Perpetual Private | Quarterly Market Update

The recovery rally spurs optimism.

June 2021

Trust is earned.

Perpetual

Contents

Snapshot

The post Covid recovery continues and has been remarkable in its success to date. Whilst there have been some unintended consequences and a dispersion between those who have benefited and those who have not, the economic environment in which we find ourselves is far more promising that we had right to hope for, only 12 months ago.

Whilst encouraging, we still have some way to go before we can declare victory over the events of the past 15 months and should continue to scan the horizon for new or complicating risks.

As the global population becomes increasingly vaccinated and international travel resumes in full, we must consider the challenge in unwinding the stimulus measures that have been deployed. Too quickly and we risk relapse, too slow and we're likely to sow the seeds of the next crisis.

With growing global optimism, and central banks likely to be slow to act, risk assets, such as shares are likely to be primary beneficiaries in the near term. It remains prudent, now more-so than it has for many years, to be highly selective in the assets we include in our portfolios, as dispersion between those companies who are ready to react to the changing environment thrive, and those who don't face significant headwinds.

Australian equities

The Australian equity market continues its steady upward trajectory, with the S&P/ASX 300 gaining 8.5% in the final quarter of the financial year. It's ascent from the March lows continues, with a 12-month return of 28.5% over the post stabilisation base of 30th June 2020. Technology showed the greatest exuberance, gaining 12.1% and recovering the losses it made in the previous quarter. Consumer Discretionary reflected increasing consumer confidence with an increase of 11.6%, bringing its 6-month return to 21.4%. Only two sectors saw negative returns, with Utilities losing 4.5%, helping to drive negative annualised returns for the sector out past 4 years. Energy saw a negative return of 2.3%, following a strong performance in the previous quarter.

International equities

Global equities continued their steady march forward, adding 9.0% in AUD terms. Technology on a global basis, loudly echoed our local technology sector, enjoying an impressive return of 12.1%. This was closely followed by the Health Care and Energy sectors, gaining 11.0% and 10.9% respectively. Indeed, performance of sectors on an international basis was consistently robust, with all but Utilities generating returns greater then 6.2%. Were it not for currency movements, the sector would have fallen in value, consistent with our experience locally. Driven by a strong performance in June, North American markets would have continued to lead the world, but for an impressive gain of 15.8% in Frontier Markets (markets not yet defined as "emerging"). Japan was the notable laggard with a return of only 1.2%.

Real estate

Australian Real Estate Investment Trusts (as measured by the S&P/ASX300 A-REIT index) delivered 10.7% over the quarter, reversing their prior quarter's weak performance as interest rates again softened. Global Real Estate Investment Trusts (G-REITs) gained 9.0%, as measured by the FTSE EPRA/NAREIT Developed Index (currency hedged), with Hotels/Hospitality tempering their strong performance from the March quarter and Residential commanding an impressive 15.5%.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned 1.5% during the past quarter. The Australian 10-year bond yield resumed its long-term downward trend finishing March at 1.8%, before drifting down to 1.5% by June 30. On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Local Currency) returned 0.9% for the period. Credit fared comfortably better with the ICE Bank of America Global Corporate Index (Local Currency) returning 2.5% over the same period.

Alternatives

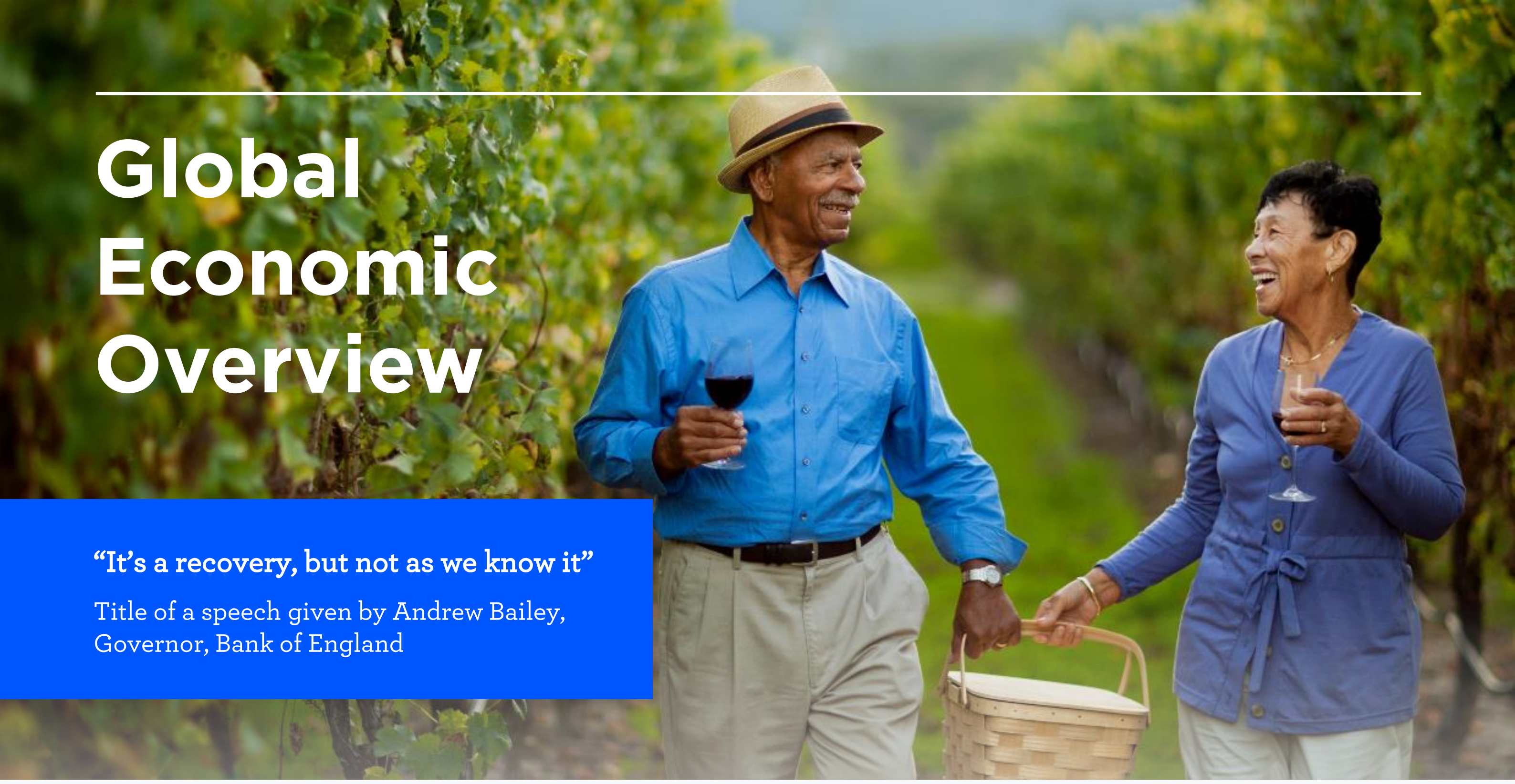
Alternatives across both growth and defensive asset classes continue to recover, benefitting from improving economic conditions and a more orderly market environment. Where assets were marked down 12 months ago, we are starting to witness up-ratings and where managers have had the wherewithal to take advantage of opportunities that have arisen with specific assets, early gains.

