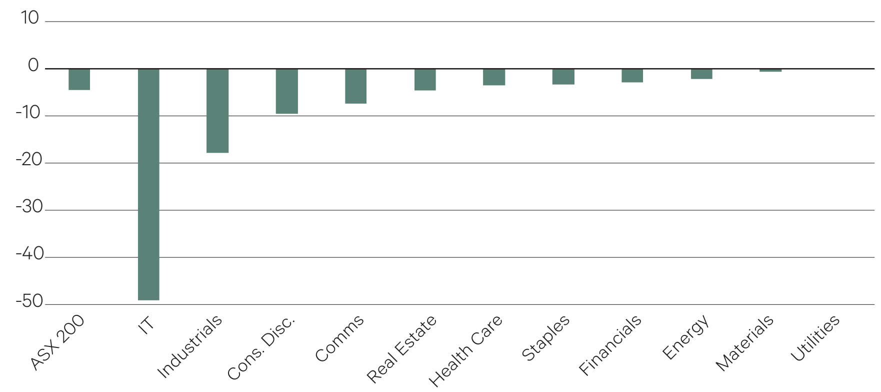
While the forward P/E of the Australian market fell materially though 2022, this simply reflected the sharp rise in bond yields. On this basis, the market can be viewed as slightly cheap.

ASX 200 forward P/E and bond yields



Source: Bloomberg

Change in P/E in 2022



Source: Bloomberg

With the exception of utilities, all sectors of the Australian equity market de-rated in 2022, with the most significant revaluation occurring in higher growth/longer duration sectors such as IT.

With profit margins at a cyclical high, this represents a source of downside risk for the market, particularly if companies face weaker demand through 2023.

ASX 200 Industrials trailing profit margin

Source: Bloomberg

International Equities

Tracey McNaughton
Chief Investment Officer

2022 was a year that will be hard to forget for equity investors. Over the calendar year, the listed value of all global stocks fell by more than US$20 trillion. This leaves the value back to where it was at the end of 2020.

The biggest challenge for global equities in 2022 was significantly higher interest rates led by the US. Official interest rates in the US rose over the year from 0.25% to 4.5%. This increased longer term interest rates which in turn reduced the valuation of equities. The most common valuation metric is price per unit of earnings. On this basis, US equities fell from 23 price-to-earnings to just under 17 – a level considered to be around fair value. Most of that decline was driven by the fall in price rather than a rise in earnings.

The general view for 2023 is that central banks are closer to the end of their tightening cycles. This means equities are less likely to be impacted by higher bond yields. This will provide some support for valuations. Offsetting this is what happens to earnings.

Corporate earnings are driven by three broad factors – profit margin, prices, and volume (or consumer demand). To date, corporate earnings have been well supported by healthy margins, high prices and reasonably solid volumes. We believe it would be complacent to expect this scenario to persist in 2023.

The Information Technology (IT) sector is an important one to watch given it is home to some of the largest companies listed in the US including Apple and Microsoft. The tech crash in 2000–03 saw IT margins fall significantly further than what we have experienced so far. We are not expecting history to repeat exactly but the IT sector was one of the largest beneficiaries of low interest rates and COVID lockdowns.

Profit margins have already begun to decline from their peak recorded at the end of 2021. This has mainly been driven by a decline in margins for the financials, consumer discretionary and communications sectors (chart). Flatter yield curves were the key headwind for financials margins last year while competition and higher costs hit margins in the consumer discretionary and communications sectors. Higher wages are the single biggest headwind to profit margins in 2023 and will hit the labour-intensive industries, such as manufacturing, retail, insurance and banking, education and healthcare, the hardest.

