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QUARTERLY MARKET UPDATE

June 2020

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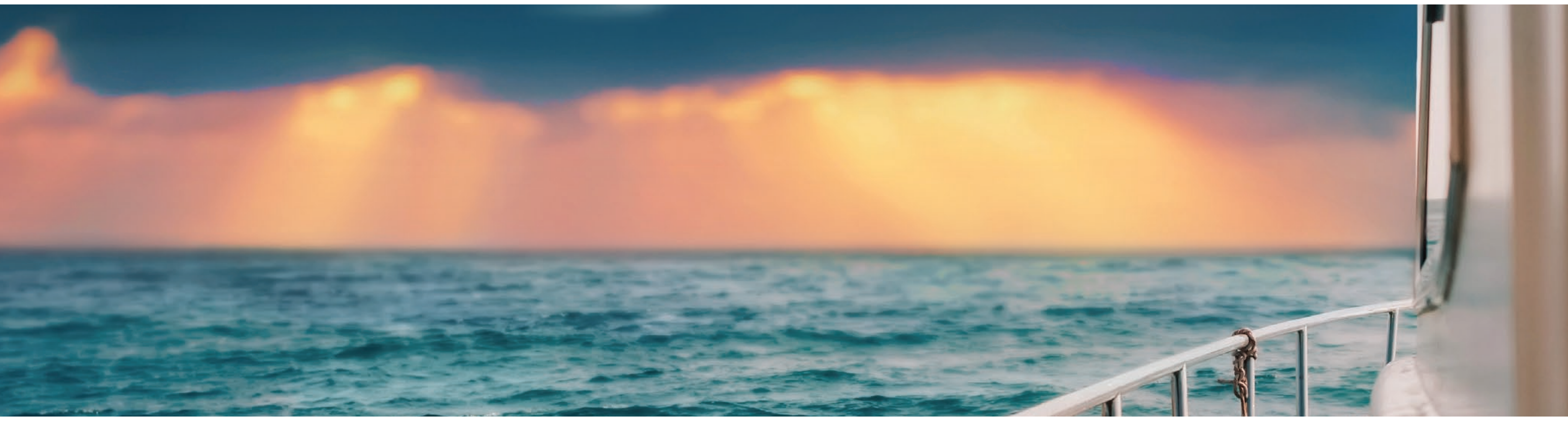
QUARTERLY MARKET UPDATE – JUNE 2020

CONTENTS

SNAPSHOT



The second quarter of 2020 was one of relief in financial markets. Having experienced the fastest sell-off in history, assets buoyed by 'all it takes' packages of fiscal policy and expansionary monetary policy regained lost ground. Australian equities rose 16.5% whilst international equities gained 17.7%. Credit markets also recovered as spreads narrowed in the face of greater liquidity and central bank actions.

AUSTRALIAN EQUITIES

The ASX 300 recovered strongly in the quarter, in response to improving virus containment and improved financial conditions. Gaining 16.5%, all sectors of the ASX 300 delivered positive returns. Technology, energy, consumer discretionary and materials returned over 20.0% each. Having benefited from the health crisis, healthcare was the worst performing sector, delivering only 2.9%. In the very same vein, consumer staples did only a little better, gaining 6.9%. Having been sold off most heavily in March, small and mid-sized companies outpaced their larger peers. The Small Ordinaries outpaced the All Ordinaries, which in turn outpaced the ASX 100 with returns of 23.9%, 17.8% and 16.0%, respectively.

INTERNATIONAL EQUITIES

Global equity markets benefited from a reduced level of investor fear and improving oil market dynamics, with the MSCI All Country World index gaining 18.3% in its 'local' currency (USD) and 6.0% in AUD terms. Having weakened as a result of risk aversion in the previous quarter, AUD returned to pre-crisis levels (a gain of 12.3% in three months). US equities, primarily driven by a handful of technology stocks (Facebook, Alphabet, Apple, Amazon, Netflix and Microsoft), outperformed developed and emerging market peers, with the S&P 500 returning 20.4% and the tech-heavy Nasdaq delivering 31.0% (in USD terms). Elsewhere, global equity markets were broadly positive, though some become negative if you consider them in AUD terms.

FIXED INCOME

Australian bonds enjoyed a more tepid period than last, though were still able to provide another positive return, as credit spreads narrowed. Overseas bonds (hedged to AUD) enjoyed even greater gains as semblance of balance in the oil market, improved credit conditions in energy markets, where large reductions in credit spreads drove high yield markets higher.

REAL ESTATE

Australian real estate investment trusts (as measured by the S&P/ASX 300 A-REIT index) were heavily impacted by the market stress, and so benefited as that stress resolved. During the quarter, A-REITs rose 20.2% whilst G-REITs (global real estate investment trusts) gained 8.6% in US dollar terms. Given the uneven impacts from lockdowns, variation between sectors was marked. Globally, the hotel and resort sector was most heavily hit, with REITs in the sector losing 13.1%.

CASH RATE

The RBA's cash rate target was held during the quarter at its all-time low of 0.25%, with the bank's board preferring alternative forms of monetary easing over lower rates. Communication continues to emphasise reluctance to move into negative interest rate territory.

AUSSIE DOLLAR

The Australian dollar recovered its crisis-led falls over the June quarter, strengthening against all major currency pairs. A combination of the RBA publicly rejecting the use of negative interest rate policy, some early success in virus containment, and a restarting Chinese economy helped to support our dollar. Against traditional safe-haven currencies the Swiss franc, US dollar and Japanese yen, it gained 10.8%, 12.2% and 13.0%, respectively. On 30 June, one Australian dollar bought US$0.69, having been as low as US$0.55 in the depths of March.

ALTERNATIVES

Against their 'cash-plus' benchmarks, alternative asset classes endured a challenging quarter as assets were revalued using traditional asset classes 'equivalents'. Assets linked to infrastructure such as toll roads and airports suffered acute disruptions to revenue as planes were grounded and populations placed under lockdown. Disruption caused by the crisis has been a source of opportunity in private markets, though heightened uncertainty around the future trajectories of economies is restraining deal activity.