Cash rate

The Reserve Bank of Australia (RBA) reaffirmed its 0.1% target for the cash rate over the quarter and left their policies on yield curve control unchanged. However, they have demonstrated some confidence in improving economic conditions, announcing a small wind back of their current bond buying program, reducing purchases from $5bn to $4bn per week from September.

Aussie dollar

The Australian dollar fell 1.4% against the US dollar over the quarter, continuing the consolidation of an impressive return to strength out of the midst of the crisis 15 months ago. The 2021 financial year has seen the AUD gain 9% in USD terms, having already delivered an impressive "bounce" in the June quarter of 2020. Hovering close to its 10-year average, our dollar faces a seemingly balanced mix of strengths and weaknesses in coming months.



Global Economic Overview

"It's a recovery, but not as we know it"

Title of a speech given by Andrew Bailey, Governor, Bank of England

What happened?

The second quarter of 2021 can best be described as one of continued recovery. Approximately 15 months since markets first took fright at the unfolding global pandemic, and 20 months since COVID-19 was first detected, we find ourselves in an environment where the global economy's recovery is becoming well established. Indeed, we are consistently seeing economic expectations revised upwards as vaccination rollouts continue to gain speed, and authorities maintain fiscal and monetary support. The IMF estimated that the "recession in 2020 would have been three times as large were it not for all these measures [monetary and fiscal support programmes][1]". It should be no surprise that all major markets saw only positive returns for the period, reflecting the growing confidence of market participants. That isn't to say that everything has been "smooth sailing". More than once through the quarter, we witnessed bond prices lurch downwards on the fear that central banks might seek to increase interest rates earlier than expected in response to increased inflation. Given their importance to asset valuations across the board, concerns about interest rates translated into volatility across asset prices; from shares through to property. Fortunately, these periods were short-lived and regular reassurance from monetary authorities that they would not seek to increase interest rates in the short-term, was sufficient to placate even the most nervous of investors.

During the quarter, the month of June in particular, we witnessed "growth" companies stage a comeback, somewhat reversing the previous quarter's rotation into "value". Following on from the increases in bond yields over the March quarter, the June quarter saw rates pull back from 12 month highs. Growth stocks responded leading to (on a global basis) a commanding outperformance for the quarter: the MSCI World Value Index gained 6.2% over the 3-month period, while the MSCI World Growth Index gained 12.5%, a 6.3% differential. A reversal between the two investment styles does not suggest that "growth" is again in the ascendency, only that we might now be witnessing a 'breather' as the broader trend in the value rotation comes to completion and rates continue to normalise. We cannot ignore that the last decade has seen the largest divergence, in both size and duration, between the two investment styles ever recorded – there is still a long way to go to narrow the gap.

Where are we?

Having faced down the first global pandemic in over 100 years and endured one of the largest economic shocks in modern times, we appear to be climbing out the other side in a relatively strong position. Locally, the Reserve Bank of Australia (RBA) is predicting growth of 4.8% for 2021 and 3.5% for 2022. Globally, the International Monetary Fund expects 6.0% growth in 2021, followed by 4.4% in 2022. This type of rebound could only have been dreamed about just 12 months ago and is certainly welcome.

The significant actions taken by governments and central banks appear to have been sufficient in both their design and their scale, from an economic point of view. The crucial connections between economic participants (such as employers and employees), have largely remained in place. We see this evidenced in the rapid rebounds in activity for economies which have come out of lockdown. This is further good news, the breakdown in economic connectivity having been one of the greatest concerns regarding the long-term effects of lockdowns.

[1] World Economic Outlook, International Monetary Fund

Another encouraging outcome has been the level of unemployment, which has also rebounded at a much faster pace than previously imagined. In Australia, unemployment was only 5.5% when measured in April, with the RBA expecting 5.0% by the end of the year. Whilst government programmes such as JobKeeper protected us from a more significant increase of unemployment, it did get as high as 7.4% in June 2020. With such policies largely withdrawn, it is encouraging that both the position and the outlook has remained so robust. The US, which features and provided in the face of COVID-19 far fewer protections for employees, saw unemployment peak at 14.8% last year, and is now back down to a rate of 5.9%.

What are the challenges we face?

With such an impressive return to health, it would be easy to be lulled into a false sense of security. We are reminded of the analogy that demonstrates the flaws in averages. Very simply, the concept is one where you have somebody with their head in the oven and feet in a freezer. Their average body temperature would suggest that they are in a healthy state, whilst common sense informs us that they would very quickly meet their demise. The same applies with the global economy and even within individual economies. Whilst on average, the world has largely recovered from the crisis brought upon us by COVID-19, the recovery has been uneven. Different countries have handled the situation very differently, both in terms of policy and in terms of behaviour. Some countries (such as Australia) have attempted to eradicate the virus, whilst others have been either unable or unwilling to take the same approach. Indeed, simple preventative measures, such as wearing a mask, have become highly politicised in certain countries. In addition, misinformation, and caution, have discouraged people to varying degrees, from being vaccinated. All of which means that the recovery though impressive, retains a degree of fragility.

