Perpetual Private | Quarterly Market Update

Cautious optimism rules as markets stay strong

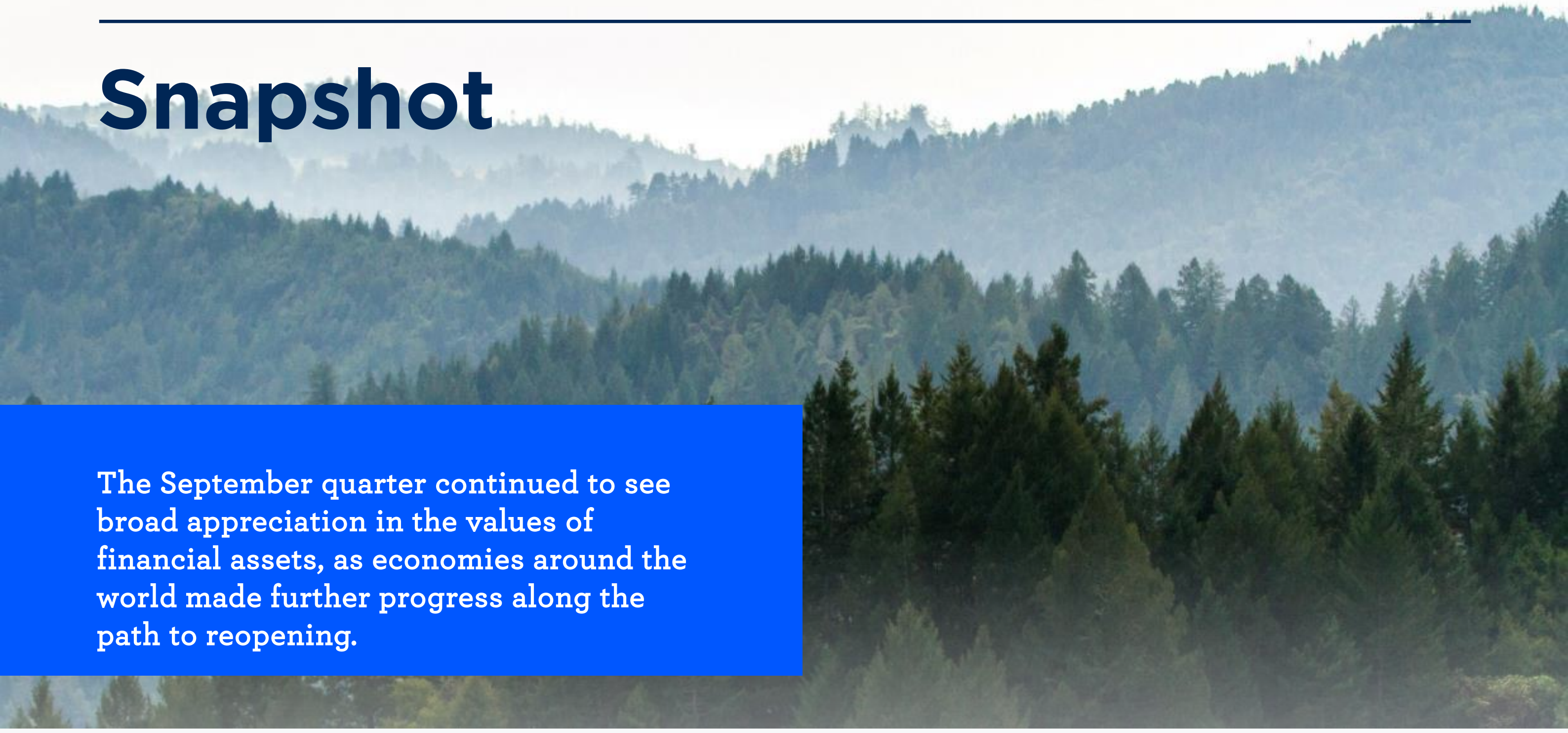
September 2021

Trust is earned.

Perpetual

Contents

Snapshot



The September quarter continued to see broad appreciation in the values of financial assets, as economies around the world made further progress along the path to reopening.

So much so that in some fields, particularly those which are service oriented, labour shortages were noted. This was most apparent in the UK, where Brexit has ended the "free movement" of people from the continent, leading to upward pressure on the cost of "low skilled" labour.

However, the emergence of Delta as the dominant COVID-19 strain has cast a shadow over the improving business environment, given its higher levels of transmissibility resulting in increased infections, hospitalisations, and deaths. Here in Australia, our previously held covid-zero approach was invalidated as first Sydney then Melbourne found that lockdowns were increasingly ineffective against the new strain.