US$20trn

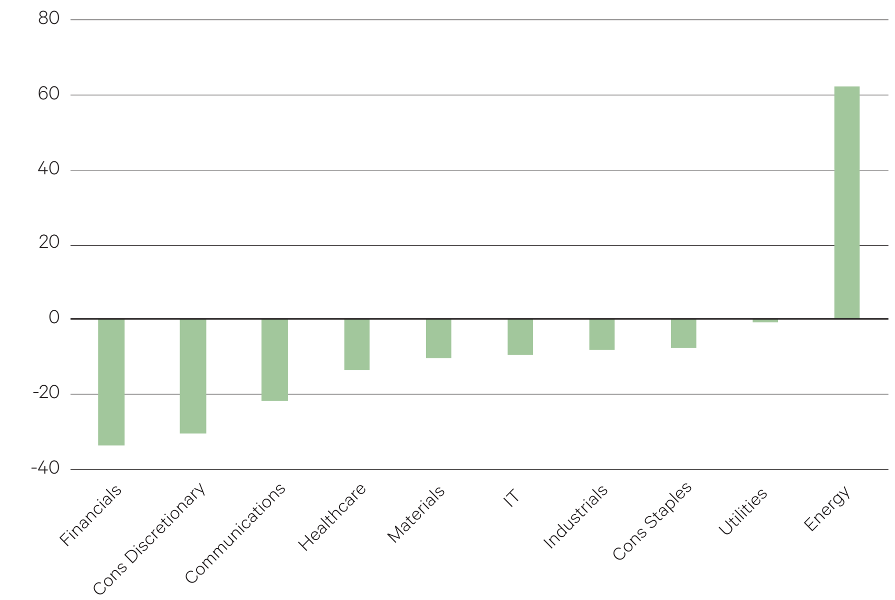
The value lost in global stock markets in 2022.

S&P500 profit margin (profit as % sales)

Source: Bloomberg

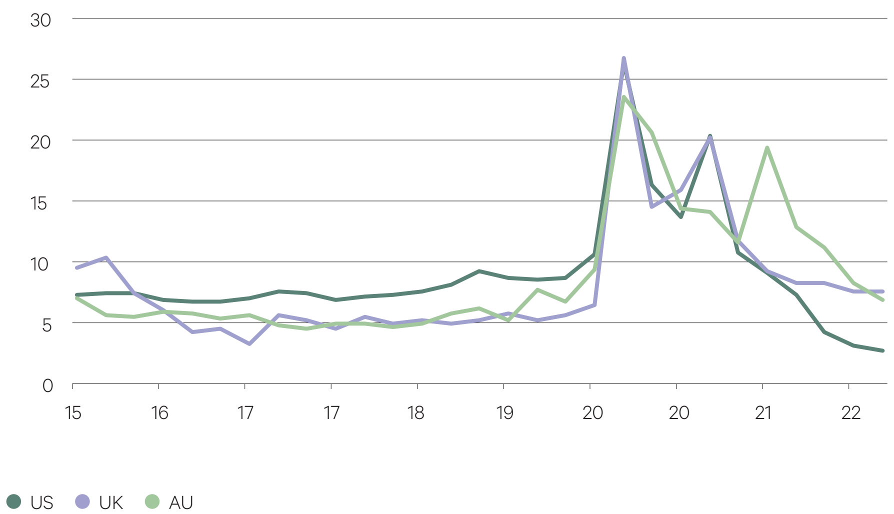
The Information Technology (IT) sector is an important one to watch given it is home to some of the largest companies listed in the US including Apple and Microsoft. The tech crash in 2000–03 saw IT margins fall significantly further than what we have experienced so far. We are not expecting history to repeat exactly but the IT sector was one of the largest beneficiaries of low interest rates and COVID lockdowns.

Change in profit margins 2022/2021 (%)



Source: Bloomberg

Household saving rates (% Income) – The shrinking savings buffer



Source: Bloomberg

US$2.4 quadrillion

The value of the global currency market.

Consumer demand has shown significant resilience in the face of higher prices in 2022. This was driven by the record fiscal package handed out by many governments around the world in the wake of the pandemic. This stimulus is running out. In the US, where fiscal support was the highest among the G20 nations, the household saving rate reached a peak of 33.8% in 2020. It has subsequently come down to 2.4%, well below its long run average of around 7% (chart). Depleted savings will make consumers more sensitive to price hikes, hampering volume growth and the ability of corporates to pass on higher costs. This will be good for inflation but bad for corporate earnings.