Markets made significant rebounds over the quarter, following the sell-off in February and March. Despite strong reasons for optimism, we are not out of the woods yet. Close monitoring of news flow, along with patient consideration, is the order of the day. We continue to encourage investors to bear the following principles in mind:

- **Stay calm** – Just as we sought to avoid getting too fearful when markets sold off, don't get too greedy as markets show only early signs of recovery.
- **Stick to the plan** – If your long-term strategy was correct before March, it is likely still correct now. If your circumstances have changed, you may wish to make the appropriate adjustments whilst markets are calmer.
- **Rebalance** – Your asset allocation underpins your long-term risk and returns. Consider returning to target weights, if deviations have occurred.
- **Scan the market** – As the investment landscape incorporates new information, we continue to seek investments and managers who will benefit from the new cycle.

GLOBAL ECONOMIC OVERVIEW

'This crisis is a crisis like no other and will have a recovery like no other.'

– Gita Gopinath, Economic Counsellor and Director of the Research Department at the International Monetary Fund (2020).

WHAT HAPPENED?

Following the rapid and severe collapse across financial markets in February and March, the June quarter has been one of renewed confidence. Having recovered from near-term lows, the period saw Australian equities gain 16.5%[1] (16.8% including dividends), with international equities posting a similarly impressive return of 17.7%[2] (18.5% including dividends). This was a theme that was consistent across most investment markets, as efforts by central banks and governments to improve financial conditions, had the desired effect.

According to the IMF, 'Global fiscal support now stands at over 10 trillion dollars', and an increase in G10 central bank balance sheets (an indication of monetary support) of $6 trillion dollars has been delivered since the pandemic began. Balanced against an expected loss of US$12.5 trillion of cumulative output over the next two years, these significant actions have given investors sufficient comfort, in the face of the high degree of uncertainty.

Looking at the VIX (Figure 1), a measure of investor fear, we can see that despite being elevated against its long-term average, it is significantly below the heights it reached in March. Indeed, driven by tech giants who were positioned to benefit from The Great Lockdown, US equity markets are near or, in the case of the Nasdaq, above their February highs. (Note: the Nasdaq has reached all-time highs since the crisis unfolded.)

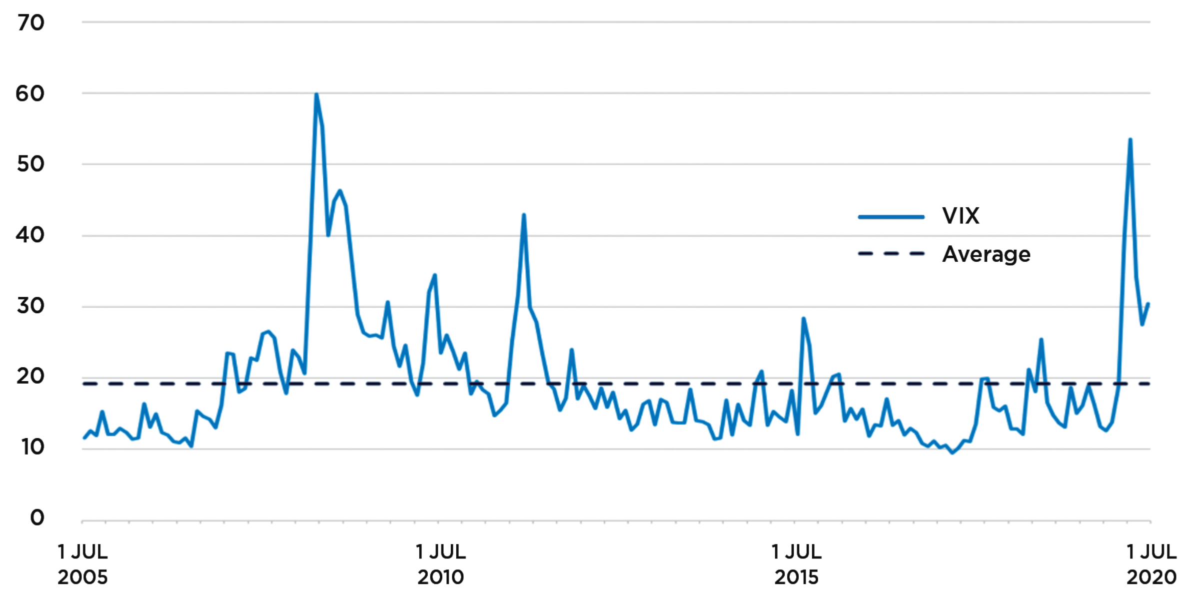
Just as we couldn't imagine, prior to the turn of the year, a world with COVID-19, it's now hard to imagine a world without it.

WHERE ARE WE?

In considering the current environment, we contrast developments against our conceptual roadmap. Quite simply, with the virus precipitating a health crisis, an economic crisis has been accepted by way of The Great Lockdown. Therefore, for the investment landscape to return to some semblance of pre-crisis normality, both the health crisis and the economic crisis will need to have been addressed. For the health crisis, this would require a medical solution, namely a vaccine. A resolution of the economic crisis is more difficult to define but would likely require unemployment levels to fall towards pre-crisis lows (it is likely that recent experience will have caused damage to labour forces, adding to long-term unemployment – an effect known as hysteresis). For this to occur, it is crucial for a stabilisation of the health crisis to occur, along with the retention of economic connections within economies and between countries, so that they may restart as lockdowns fade.

We will undoubtably spend many years ahead reviewing the effectiveness of lockdown as a solution to the pandemic. One thing that is clear and has been readily recognised by authorities is the imperative to ensure that connections between economic agents (businesses, workers,

FIGURE 1. VIX



Source: FactSet, 2020.

suppliers, etc.) remain. Whilst we are familiar with the expression 'Have you tried turning it off and on again?' when facing computer problems, the same benefit does not readily lend itself to economies. With businesses and employees being able to maintain their connections through measures such as the JobKeeper program (to name but one), the hope is that as restrictions are eased, output levels can rapidly return. The more these connections are lost, the slower the rebound. This is something which is implicitly acknowledged by much of the fiscal response, with the RBA stating that these programmes had 'helped to keep the employment relationship between businesses and workers'.[3]

WHAT ARE THE DARK CLOUDS ON THE HORIZON?

Just as we couldn't imagine, prior to the turn of the year, a world with COVID-19, it's now hard to imagine a world without it. The world has irreversibly changed and whatever the future looks like, the 'recovery will be one like no other'.