Despite this, as vaccination programmes continue to inoculate populations, the world is beginning to reintegrate, with borders opening and supply disruptions beginning to alleviate.

Australian equities

Australian equities continued to gain in value, though at a reduced pace with the S&P/ASX 300 Accumulation index gaining 1.8% over the period. Resources showed a significant divergence as the Energy sector gained from a tighter supply environment, rising 8.0%. Materials meanwhile, fell by almost 10% (9.6%) as Iron prices pulled back due to falling Chinese demand. Indeed, the Materials sector was the only one out of the 11 to post a negative return.

International equities

Global equity markets advanced in the quarter, with the MSCI All Country World index rising 3.9%. Matching our domestic market, Materials were a detractor, losing 1.2%, alongside Consumer Discretionary (-1.4%) which gave back some of its previous gains due to the impact of Delta. Energy, as with the Australian market, gained the most (6.8%) closely followed by Financials and Information Technology (5.9% and 4.5% respectively). Across regions, Japan produced belatedly strong returns (in AUD terms) of 8.7%, lagging most other regions over longer timeframes. Of note, was that Emerging and Frontier markets, lacking in sufficient vaccine supplies, lost 4.3%.

Real estate

Australian Real Estate Investment Trusts (as measured by the S&P/ASX300 A-REIT index) maintained momentum from the previous quarter, gaining 4.8%. Global Real Estate Investment Trusts (G-REITs) meanwhile, stayed roughly flat, slipping back 0.2%. Of the subsectors residential real estate continued to benefit from low interest rates, gaining 11.2% to post an impressive 12 month return of 50.8%[1].

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite index returned 0.3%. Movements across other bond markets were even more tepid, with the Bloomberg Global Aggregate only returning 0.1%. Even the riskier end of credit markets, as represented by the Bloomberg Global High Yield index delivering a meagre 0.1%, having seen significantly greater moves over the preceding 9 months (9.2%).

Alternatives

Assets across both growth and defensive alternative asset classes have continued to recover and gain in strength. Stimulus measures undertaken by governments worldwide and supportive monetary conditions have provided a strong updraft across many of the Alternative sub-asset classes, resulting in healthy levels of transactions and an increasingly constructive investment landscape.