As noted here previously, with transmission comes mutation. Occasionally, the right combination of mutations aligns to form a new dominant strain. The Delta strain, thought to have developed in India, is a new complicating factor. Whilst not yet fully understood, an additional mutation to the spike protein appears to have significantly increased the transmissibility of the virus, affecting even children, who have largely been spared by other variants. Fortunately, of the various dominant strains which have emerged, existing vaccines continue to be effective. This is encouraging, as it suggests that our progress towards herd immunity remains intact. Recognition of this problem is, in part, encouraging the donation of the vaccine to developing countries who are less able to procure doses themselves. Ultimately, nobody can have COVID-19 under control until we all have COVID-19 control.

Another complicating factor is that of inflation. With very easy monetary policy likely to continue for the next couple of years, and government spending at record-breaking levels, there remains the risk that inflation could become out-of-control. Historically, high levels of inflation have been very difficult to contain once in place. It is the fear of such an environment that drove the brief market convulsions during the quarter. Should central banks be forced to rapidly increase interest rates to rein in inflation, the natural flow-through to asset prices could be significant. Whilst certainly not impossible, at present such a scenario seems improbable.

Firstly, since the Global Financial Crisis of 2007/08, central banks have been attempting to bring inflation up to their target levels (at or near 2% for most countries). They have almost universally fallen short, every year since. In Europe for instance, the average inflation shortfall from this target has been 0.9% per annum. This is meaningful as it is one of the only areas (under the direction of the European Central Bank), that has implemented a negative interest rate policy. Given the implicit encouragement this gives to spending, the failure to generate sufficient demand and therefore inflation, is notable. Whilst the level of global government spending has never matched the heights of today, it remains to be seen whether it will generate inflation. In the words of Philip Lowe, "inflation in underlying terms remains low and below central bank targets".[2] Budgeting money for infrastructure projects for instance, has a lagged effect, as many projects aren't "shovel-ready" requiring months of planning before they can begin. Equally, technological gains have an inherently deflationary effect as tasks become automated, reducing pressure on the labour force and therefore wage inflation. Wage inflation is one of the most effective ways to generate a sustainable level of core inflation and has also been notably muted over the past decade. It is thus no surprise to us that many of the major central banks have turned their focus to levels of employment, or more accurately labour market tightness, rather than their usual laser focus on expected inflation.

Secondly, because of the combined effects of lockdowns and border closures (internationally and domestically) there has been a significant disruption to international shipping. This, in turn, has disrupted international supply chains leading to an environment where demand has been outpacing supply for a large number of goods. This is necessarily inflationary and explains also why key central banks are deeming it to be transitory in nature. As international travel begins to return towards pre-covid levels, shipping costs will fall, as will shipping times, relieving pressures on supply and inherently that of inflation. It's worth considering that during this past year, we have witnessed used cars gaining in value, and television prices increasing for the first time since 1954. Certainly, this can be somewhat attributed to shortages in the availability of computer chips. Though again, their production has been inhibited by COVID-19, as the result of temporary factory closures and an inability to obtain certain key inputs.

[2] Statement by Philip Lowe, Governor: Monetary Policy Decision, RBA, 1st June 2021

Where to from here?

Never before have we witnessed such a sudden and severe economic disruption. Never before have we witnessed such a rapid rebound. This is a testament to the swift and extensive response by fiscal and monetary authorities. Whilst encouraging at the top line, the recovery has been uneven both within economies and across economies. This is likely to lead to intermittent bouts of volatility, and potentially even some social disharmony, as those who were most acutely hit by the crisis resent those who benefited. In a business sense, as "normality" begins to rebalance across sectors (think a return to the consumption of services such as restaurants away from the consumption of goods, such as new TVs), we are likely to experience sudden shifts and even brief echoes of the original crisis. Longer term, the potential for policy error is something that we will continue to focus on. Authorities deserve (almost) full marks for their handling of the first part of the crisis. The challenge though, is to put the proverbial "genie back into the bottle", without generating a whole new set of problems. Hopefully, the sentiment shared by Andrew Bailey, Governor of the Bank of England; "the evidence here and in other countries indicates that the economic impact of Covid has attenuated with each successive wave – we are all by nature adaptive in our behaviour", will be reflected in any challenges that arise as we move into the next phase of the recovery.