Whilst it is certain that large parts of economies will be able to quickly return to similar business operations as the virus becomes increasingly managed/manageable, there will be sectors whose ability to retain appropriate connections are compromised and whose return to pre-crisis levels will be painfully slow. There will also be behavioural changes that will likely divert spending from one sector to another, leaving 'winners' and 'losers' within economies. In his speech discussing the likely economic recovery to the Economic Society Australia, Deputy Governor of the RBA Guy Debelle noted that 'uncertainty includes the behavioural response'.

Given that support programmes cannot run indefinitely and that consumer behaviour changes given time and exposure, the key element here is timing. Anything that can work to slow the recovery risks further damage.

On the virus front, we have a long distance to travel. In their World Economic Outlook, the IMF observes: 'In the absence of a medical solution, the strength of this recovery is highly uncertain and the impact across sectors and countries, highly uneven.' Despite regular encouraging reports with regard to a vaccine, some estimates suggest one will not be approved until at least April 2021, with only a 28% chance of earlier success.[4] Once approved, sufficient stockpiles will need to be built to meaningfully stamp out infections. In the meantime, we are likely to experience flare-ups and even waves (new and distinct explosions in transmission) as social distancing is relaxed. A further complication is if the virus mutates, it likely pushes back any medical solution indefinitely and potentially invalidates any degree of herd immunity.

Additionally, strained relationships between global powers have been exacerbated by the crisis. The IMF warns: 'Geopolitical tensions and trade tensions could damage fragile global relations at a time when trade is projected to collapse by 12%.'[5]

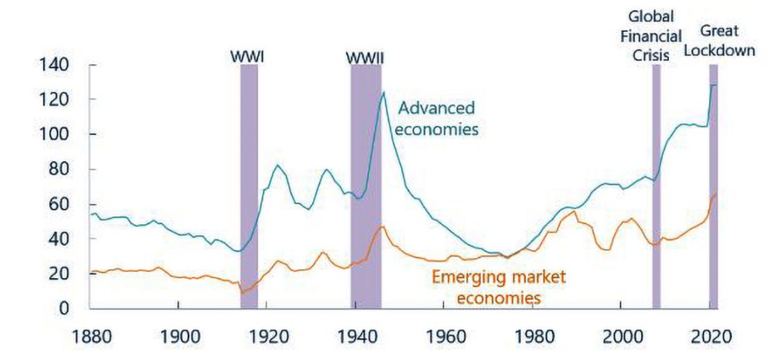
With the US president campaigning for a second term, he no longer has the significant advantage of a booming economy. This leaves the 'wartime leader' strategy as his next best hope of re-election. The change in this dynamic readily explains the increasing focus on anti-China rhetoric from the White House. When we consider the fanfare with which the largely token 'Phase 1' trade agreement was announced, the contrast with today's relationship between the two countries is stark. We suspect, regardless of the outcome of the election, we will never see a 'Phase 2' deal. As COVID-19 continues to gain momentum amongst the US population, President Trump will seek to divert attention elsewhere.

This leads us to believe that we will continue along a path of escalating tensions until the election in November. We focus here on the US-China relationship, not because it is unique, but because as the two largest economies they are the most immediately meaningful for capital markets. Russia, Iran and North Korea all present challenging dynamics to the global order. Within countries, economic hardship will add fuel to social unrest.

Ultimately, it has been widely accepted that the monetary and fiscal policy response to the crisis have been both necessary and sufficient for the time being. Whilst positive, this leaves ample opportunity for policy error. Withdrawing and reversing stimulus too soon could result in an economic

FIGURE 2. GLOBAL PUBLIC DEBT IS EXPECTED TO EXCEED THE POST-WORLD WAR II PEAK

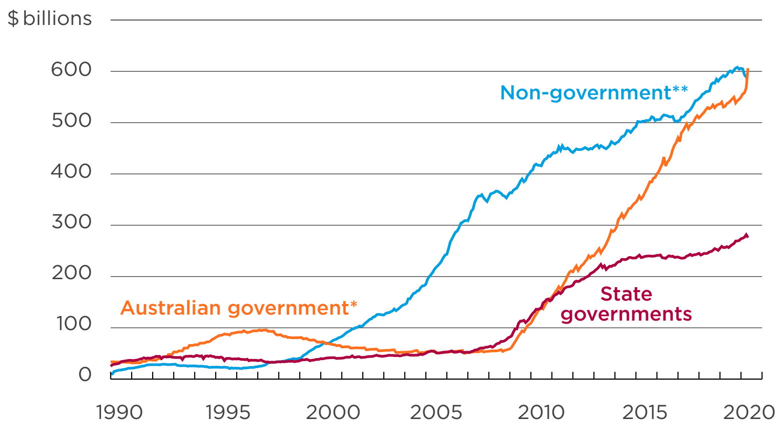
GLOBAL PUBLIC DEBT AS A PERCENTAGE OF GDP



Sources: Historical Public Debt Database; IMF, World Economic Outlook; Maddison Database Project; and IMF staff calculation.

FIGURE 3. AUSTRALIAN DEBT

BONDS ON ISSUE IN AUSTRALIA



* Excludes bonds purchased by the Australian Government.
** Excludes ADIs' self-securitisations, includes government-guaranteed bonds.

Sources: ABS; AOFM; Bloomberg; KangaNews; Private Placement Monitor; RBA; State Treasury Corporations.

relapse. Continuing stimulus too long could lead to the formation of price bubbles, competitive distortions, as well as driving public debt even higher.

In responding to both the Global Financial Crisis (GFC) and more recent events, government debt is near historic highs. This is something that is clear to observe both globally and within our own economy. Excessive debt levels are known to hamper growth and become economic fault lines; vulnerabilities that make another crisis more likely.

These factors will weigh on economic recovery and require policy makers to remain vigilant and adapt policies as the situation evolves. As Phillip Lowe, Governor of the RBA pointed out, 'Uncertainty about the health situation and the future strength of the economy is making many households and businesses cautious, and this is affecting consumption and investment plans'. Such issues lend themselves to active monitoring of data as it emerges, keeping a keen eye on connections with and between economies.

WHERE TO FROM HERE – AND HOW SHOULD I CONSIDER INVESTING IN THIS ENVIRONMENT?