2022 was the year when equity markets adjusted to higher interest rates. 2023 will likely be the year they adjust to lower earnings. We remain cautious until we are confident equities have priced this outlook in.

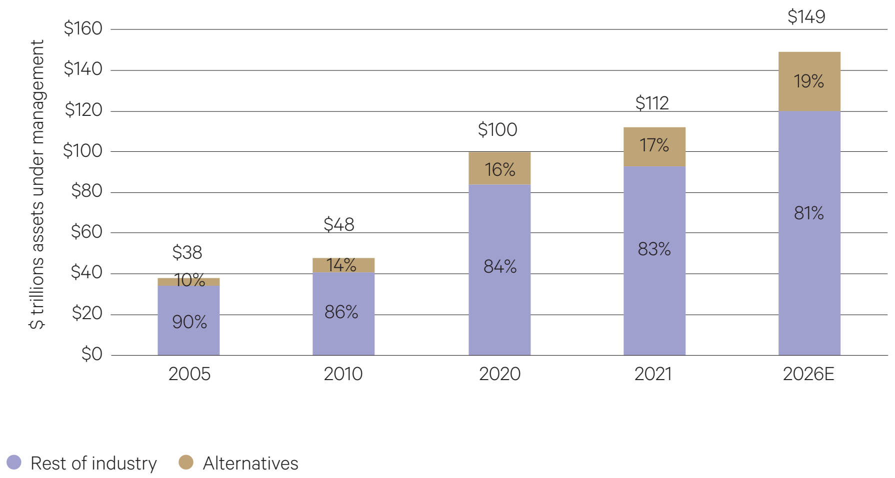
Alternatives

Darragh Kennelly
Investment Analyst

Stephen Dickinson
Investment Analyst

The Alternative asset class continued to grow in size in 2022, benefiting from its low correlation to traditional asset classes. Private markets have become an essential source of financing for a wide range of innovation and economic activity globally which will continue to provide long-term tailwinds for investment into private markets. As the number of companies listed publicly across the world continues to fall the opportunity set grows in private markets.

Alternatives continue to gain a greater share of total investible assets under management

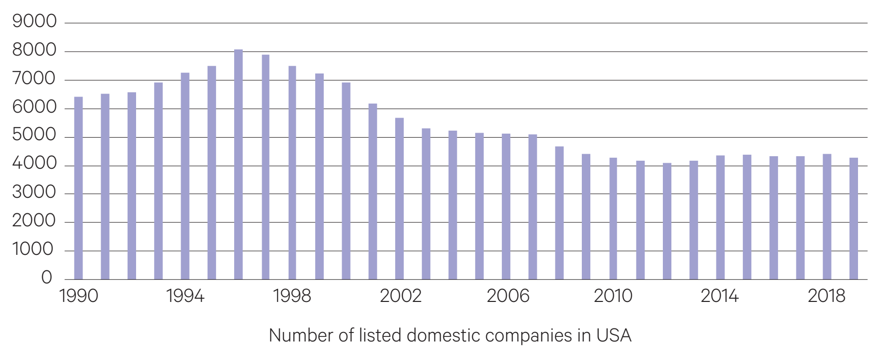


Source: BCG

Private equity

Private equity (PE) outperformed public equity in 2022. Less volatile private markets benefited from earnings growth while public markets suffered from a derating of price earnings multiples. History tells us that private equity often performs strongly following big selloffs in public markets. Many PE managers with elevated levels of dry powder are looking to opportunities in 2023 that will arise from depressed valuations. Secondary markets will be a focus as heightened uncertainty often leads to wide discounts to net asset values (NAV) in secondary markets. Increased volatility can create attractive entry points and mergers and acquisitions will also be a big theme for PE managers in 2023.