Australian cash rate and dollar

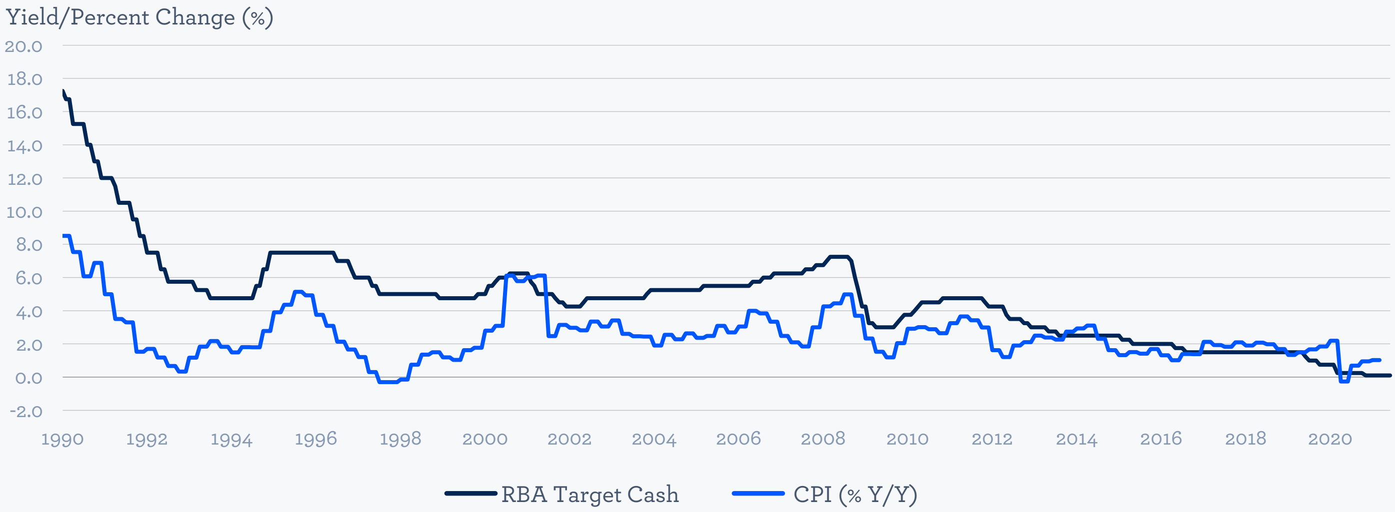
Australian cash rate

At their meeting in July, the RBA again committed to maintaining the cash rate target at 0.10%. With Governor Lowe acknowledging that the “economic recovery in Australia is stronger than earlier expected and is forecast to continue”[3].

Leaning in to the improving economic outlook, the Board did begin to marginally reduce the rate at which they will be purchasing government bonds (following the completion of their current bond purchase program in early September) from $5bn per week, to $4bn per week.

Whilst this is a sign of increasing confidence, it is just a small step, the Bank noting that we remain some distance from the inflation and employment objectives. We expect this cautious approach to remain and continue to expect the Bank to normalise monetary policy only tentatively, reserving the right to reverse such decisions should the data fail to come through as expected.

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

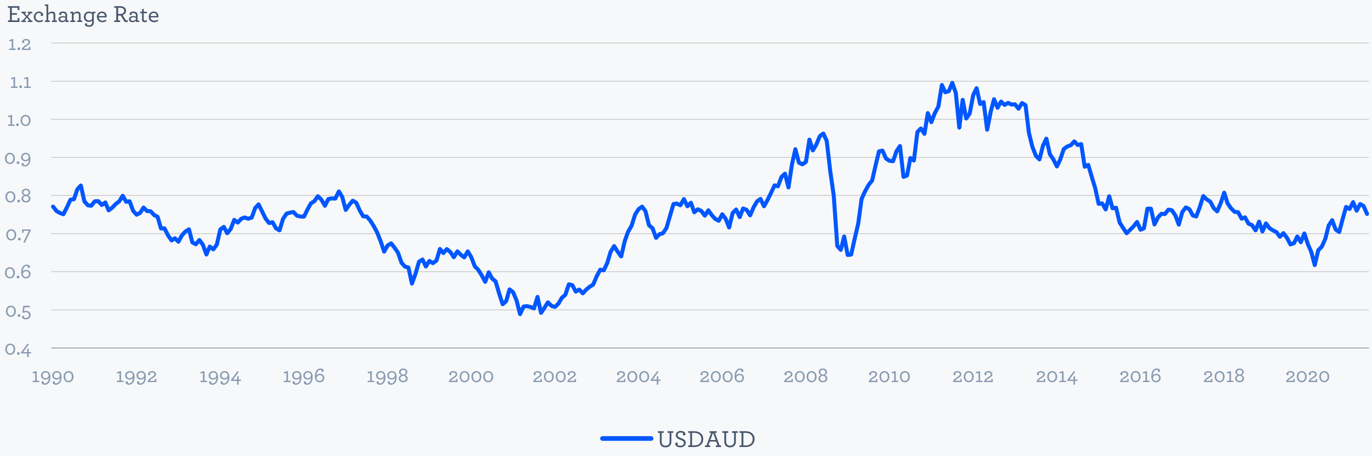


Source: FactSet, Perpetual Private

[3] Statement by Philip Lowe, Governor: Monetary Policy Decision, 6th July 2021, Reserve Bank of Australia

Figure 2. Australian Dollar U.S. Dollar (Daily) Long Term

USD Per AUD Long-Term Exchange Rate



Source: FactSet, Perpetual Private

Australian Dollar Outlook

The Australian dollar has settled near its long term averages and faces a rather balanced mix of supporting and detracting scenarios. On the one hand, Australia has managed virus outbreaks comparatively well and came into the crisis with low levels of debt when compared to the size of our economy. Furthermore, economic recoveries tend to demand large amounts of resources of the type we tend to be rich in. On the other hand, our vaccination levels remain low compared to many other developed nations, with lockdowns still an all too frequent feature of day-to-day life. Furthermore, we are caught in the crossfire of heightened levels of geopolitical tension, as China seeks to exert itself on the global stage, and the US (our traditional ally) seeks to resist.

Australian and international equities

Australian equities

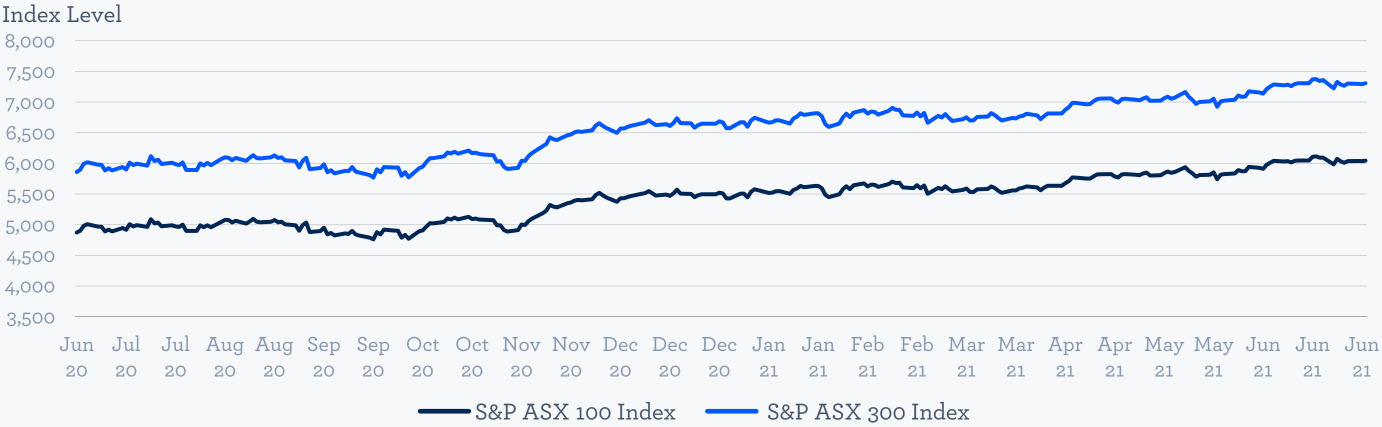
The rolling lockdowns nationally, first Victoria and then New South Wales later in the quarter along with other snap lockdowns across the country, did little to dampen economic growth. The Australian equity market remained well supported by the continued accommodative monetary support, combined with strong corporate and economic data including increased job vacancies, and subsequently higher employment, as well as marked improvements in the pace of the vaccination rollout.