In discussing current market valuations, Gita Gopinath of the IMF considers 'two important factors we think of as being important: One, the extraordinary policy support, and two, in the face of tremendous uncertainty about where the world is headed, I think markets are taking a more positive outlook for the future, and I think that combination explains what we are seeing right now'.[6]

This reflects our concerns for the coming months. Whilst our medium- and long-term outlooks are constructive, we note the potential for heightened volatility as financial markets reckon with real-world developments. Significant setbacks in virus containment, escalations in geopolitical tensions, policy error by governments or central banks, must all be avoided for financial markets to maintain their current trajectory. That isn't to say we're expecting assets to fall, but simply recognise vulnerabilities in the current status quo. A key consideration regarding volatility when making investment decisions is that it provides greater opportunity for investment gains, but also provides greater opportunities for investment losses.

Whilst we wait for meaningful and actionable data, the prudent path ahead is one of confirming assumptions, observation and patient contemplation.

The importance of having a long-term strategy is in the benefit of being able to see through the noise generated by knee-jerk actions, as market participants swing between fear and greed. This enables us to make considered and patient investment decisions, holding off until the right conditions present themselves. As noted in previous updates, we encourage investors to:

- **Stay calm** – Just as we sought to avoid getting too fearful when markets sold off, don't get too greedy as markets show only early signs of recovery.
- **Stick to the plan** – If your long-term strategy was correct before March, it is likely still correct now. If your circumstances have changed, you may wish to make the appropriate adjustments whilst markets are calmer.
- **Rebalance** – Your asset allocation underpins your long-term risk and returns. Consider returning to target weights, if deviations have occurred.
- **Scan the market** – As the investment landscape incorporates new information, we continue to seek investments and managers who will benefit from the new cycle.

As we move through to the next quarter, expect bumps along the journey. The exact path ahead is particularly clouded at present, with uncertainty remaining high. That does not lend itself to fear, but to caution. In the fullness of time, those who exhibit the correct investment behaviours now, stand to enjoy the best results.

1. As represented by the S&P ASX 300.
2. As represented by the MSCI AC World in US dollar terms.
3. The Reserve Bank's Policy Actions and Balance Sheet, Speech by Guy Debelle, Deputy Governor, at the Economic Society Australia.
4. Good Judgement Inc, Covid Recovery Dashboard.
5. IMF World Economic Outlook Update, June 2020.
6. IMF World Economic Outlook Update, June 2020 Press Conference.

AUSTRALIAN CASH RATE

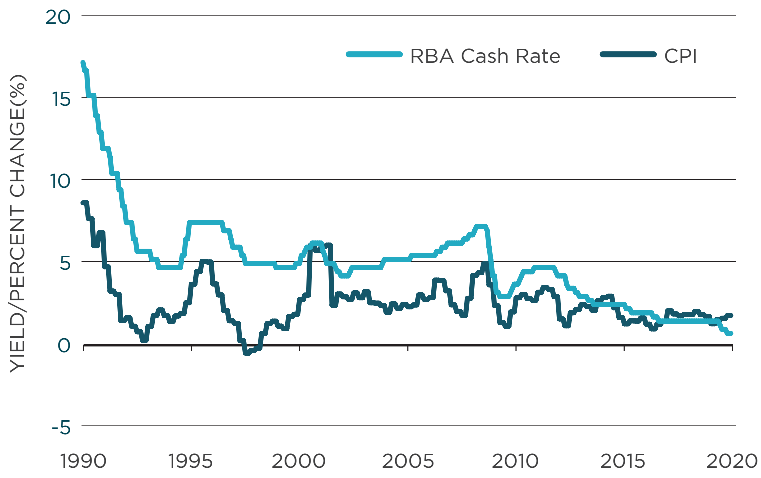
Having cut the cash rate target twice in March in response to the fallout from the COVID-19 pandemic, the RBA held its cash target rate at its all-time low of 0.25%.

In addition, the Reserve Bank has put in place a comprehensive package to lower funding costs and support the supply of credit to the economy. Whilst consideration has been given to the use of negative rates as a policy tool, the Board questions their efficacy and instead prefers to make use of its extended toolkit.

AUSTRALIAN CASH RATE OUTLOOK

Our outlook for cash rates in Australia has not changed over the past three months. There is an institutional resistance to negative rates. As such, a focus on unconventional and possibly targeted measures will be employed. In line with its global peers, the Reserve Bank has communicated that it stands ready to do 'whatever it takes' to meet its policy goals and ensure the proper functioning of the financial system.

FIGURE 4. AUSTRALIAN LONG-TERM INTEREST RATE VS INFLATION 1990 – 2020



Source: FactSet, 2020.

AUSTRALIAN DOLLAR

The Australian dollar benefited from the higher degree of optimism that was prevalent throughout the quarter. Having experienced weakness, the dollar traded to its lowest level against the US dollar in 17 years in March.

As stimulus packages were unveiled and curves flattened, the AUD steadily gained 12.2%, from US$0.61 to its pre-crisis levels around US$0.69. With a 20-year average for this cross at US$0.78, there are some tailwinds emerging for the AUD – particularly as the US experience of the virus is likely to be more severe, with later and patchier lockdown measures being applied, leading to lower rates for longer. Additionally, as panic from the initial recognition of the crisis subsides, the desire to hold USD for safe-haven purposes will also begin to fade. Against other currencies, the Australian dollar strengthened 9.9% against the euro, 12.4% against the Japanese yen, 12.9% against the British pound and 12.2% against the Chinese yuan.

FIGURE 5. AUSTRALIAN DOLLAR VS. US DOLLAR (DAILY)
US PER AUD LONG-TERM EXCHANGE RATE

Source: FactSet, 2020.

AUSTRALIAN DOLLAR OUTLOOK

With long strides towards recovery taken by the Chinese economy and the AUD trading under its long-term average, our expectation is for a mean reversion to occur for our dollar. Despite simmering tensions amongst trading partners, as well as problematic disputes and disruptions, a path to recovery is underway. Furthermore, given the grand scale of fiscal spending underway, the inevitable growth in infrastructure spending is likely to benefit Australian commodity exports.