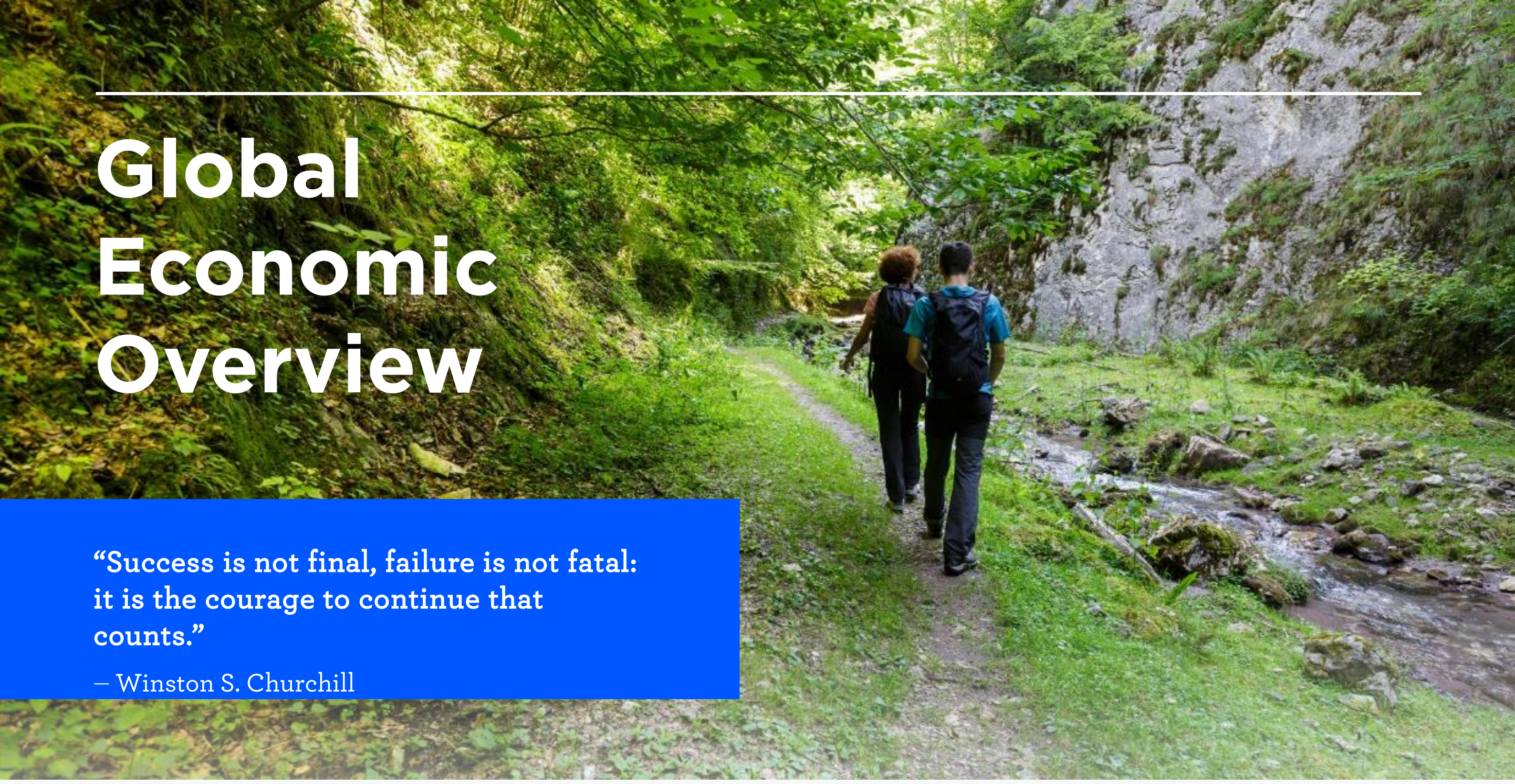
Cash rate

The Reserve Bank of Australia ('RBA') continues to hold its target cash rate at 0.1%, eyeing instead a tapering of its bond buying programme (generally referred to as Quantitative Easing) in the first instance. Despite discussion throughout the quarter that tapering was imminent, the rise of Delta and subsequent lockdowns across Victoria and New South Wales, led the Board to hold its line and indeed extend the programme until February 2022.

Aussie dollar

The Australian dollar found some weakness in the quarter, as Melbourne and Sydney found themselves in lockdown once again, falling 1.6% against the U.S. dollar to 72 cents. Elsewhere, the Aussie strengthened 1.6% against the British pound and 0.9% against the Euro, as these economies dealt with Brexit related adjustments and a more tentative recovery respectively.

[1] Measured by the MSCI World / Residential REIT index



Global Economic Overview

> **"Success is not final, failure is not fatal: it is the courage to continue that counts."**
>
> – Winston S. Churchill

Delta and change

Within both finance and certain branches of mathematics, "delta" refers to change. Whilst the naming of the Delta strain of COVID-19 was just a quirk of timing, the economies of many countries will likely acknowledge that their path to pre-pandemic norms has been changed.

The June quarter had largely continued along the theme that the virus had either been contained or at least managed, however the emergence of Delta as the predominant variant steadily eroded this belief. Countries and regions that had managed to minimise or eradicate the virus, found that previously successful protocols had become insufficient. Therefore, it is unsurprising that the September quarter experienced a reversal of some of the newly emerging trends; primarily assets geared to the reopening of economies and borders.

April and May saw markets begin to position for a recovery in economic activity, reflected in the relative performance of Value vs Growth indices, but by June this had begun to reverse. Though it was becoming widely expected that a return to some semblance of a pre-covid environment was steadily approaching, the reality of Delta and its associated setback soon became apparent. The 3rd quarter of the calendar year saw financial assets take pause, as for the second time in 18 months market participants had to reckon with a development which could have proven to be a significant setback to the health of the global economy.

Fortunately, in the course of time, we have found our worst fears allayed and to borrow words from Dr Philip Lowe of the RBA "the Delta outbreak has delayed – but not derailed – the recovery of the Australian economy"[2]. This comment, aimed at our domestic conditions, largely applies to the rest of the world, albeit with some dispersion between Developed and Developing countries. With new dominant strains an ever-present concern when dealing with a global pandemic, we are fortunate that vaccines developed, in record time, to deal with the "garden variety" of COVID-19, remain highly effective against Delta. Should that not have been the case, the setback would have been meaningful. Thankfully, as suggested in a paper by the U.S. Centre for Disease Control (CDC) we may be witnessing a virus that conforms to the path of "convergent evolution"; a technical term which simply means there are a limited number of ways for covid to improve and at some point, these will be exhausted and the scope for new dominant strains depleted. As such, we are inclined to look past the current setback and consider (in absence of a successor to Delta), an environment where social movement becomes increasingly less restricted, and the world begins to open up once again.