This has made for another strong quarter for the Australian equity market, surging beyond its pre-Covid peak level to now close out the quarter at an all-time high. The S&P/ASX 300 Accumulation Index delivered an 8.5% return for Q2 in AUD terms, which was broadly in line with returns on global equity markets, with the MSCI All Country World Index delivering a slightly higher 9.0% return in AUD terms for the quarter.

Momentum in the global recovery and signs of stronger economic growth benefited cyclical stocks, with strong returns across Technology (12.1%), Consumer Discretionary (11.5%), A-REITs (10.7%) and Materials (9.5%). They were followed closely by Financials (8.9%), Healthcare (8.7%) and Industrials (6.2%). Utilities struggled for the quarter (-4.5%), as did Energy stocks (-2.3%).

Figure 3. Australian Shares

Australian Shares – Large Companies



Source: FactSet, Perpetual Private

Australian equities outlook

The vaccination campaign nationally continues to accelerate, as recent Covid clusters and the ensuing lockdowns have sparked an increased sense of urgency in the pace of the rollout. Until widespread vaccination has been achieved, outbreaks may necessitate further restrictions and further snap lockdowns.

The accelerating pace of the vaccination rollout nationally, combined with the current accommodative fiscal and monetary backdrop and continued strength in economic data, including falling unemployment levels, should continue to support equity markets in the year ahead. In particular, the market should favour those more cyclical stocks (i.e. Materials, Consumer Discretionary, Financials and REITs) that are more sensitive to the economic cycle, benefiting from continued economic growth.

With the economy having recovered much faster than anticipated, this rebound in economic growth and activity has fuelled inflation and we have seen a bump in bond yields as a result. This environment bodes well for value managers, as growth managers are invested in companies that are more sensitive to inflation and potential rising rates, albeit a few years away. The key focus of investors right now is on whether or not inflation is transitory. Rhetoric from the RBA and central banks more globally continues to be monitored, and with the market now at all-time highs, we expect as this rhetoric evolves, that it will spur higher levels of volatility in the year ahead for equity markets.

International equities

Global equity markets reached all-time highs in the second quarter, this is despite increasing inflationary pressures leading to higher input and consumer prices. Reflecting a consensus view that inflation spikes will moderate, bond yields and inflation expectations generally declined (in contrast to sharp bond yield increases in the first quarter). While most central bankers continue to state their view of transitory high inflation, the Fed's rhetoric became hawkish, more so than previously expected. Following its June meeting, it forecasted two 25 basis point rate hikes in 2023, versus 2024 according to prior guidance. Central bankers also began discussing the need to plan for tapering asset purchases at future meetings. Other developed central banks similarly adjusted policy, while several emerging markets policymakers raised rates.

As a broad cohort, value stocks, which typically benefit from inflationary cyclical upswings, trailed growth stocks, while small caps lagged large caps. US equities advanced higher, beating their developed ex US and emerging market counterparts. The S&P 500 returned 10.0%; the MSCI ACWI 9.0%; and Emerging Markets 6.6%. European equities increased however underperformed US counterparts. Eurozone business activity expanded at the fastest rate in 15 years, as the vaccine rollout and subsequent economic reopening lifted confidence. UK stocks, however, have trailed most other major developed markets YTD and continue to trade at a steep discount to broader developed stocks despite business activity indicators reaching their highest levels on record in the second quarter. Europe ex UK stocks returned 6.7% versus the UK's 5.8% in local currency terms. Asia including Japanese markets were soft over the quarter but posted positive gains.

From a sector perspective, Financials, Consumer and Materials all delivered double digit returns, while Information Technology, Consumer Discretionary and Communication Services stocks were the laggards.

International equities outlook

We expect continued strength in global equity markets, in particular cyclical stocks pegged to economic reopening, the key drivers being further fiscal stimulus, continued monetary policy support and escalation of the vaccine rollout. That said, we are mindful of potential bouts of volatility over the next few quarters: recent spikes in bond yields incited mini taper tantrums in stocks, particularly large cap tech, which reap the greatest benefit from low rates, while COVID-19 virus variants pose threats to the pace of the economic rebound.

It appears investors expect the recent inflationary spikes will be transitory, however recent hawkish rhetoric from central bankers will likely produce volatility in expectations which will feed into stock markets, this is important given global equity markets have reached all-time highs at the end of the June quarter. Despite the pullback, we continue to believe that this environment and the divergence in valuations will support value over growth stocks for the short to medium-term.