AUSTRALIAN EQUITIES

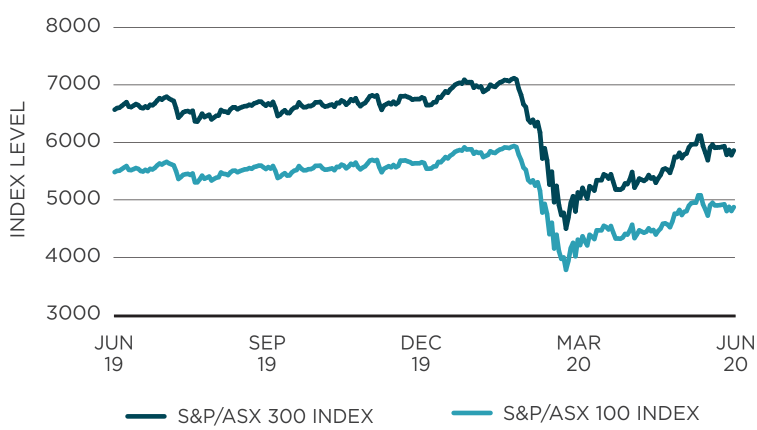
The Australian equity market, as measured by the S&P/ASX 300 Accumulation Index, rallied strongly through the quarter, gaining 16.8% and partially erasing the previous quarter's 23.4% loss.

The local market strongly outperformed the aggregate global index as measured by the MSCI All Country World Index, which posted a gain of 6.0% in AUD terms. Domestically, all sectors generated positive returns, with information technology, consumer discretionary and energy the standout performers, generating gains of 44.4%, 30.8% and 28.4%, respectively.

On the commodity and energy front, Brent crude oil rebounded by 81.0% after collapsing by 65.5% in the previous quarter, due to the pandemic and an oversupply of oil caused by Saudi Arabia and Russia. Copper rebounded by 21.1% to more than reverse the previous quarter's losses, while gold continued to rally, rising another 12.8%, adding to the previous quarter's gain of 4.8%. This is likely attributable to gold's perceived value as a safe-haven asset and as an inflation hedge.

On the economic front, the outlook remains uncertain as governments try to balance the winding back of restrictions against the threat of a potential re-emergence of the virus. Governments at both the state and federal levels have provided massive stimulus and support packages, softening the economic fallout of the virus, but data is starting to show the impact of the pandemic. Unemployment is rising sharply and the economy remains on track to dip into recession for the first time in almost 29 years.

FIGURE 6. AUSTRALIAN SHARES – LARGE COMPANIES



Source: FactSet, 2020.

AUSTRALIAN EQUITIES OUTLOOK

The domestic share market bounced back strongly during the quarter to recover most of the recent losses caused by the COVID-19 pandemic. Key to the market's recovery was the strong fiscal and monetary support provided across all levels of government, along with the establishment of strict quarantine and social distancing measures. These efforts aggressively flattened the pandemic's infection rate, thus avoiding the overwhelming of hospitals and medical services.

With the virus largely contained across most states, and hospitals well prepared to manage a potential large influx of future patients, governments are now moving to ease restrictions and bring the economy back up to full speed. However, the outlook remains uncertain, as until a proper course of therapeutics and ultimately a vaccine is found, the risk of future outbreaks remains an issue, both locally and overseas. Therefore, caution is warranted, and equity markets will remain volatile for the foreseeable future as governments around the world manage their way through this crisis.

Although the outlook remains uncertain, the sharp market sell-off caused by the pandemic allowed for bottom-up fundamental stock pickers to rotate their portfolios and establish or add to high-quality stocks that had been heavily oversold. Although this period of volatility is expected to continue for some time, our long-standing belief, that long-term fundamentals drive returns, remains intact. This period of uncertainly has brought this belief back into focus as investors seek the security of companies with strong balance sheets and sustainable earnings.

INTERNATIONAL EQUITIES

Global equity markets moved substantially higher in Q2, after falling dramatically in March. Investor sentiment rebounded off the back of record level monetary and fiscal stimulus and the reopening of several economies, despite evidence of a second wave of COVID-19 cases in some markets.

The MSCI All Country World Index gained 6.0% in AUD terms. US equities outperformed developed and emerging market peers with the S&P 500 rising 7.0% versus the MSCI EAFE's 2.1%, and the MSCI Emerging Markets' 5.0%. Notably, this outperformance is attributable to a handful of technology stocks: Facebook, Alphabet, Apple, Amazon, Netflix and Microsoft. Small caps had a strong rally in Q2 following the March plunge, outperforming large caps by 5.0%. Growth stocks continued their dominance over value by a whopping 11.6%.

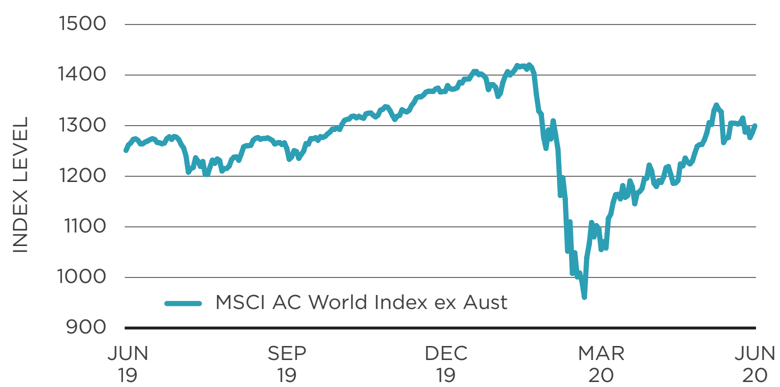
From a sector perspective, information technology continued its ascendency in Q2, returning 15.6%. Consumer discretionary was close behind with a 14.4% return. Materials also had a strong quarter, returning 11.6%. Energy stocks rebounded in Q2 with a 4.7%. Industrials returned 4.3%, and healthcare 2.5%. Consumer staples, financials, real estate and utilities all fell during the quarter.

INTERNATIONAL EQUITIES OUTLOOK

Having swung from pessimism to optimism, our base case for international equities is one of continued volatility. With many intricacies to the economic and health crises, we expect both positive and negative surprises along the path to recovery. Whilst we take comfort from the focus authorities have given to the issues at hand, health crises face non-trivial challenges which have the potential to buffet performance. Geopolitical tension is high, particularly given developments in Hong Kong with its new security laws, Iran having been the target of state-sponsored cyber-attack, not to mention North Korea and Russia. This has significant potential to add further stress to international trade at a point where it is still reeling from impacts of lockdown.