Number of listed companies in the US continues to decline



Source: Worldbank

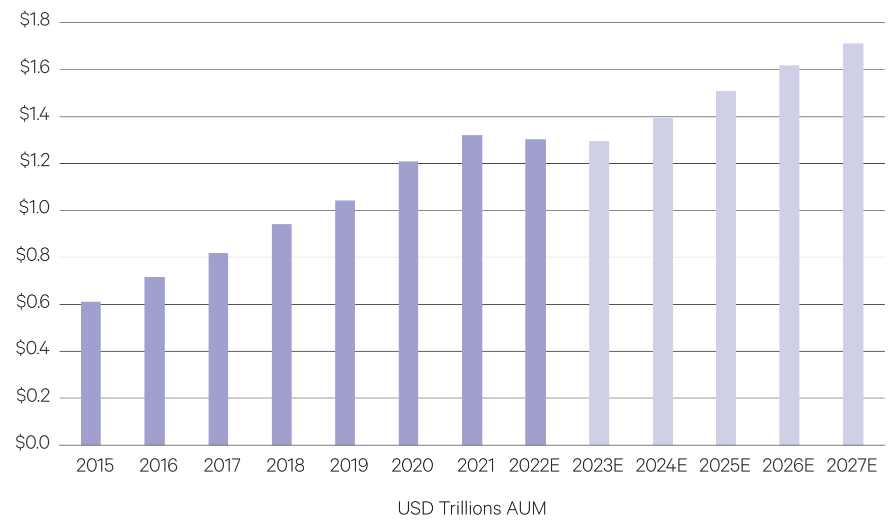
47%

The decline in listed companies in the USA since 1996.

Private credit

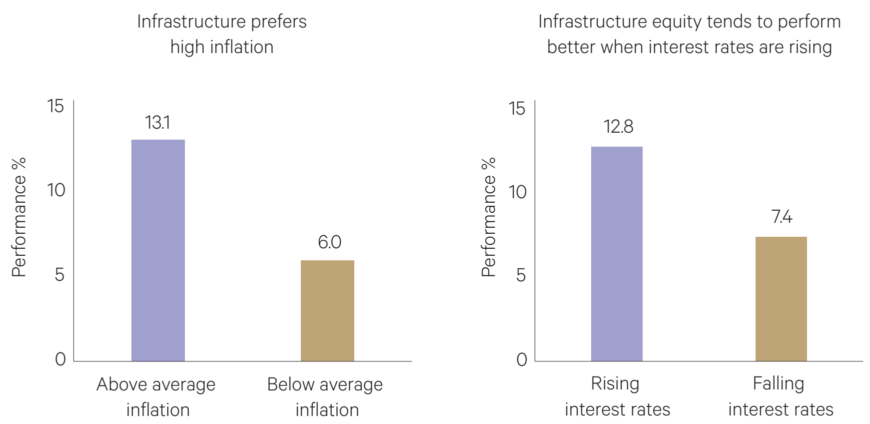
Given its predominantly floating rate nature, private credit benefited from the rising rate environment of 2022. Focus will turn to credit quality and the ability of companies to meet higher debt payments in 2023. Default rates have remained low to date and covenants and underwriting standards are much higher than in previous cycles. The large presence of PE sponsors in the private credit market means credit quality is higher than in the past for direct lending and syndicated loan markets. Asset backed and securitised markets remain attractive going forward whilst pockets of distress will present specialised managers with opportunities in 2023.

Private credit markets forecast to grow at a strong pace



Source: Pitchbook

Infrastructure has tended to outperform in high inflation periods



Source: Macquarie

Decarbonisation, digitisation and deglobalisation continue to drive investment in infrastructure.

Infrastructure

The long-term tailwinds of decarbonisation, digitisation and deglobalisation continue to drive investment into infrastructure and the opportunity set continues to grow on the back of the energy crisis accelerating the transition to renewables. With inflation running at multi-decade highs investors are increasingly looking to infrastructure for protection given the ability to directly or indirectly pass-through higher costs. As renewables gain a greater share of the power grid the need for new transmission and storage infrastructure will become apparent. Digital and telecoms infrastructure continue to benefit from the rollout of 5G and the migration to the cloud whilst the broader infrastructure upgrade cycle will require significant investment.

Property

Real estate has been one of the strongest performing asset classes in recent years as demand for structural growth areas of industrial and logistics increased, and cap rates tightened to historic levels. Valuations may see some softness as cap rates widen from increased interest rates however some of this softness will be offset by the continued demand for income producing real assets and record low vacancy rates across many subsectors of real estate.