Figure 4. International Shares (Local Currency Terms)

Source: FactSet, Perpetual Private

A-REITS and G-REITS

(Listed property securities)

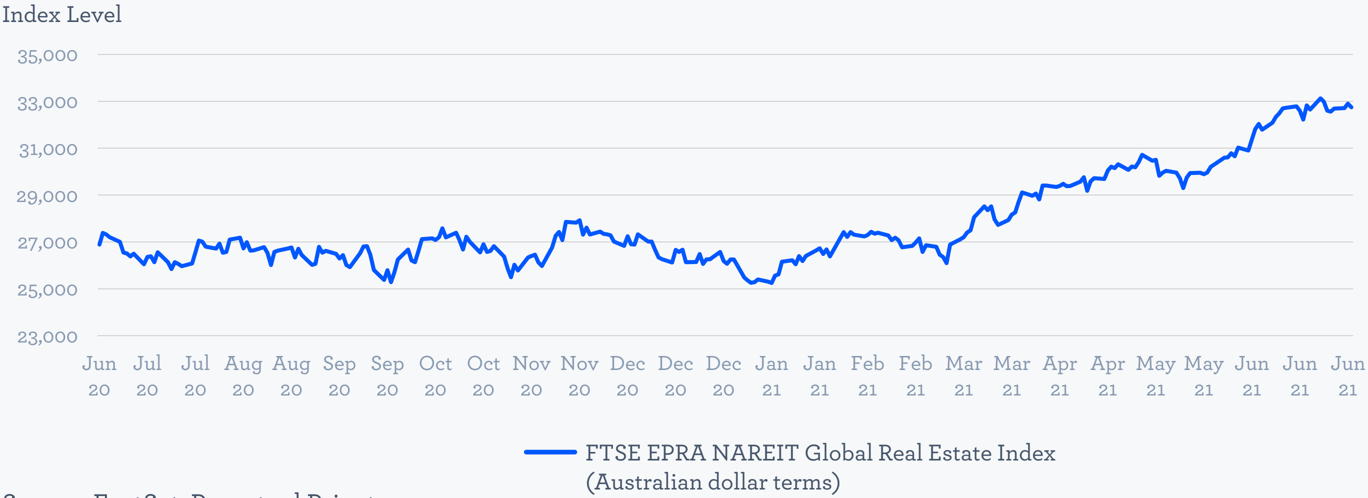
In AUD terms, Global Real Estate Investment Trusts (G-REITs) rose 10.8% over the quarter to the end of June 2021 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index rose by 9.0%. Over the quarter, Self-Storage continued its rally, while Residential and Mixed Use were the best performing sectors. Capital raising during the quarter was broadly opportunistic, with Covid winners being the most active in the market.

In Australia, A-REITs rose 10.7% over the quarter, outperforming the broader equity market (S&P/ASX 300 Accumulation Index) which rose 8.5%. The quarter saw a rebound in performance of those REITs which underperformed during Q1 with 'growth' REITs and REITs with large fund management arms rallying. These moves were on the back of improved earnings guidance. In the smaller end of the market, Centuria announced it would be merging with PrimeWest.

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

Source: FactSet, Perpetual Private

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



Source: FactSet, Perpetual Private

REITs outlook

The COVID-19 pandemic continues to result in significant disruption and volatility across global real estate markets. Until markets have 'certainty' around government policy (e.g. travel restrictions, vaccinations, stay at home orders, etc) and an economic recovery becomes self-sustaining, we expect markets to be less focused on company and real estate fundamentals and more focused on having exposure to less affected sectors (eg industrial).

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

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

We expect the accommodative monetary policy to remain a feature of markets for some time, particularly in Europe and the US, which will support real estate valuations. Despite central banks globally insisting that short term rates will be anchored at historical lows, volatility elsewhere in bond markets will lead to higher volatility in REIT markets.

Our managers are focused on those assets with strong and/or improving balance sheets and improving earnings prospects. We remain of the view that 'quality' real estate with access to capital markets remain the most attractive investments at this time. The outlook for REITs varies meaningfully by sector and investors should be circumspect on the robustness of short-term earnings underpinning current sector level valuations and the valuations ascribed to individual assets.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned 1.5% during the June 2021 quarter. The Australian 10-year bond has experienced some volatility but trended lower in the last few months, finishing the June quarter with yield of 1.5% down from 1.8% at the end of March.

In May 2021, the seasonally adjusted estimate for Australian unemployment was 5.1%, down from 5.5% a month prior. Furthermore, the Participation rate improved slightly to 66.2% from 65.9%. The March reading for CPI is still below the RBA target. CPI rose 1.1% for the 12-months ending March 2021 led by an 8.7% increase in automotive fuel. The RBA expects to hit its 2% inflation target some time in 2023.

In their July statement, the RBA noted that the job market and economic growth are better than they originally expected, but wages growth and inflation have not improved at the same rate. The RBA will continue its bond buying program until at least mid-November, lowering the rate across the yield curve and lowering the costs for borrowers.

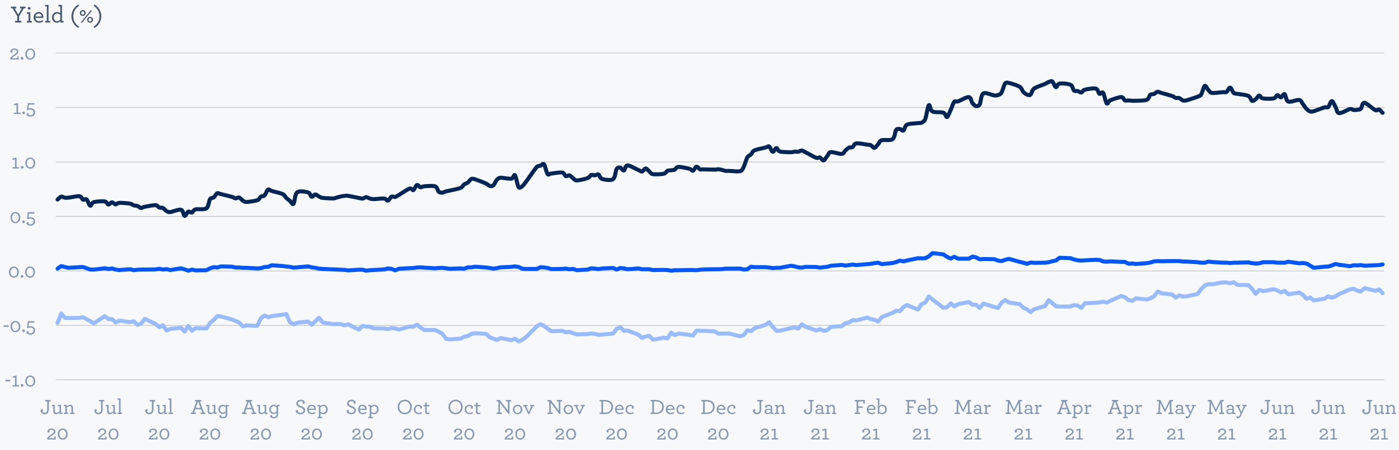
On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned 0.9% for the period. Credit fared a little better with the ICE Bank of America Global Corporate Index (Local Currency) returning 2.5% over the same period. High yield debt as measured by the ICE Bank of America High Yield Index (Hedged) performed well, returning 1.7% for quarter.