Our long-standing bias towards active, bottom-up stock picking managers across the portfolio remains unchanged, which we feel is suited to the current situation, where risk can be actively managed and long-term opportunities created.

FIGURE 7. INTERNATIONAL SHARES (LOCAL CURRENCY TERMS)



Source: FactSet, 2020.

A-REITs AND G-REITs (LISTED PROPERTY SECURITIES)

In AUD terms, global real estate investment trusts (G-REITs) fell 2.2% over the quarter to the end of June 2020 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index rose by 8.6%.

Similar to last quarter, company fundamentals were not the market's focus. Rather, market participants were focused on monetary and fiscal stimulus measures. The variance between sectors during the quarter was marked with speciality REITs rallying 26.1%, while self-storage was the worst performing sector, falling 3.7% in local currency returns. Unsurprisingly, lodging and hotel REITs lagged the benchmark, with material uncertainty around the outlook for travel remaining.

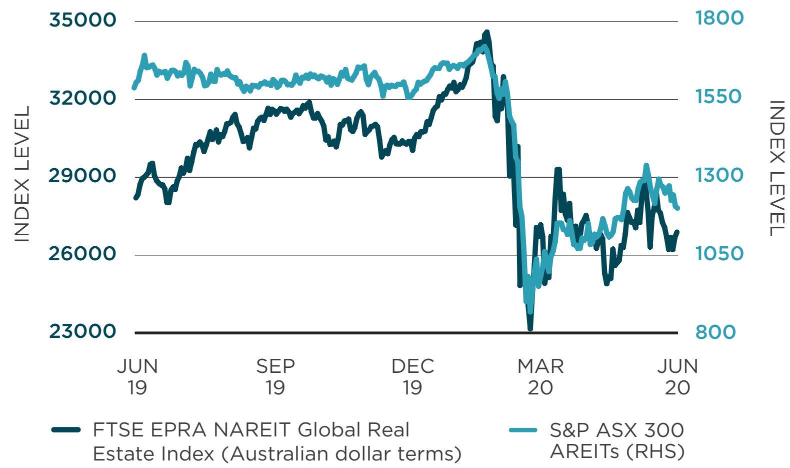
In Australia, A-REITs rose 20.2% over the quarter, outperforming the broader equity market (S&P/ASX 300 Accumulation Index) which rose 16.8%. Despite outperforming during the quarter, on a calendar year to date basis, A-REITs have trailed Australian equities. During the latter parts of June, several retail REITs confirmed what was expected – lower or nil distributions for 2H20 on the back of COVID-19. Additionally, a number of REITs released draft revaluation guidance with various retail portfolios expected to be revised down between 8% and 11%. Office and industrial asset valuations were broadly unchanged.

During the quarter, the market swung between optimism driven by the potential re-opening of economies and pessimism driven by the reality that COVID-19 will cause a recession. It is widely expected that the June quarter macro-economic data will be worse than the March quarter data.

REITS OUTLOOK

In the near term, the COVID-19 pandemic is expected to result in significant disruption, volatility and uncertainty in the global economy and financial markets. Despite the recent market rally, we expect COVID-19 and the associated disruption to drive markets in the near term until greater clarity is received from governments as to when normal activity can resume, and an

FIGURE 8. REAL ESTATE INVESTMENT TRUSTS (A-REITS & G-REITS)



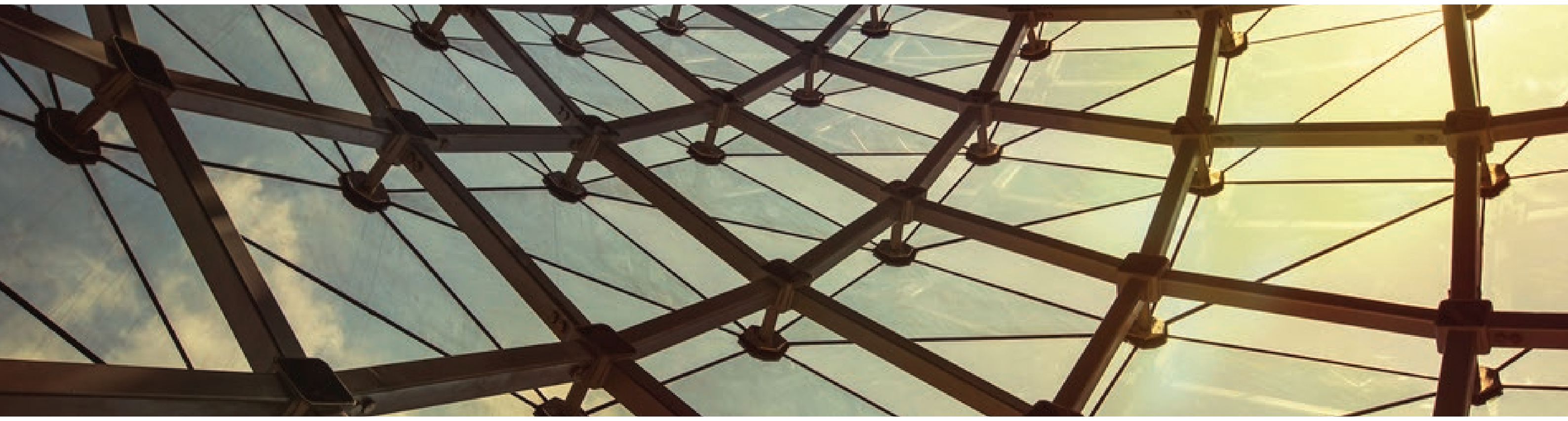
Source: FactSet, 2020.

economic recovery becomes evident. In the interim, and while uncertainty around COVID-19 remains, we expect markets to be less focused on company and real estate fundamentals.

As with all market crises, those assets with weak balance sheets or severely negative earnings prospects are sold off the most, and typically don't benefit from 'relief rallies'. While many REITs were in good shape coming into the crisis, operating conditions have changed meaningfully for some sectors, including hotels and retail, and it is still unclear as to what the near- and medium-term impact will be on revenue and earnings. For corporates, it's likely that management teams will use this crisis to further 'right size' their retail footprints. With working from home the norm for many companies during this period, it is possible there may be a shift in thinking about office space requirements by many corporates as leases expire over the coming months and years.