Record low vacancy rates across many subsectors of real estate.

Asset Class Quilt of Market Returns

2022 was a difficult year across almost all asset classes with interest rates, inflation and geopolitics all impacting.

The US equity market suffered as higher interest rates undermined valuations. Growth sectors such as the consumer discretionary and information technology were the notable underperformers. Energy was the notable outperformer rising by 59%. The Australian equity market outperformed its global peers with only modest losses. This was helped by the 25% weight to the materials sector in the ASX index. Emerging markets were weighed down in particular by the technology-heavy Asian region.

Returns for fixed income were the worst on record as rapid increases in interest rates combined with low starting yields to generate a negative total return. Credit spreads widened as the markets responded to macro uncertainties weighing on returns for investment grade and high yield markets last year.

The most interesting observation to make from this year's Asset Class Quilt is the limited number of places in which an investor could hide in 2022. In the past two decades, we have never seen a situation where the meagre return from cash was the only place to grow returns. Even in 2008, when US equities were down by 38.5%, fixed income provided a cushion. It was also notable that inflation, which averaged above 6% for the year in Australia, beat all investment options. This highlights the unusual nature of 2022.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
High	EM Eq 51.6%	AE 27.6%	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%	Gold 29.6%	AFI 11.4%	HY 19.6%
	HY 32.4%	EM Eq 22.4%	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%	EM Eq 16.4%	IFI 10.5%	AE 18.8%
	IE 30.8%	HY 13.2%	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%	HY 14.8%	Gold 10.1%	EM Eq 15.1%
	US Eq 26.4%	IE 12.8%	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%	US Eq 12.8%	Cash 5.0%	US Eq 13.4%
	Gold 19.4%	IG 9.5%	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%	IE 9.6%	IG 4.3%	IE 13.2%
	AE 15.9%	US Eq 9.0%	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5	IFI 9.3%	HY 3.1%	IG 11.2%
	IG 14.3%	IFI 8.9%	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%	AFI 6.0%	US Eq 0.0%	IFI 9.7%
	IFI 6.6%	AFI 7.0%	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%	IG 5.8%	IE -7.6%	AFI 7.7%
	Cash 4.9%	Cash 5.6%	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%	Cash 4.7%	AE -11.4%	Gold 7.1%
Low	AFI 3.0%	Gold 5.5%	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%	AE 3.3%	EM Eq -20.4%	Cash 4.0%

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
US Eq 29.6%	US Eq 11.4%	AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%	Gold 25.1%	US Eq 26.9%	Cash 1.3%
IE 24.1%	IFI 10.4%	IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%	US Eq 16.3%	IE 20.1%	Gold -0.3%
AE 19.7%	AFI 9.8%	AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%	EM Eq 15.8%	AE 17.7%	AE -3%
HY 7.3%	AE 5.0%	Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%	IE 14.1%	HY 0.9%	AFI -9.7%
Cash 2.9%	IG 3.1%	US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%	IG 10.4%	Cash 0.0%	IFI -12.3%
IFI 2.3%	IE 2.9%	IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%	HY 7.0%	IFI -1.6%	HY -12.7%
AFI 2.0%	Cash 2.7%	HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%	IFI 5.1%	AFI -2.9%	IG -16.7%
IG 0.3%	HY 0.0%	IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%	AFI 4.5%	IG -3.2%	US Eq -19.4%
EM Eq -5.0%	Gold -1.4%	Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%	AE 3.6%	Gold -3.6%	IE -19.5%
Gold -28.3%	EM Eq -4.6%	EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%	Cash 0.4%	EM Eq -4.6%	EM eq -22.4%

AE: Australian Equities
HY: High Yield Credit
Gold
IFI: International Fixed Income
EM Eq: Emerging Market Equities
Cash
AFI: Australian Fixed Income
US Eq: US Equities
IG: Investment Grade Credit
IE: International Equities

Source: Bloomberg, 2022 data as at 31/12/2022

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