US inflation has been running hot for the last few months with CPI up 5% for the 12 months to the end of May. The Personal Consumption Index (PCI), the Federal Reserve's preferred inflation gauge, was up 3.9% over the same period, the fastest pace since 2008. Not including food and fuel, the PCI was up 3.4%.

Figure 7. Australian Government Bonds

Source: Factset. * Note: Bond prices are inversely correlated with bond yields

Figure 8. Global Government Bonds



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

The Federal Reserve (the Fed) is committed to its targets of full employment and 2% inflation. In their recent statement, they explained that they are happy for inflation to run higher than 2% in the short term, as inflation has run persistently below that and higher inflation is required to anchor CPI at around 2% over the long run. The Fed added that the recent increases in inflation are because of transitory factors.

In June, the Fed decided to retain its cash target between 0.00% and 0.25%. The committee expects to maintain this target range until labour market conditions reach levels consistent with full employment. Unfortunately, non-farm payroll numbers have disappointed over the last few months. Unemployment was 5.9% in June, up from 5.8% in May. To help maintain the flow of credit to consumers and businesses, the Fed agreed to increase its holdings of treasury securities by at least $80 billion per month and of agency MBS by at least $40 billion per month. US 10-year treasuries finished the period with a yield of 1.45%, down from 1.74% at the end of March 2021.

Fixed interest outlook

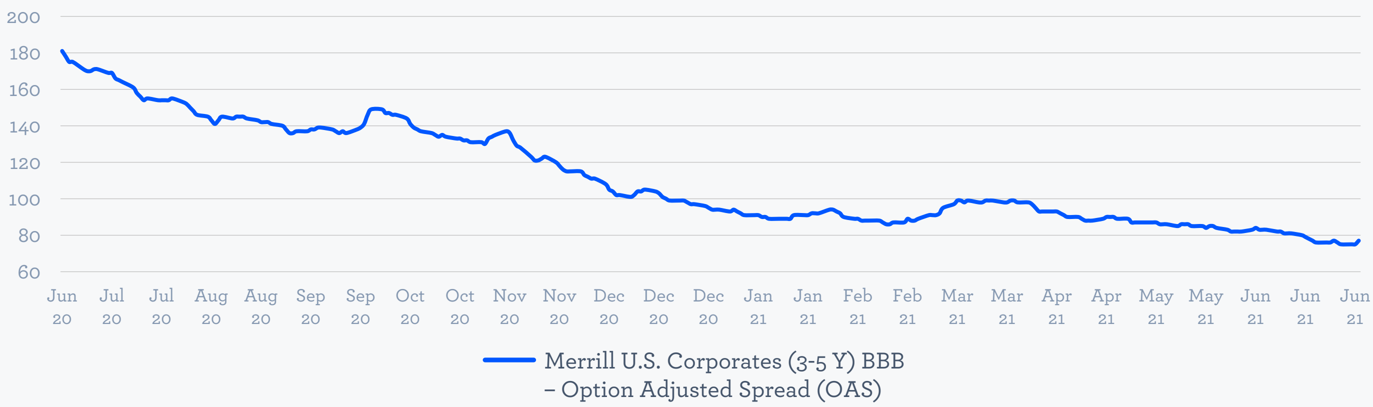
After some very good economic news and the strong fiscal support proposed by most developed market governments, inflation expectations remain high. However, the enthusiasm for policy overshoot and higher rates from earlier this year has subsided. Both the US and Australian 10-year bond yields have fallen from their early 2021 highs. We expect continued volatility in government bonds.

We continue to have a positive view on credit when compared to longer dated developed market government bonds. Investment and non-investment grade spreads are tight but are supported by the flow of credit to the consumer and businesses. Under these conditions, defaults should stay low.