Given the recent drawdown in markets, valuations appear to be more attractive relative to the recent past. However, we remain cautious on the robustness of short-term earnings underpinning current valuations and the valuations ascribed to various assets. Longer term, we believe that REITs are well placed to benefit once the economic recovery begins to take hold. Furthermore, we expect the accommodative monetary policy and quantitative easing to remain a feature of markets for some time to come, supporting real estate values.

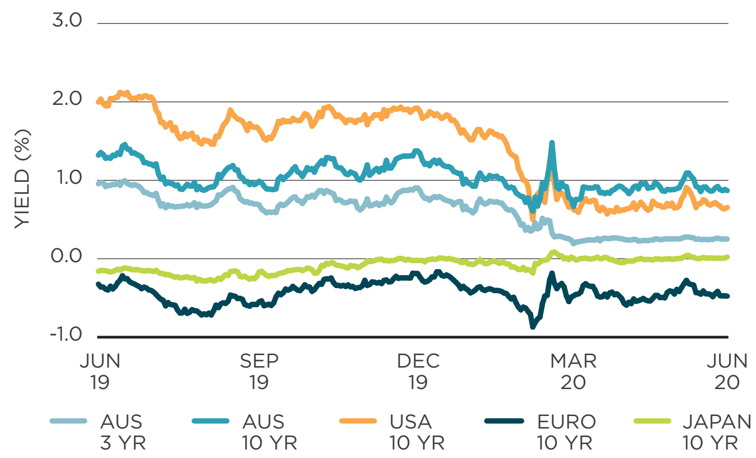
FIXED INTEREST



The Bloomberg AusBond Composite Index returned 0.5% during the June 2020 quarter, whilst the Bloomberg AusBond Bank Bill Index returned 0.1%. The Bloomberg Barclays Global Aggregate Bond Index (AUD Hedged) returned 2.3% during the June 2020 quarter. Australian 10-year bonds were yielding 0.9% at the end of the quarter, whilst its US counterpart was yielding 0.6%.

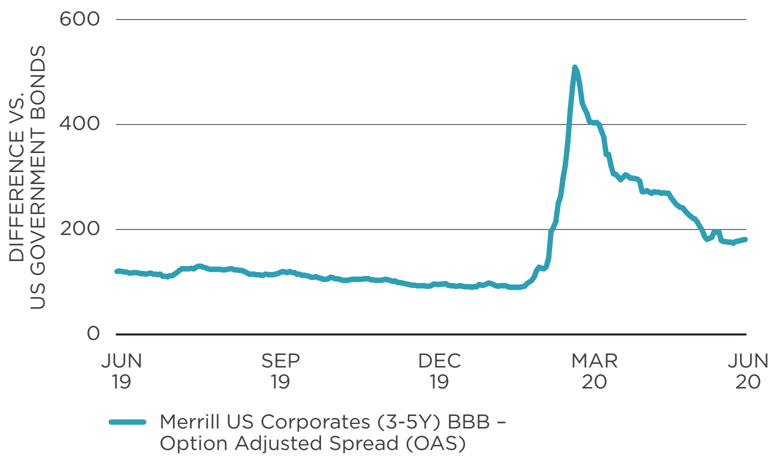
The RBA kept the official cash rate steady at 0.25% during the quarter. RBA Deputy Governor Debelle said the Australian economy had performed somewhat better than expected in the June quarter. The Australian unemployment rate increased to 7.2% as at the end of May, representing an increase of 2.0% since March. The Consumer Price Index (CPI) remained at the lower end of the RBA's target as at the end of March, maintaining downward pressure on the cash rate.

FIGURE 9. AUSTRALIAN & GLOBAL GOVERNMENT BONDS



Source: FactSet, 2020. *Note: Bond prices are inversely correlated with bond yields.

FIGURE 10. GLOBAL CREDIT MARKETS



Source: FactSet, 2020. *Note: Bond prices are inversely correlated with bond yields.

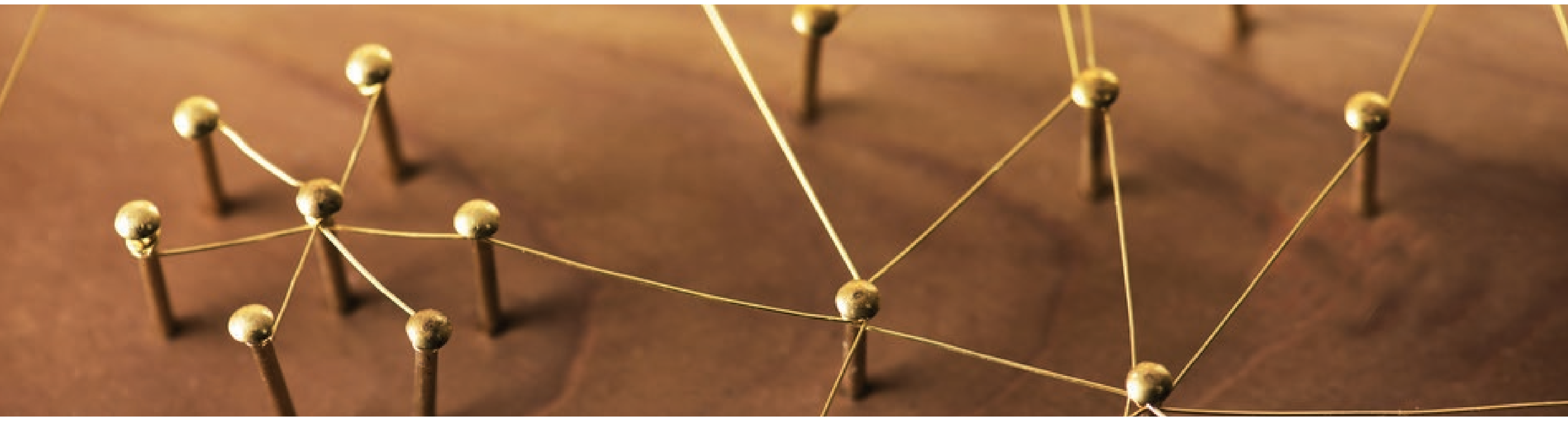
The Federal Reserve also maintained its target rate in a range of 0.00% – 0.25%. To support the flow of credit to households and businesses, the Federal Reserve has confirmed it will increase its holdings of Treasury securities, and agency residential and commercial mortgage-backed securities, to sustain an orderly functioning market.