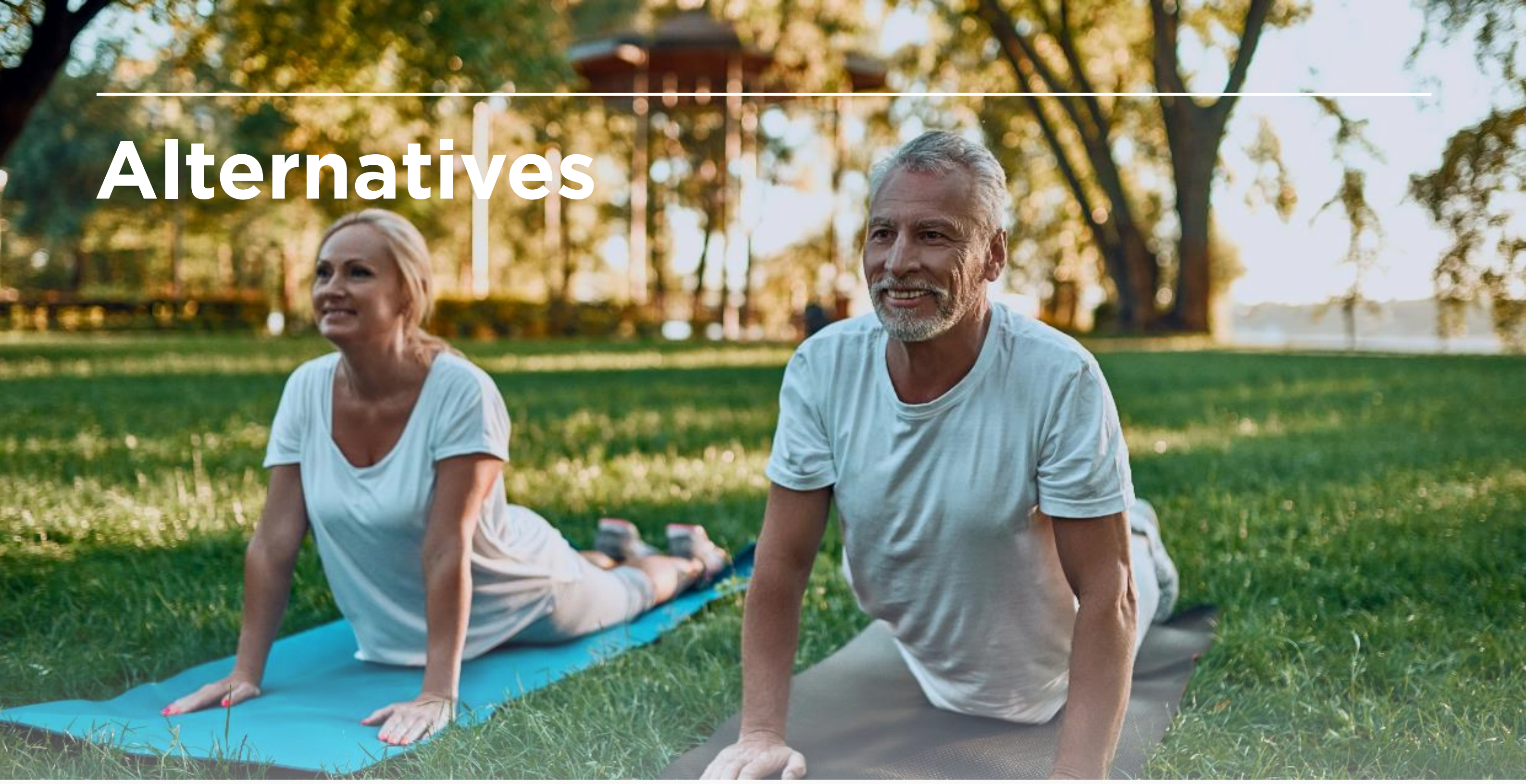
There are some potential risks that may change our positive view of credit. These include a further deterioration in economic activity from COVID and the deterioration of US-Chinese relations.

Figure 9. Global Credit Markets

Difference VS. US Govt Bonds



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



Alternatives

Growth alternatives

As we move further into 2021, and the economic recovery gains momentum, we continue to see asset valuations across Private Equity, Real Estate and Infrastructure recover. These valuations have been supported by unprecedented and coordinated fiscal and monetary policy action, the reopening of economies, and the improving outlook.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows amongst the volatility created by Covid and the low interest rate environment. Within Unlisted Infrastructure, regulated and contracted assets remain well bid and valuations have remained stable or increased with demand from institutional investors remaining strong. We continue to see relative value in volume-linked infrastructure assets, across both private and public markets. It appears that other institutional investors concur with our views and are now looking more actively at volume linked opportunities.

The opportunity-set for Distressed Debt has been smaller than expected due to the policy actions of governments and central banks globally. Distressed Debt exposures with 'tradable' securities have seen a rebound in net asset valuations as liquidity continue to flood markets. Given this rebound, we now see greater opportunity in other Private Equity sectors such as LBO and Co-Investment strategies. With the reopening of economies, the Northern hemisphere summer drawing closer, and borrowing costs remaining low, we are optimistic that the transaction environment will improve.

With Real Estate markets, sector dispersion has been wide with Industrial and Logistics assets well bid, while valuations for Retail and Hotel/Hospitality assets remain uncertain. Similar to Private equity, capital is beginning to flow more freely with economies reopening which supports acquisition activity. However, the nexus between availability of capital and valuations remains our focus. On a relative value basis, we see opportunities in income producing assets across major sectors (multi-family, office) in secondary markets globally. Domestically, we believe the dynamics favour East Coast markets, with CBD style locations being most attractive.

In line with our views within credit and equity markets, the environment appears to be ripe for managers who emphasise security selection. As such, we are more positive on the outlook for certain hedge fund strategies than we have been for some years, particularly long/short equity and credit-focused strategies.

Income alternatives

Generally speaking, debt-focused alternatives strategies have performed in line with our expectations. A number of exposures which had been marked down through COVID-19 have been marked back towards par. Defaults post the COVID-19 recession have been limited and restructurings, more forbearance and loan holidays have been offered by lenders. Those sectors where issues are prevalent are concentrated in Retail and Hospitality and in the Energy and Materials sectors.

Our expectations of an uptick in default rates continues to moderate, supported by the desire of governments globally to underwrite the economic recovery both financially as well as by limiting 'stay at home' orders where possible. We continue to look for opportunities and yield across investment grade, sub-investment grade and high yield bonds as well as structured credit, where we see attractive relative spreads above cash, despite the easy money now having been made. In such an environment, we remain focused on managers where we have the highest confidence in their credit analysis and security selection.

We continue to monitor the Leveraged Loan market. Pricing has stabilised in recent months, where even after adjusting for higher expected default rates and lower expected recovery rates the yield remains relatively attractive.

The slowing in the pace of deployment across corporate private debt strategies continued into the first quarter. It would appear the tick up in pace we saw immediately after the COVID-19 lockdowns was a result of pent up demand, rather than a sustained recovery. We hope to see deployment return to trend by late 2021. Similarly, we hope to see the pace of realisation in Private Debt markets pick up, however we are not optimistic in the near term. Infrastructure debt remains challenging from an expected return perspective with demand from European financial institutions pushing pricing to a point where we do not see value.

More Information

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