Credit markets tightened significantly during the June quarter, retracing a large part of the widening that had occurred in the deepest days of COVID-related market dislocations. Most notably, global high yield returned 11.4% over the past quarter on an AUD hedged basis.

FIXED INTEREST OUTLOOK

We expect monetary policy to remain accommodative globally until economic growth is re-established. Although volatility may be elevated in the near term, we believe such accommodative conditions will continue to favour spread sectors, particularly corporate bonds. Historically, large spread corrections, such as during the GFC and eurozone crisis, have been followed by a gradual recovery. While spreads may not recover to their pre-COVID lows, central bank purchases are helping to normalise trading conditions and subsequently drive spreads lower. However, the unprecedented nature of this downturn, translating into prolonged uncertainty about the speed and magnitude of the recovery, warrants a very disciplined approach to credit risk, meaning a focus on quality issuers with strong balance sheets and ample access to liquidity remains paramount.

While we expect a recovery in 2021 for the global economy, the extent is yet to be determined as the speed by which economic activity resumes is still unclear. We are encouraged by the speed and the magnitude of both fiscal and monetary policy measures taken by all major economies, providing the necessary stimulus to enable economies to heal eventually. The fiscal policy measures will increase the debt burden across developed economies materially, requiring governments and central banks to be 'joined at the hip'. It is unlikely central banks will allow for government bond yields to move materially higher from current levels in order to ensure debt affordability.



PUBLICLY TRADED ALTERNATIVE MARKETS

INCOME ALTERNATIVES

For the Perpetual Income Opportunities Fund (IOF), our focus across non-investment grade credit remains within senior secured leveraged loans, predominantly in the USA and Europe. This is a floating rate, liquid bank loan syndicated market. As at the end of the June quarter, the bounce from COVID-19- induced lows has pushed current investor yields (to maturity) down to approximately 6.8% from 9.9% p.a., with an equivalent average credit spread of 6.5% p.a., at an average price of 89.5 cents in the dollar. Whilst current default rates remain relatively low across both sides of the Atlantic, they are expected to rise as the impacts of the crisis are felt throughout various sectors of the economy. On a positive note, this market has little exposure to the energy and energy-related sectors, which have faced particular difficulties on the back of a contraction in demand and a breakdown in negotiations between OPEC producing nations and their allies.

We increased IOF's exposure to the leveraged loan market at the beginning of the June quarter and took advantage of lower prices as the market looked attractive, after adjusting for higher expected default rates and lower expected recovery rates. We intend to opportunistically allocate capital in the medium term as we continue to monitor the ongoing developments of the COIVD-19 pandemic.

Absolute return funds . . . delivered positive returns during the June quarter.

To further diversify our traded credit exposure, we continue to research managers and strategies across diversified credit strategies which, in addition to syndicated bank loans, incorporate high-yield and structured credit opportunities. We believe now is a very good time to fast track this research, given the impact to liquidity that COVID-19 has had across broader credit markets, particularly those of a structured nature, such as residential and commercial mortgage-backed securities.

GROWTH ALTERNATIVES

Listed infrastructure, in our view, is one of the few sectors of the equity market which exhibits a relatively low correlation with broader equity market returns, hence our allocation to this sector as part of the Perpetual Growth Opportunities Fund. Despite a lower interest rate outlook, listed infrastructure has seen adverse impacts from the COVID-19 pandemic. This impact has been pronounced in areas such as airports and toll roads, which are expected to incur significant revenue declines. We had opportunistically lightened the Fund's exposure following a bounce in the sector during late March. We expect to be adding to current exposures during periods of weakness.

Absolute return funds, including the Perpetual Growth Opportunities Fund's investment into Invesco's Global Targeted Return Fund ('Invesco GTR'), delivered positive returns during the June quarter. Thus far the sector has provided solid capital protection attributes during the COVID-19 crisis, given the relatively low to neutral market exposure exhibited.

PRIVATE ALTERNATIVE MARKETS

COVID-19 has seen short-term activity across private equity and debt markets grind to a halt, which will delay the pace of realisations previously expected across the portfolios. Valuations across private markets; private infrastructure, private equity, private property and private debt, are likely to come under pressure over the short to medium term. At this stage, it is too early to ascertain the impact, with a lot still depending on the duration of the crisis. However, we are comfortable that the managers and strategies we have invested with are of a quality nature, and that value will be realised over the longer term.

Throughout late 2018 and CY2019, we maintained a cautious approach towards private equity and private infrastructure, given heightened levels of deal activity, rich valuations and heightened levels of leverage within some strategies. We allocated minimal capital to these sectors and our approach remains to selectively invest with managers and strategies that operate in niche markets, which are relatively less competitive and well sized to provide flexibility when exiting. Our biases away from sector specific strategies (e.g. energy, consumer) adds an additional layer of diversification, which will protect the downside in the current environment.

The Perpetual Growth Opportunities Fund's exposure to distressed debt and restructuring strategies will incur some volatility in the current environment. We had opportunistically increased the exposure to distressed debt and restructuring strategies during late 2017 and early 2018. With a significant amount of dry powder left to invest, these strategies are well placed in today's environment.

We are comfortable that the managers and strategies we have invested with are of a quality nature, and that value will be realised over the longer term.

We have long held the view that we are still in a post-GFC environment where there remains an overhang of companies and sectors that will undergo restructuring and consolidation due to market dislocation. COVID-19 has proved to be the event causing such market dislocation, which will necessitate further restructuring and consolidation, sooner rather than later. As providers of capital in this market, we believe we are taking on debt-like risk where the downside is protected, for equity-like returns.

As both Australian and global banks continue to consolidate their loan books, we continue to see opportunities to invest in strategies that conduct direct lending to companies that require capital. Our focus is on lending strategies that are senior in the capital structure and secured against assets. Across the Perpetual Income Opportunities Fund we have identified and built material investments in four key credit sectors: infrastructure debt, private corporate debt, senior bank loans, and commercial real estate mortgages. COVID-19 is likely to create significant private debt opportunities going forward. The funds are invested in private debt strategies which have ample dry powder to take advantage of such opportunities.

The specialist credit allocation within the portfolio is currently yielding approximately 3.5% per annum (net of fees). In comparison, the Australian cash rate is currently yielding 0.25%.

MORE INFORMATION

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