[2] Speech "Delta, the Economy and Monetary Policy", Governor Dr Philip Lowe, Reserve Bank of Australia, 14th September 2021

Main themes

Assuming this path, there are three main areas which occupy our thinking. We consider each in turn below:

Inflation

To some degree, concerns of inflation can be viewed as a positive sign and testament to the effectiveness of the stimulative policies undertaken by governments (fiscal) and central banks (monetary). When we consider the dramatic shock to economies brought about by The Great Lockdown, policy response has been remarkably successful. Even though the growth trajectory of many economies was brought to a sudden halt, the existence of inflationary pressures suggests that the actions taken have prevented far worse scenarios from prevailing.

The alternative, deflation, is almost universally considered to be a hard to redeem, downward spiral. Indeed, the orthodoxy held by the more respected central banks, is that inflation levels at or around 2% are a suitable level for constructive economic growth. Recent months have seen bouts of fear that inflation due to an overstimulation of economies may force central bankers to increase interest rates earlier than anticipated, with far reaching impacts for investment markets.

These fears are not without merit. We observe numerous examples of rapidly increasing prices for goods in certain markets. We are all aware of the price increases being experienced by goods such as second-hand cars and (new) televisions; fascinating as they are practically unique i.e., never experienced before.

The crucial point to note from these examples, is that they are driven by disruptions in supply more than they are driven by excessive demand (in both cases a lack of computer chips). With closed borders and constraints on shipping, the theme of supply disruption is relevant to much of the current inflationary pressures. Given these impacts would likely dissipate as the world re-opens, it is understandable that so many economists see the current spike in inflation as transitory. Despite this, there is still a risk that should these “transitory” factors persist, they will influence inflation expectations and therefore cease to be transitory. To paraphrase the U.S. Federal Reserve Chairman, Jerome Powell; the current spike in inflation will remain transitory, until it brings about a change in the inflation regime i.e. it is transitory until it ceases to be transitory.

The key concern here is that should long-term inflation expectations begin to rise, maintaining price stability will become an increasingly difficult task and likely demand more aggressive increases in interest rates, as opposed to the current anticipation of a tentative and gradual upward glide path, beginning in 12-18 months. Fortunately, inflation expectations remain well anchored. According to the IMF, “inflation is expected to revert to pre-pandemic levels by mid-2022”[3] and that “long-term inflation expectations present a relatively strong degree of anchoring”. Should these beliefs prove to be correct (as per our base-case) the likelihood is that a sufficient degree of support will continue to be provided to the ongoing economic recovery.

Geopolitics

Despite the ongoing and steadily escalating tension between China and the U.S. (and its allies), we do not see any meaningful risks stemming from this in the near-term. Firstly, when we look back on history, markets have rarely paid much notice to geopolitical tensions. Even after the beginning of World War 2, U.S. markets continued to rise for months.

They key caveat to this is where events escalate to conflict and capital assets (factories, buildings, etc) start being destroyed. Putting aside the tragic loss of life that is likely associated with such developments, it stands to reason that these tangible impairments to assets would be reflected by the associated financial assets. Certainly, in our globally interconnected world, a conflict is likely to disrupt supply-chains and lead to scarcity of some goods.

Fortunately, despite posturing from both sides, it is likely to remain just that for some time, posturing. It is in neither side’s interest to engage in outright conflict (both “sides” will lose more than they gain) and so we anticipate the current pattern of strong rhetoric and sabre rattling to continue over the coming years. If we frame this in economic terms, we have departed the equilibrium point of a U.S.-lead world and now need to adjust to a new one. How that looks remains to be seen but we assign a low probability to any developments that might impact markets over the coming few years.

[3] World Economic Outlook: Recovery During A Pandemic, International Monetary Fund, October 2021

Equities

Despite the Delta driven setback, not only have equities continued to march forward, but conditions are largely constructive for them to continue to deliver healthy returns. Whilst we retain some concerns that pent up demand for services might not be as great as some are predicting, it is reasonable to expect an increasingly confident consumer. This can be justified by a more buoyant social atmosphere as workers gradually return to offices, travel becomes less constrained, and the hospitality and entertainment sectors start to rebuild. When we look globally, those countries and regions who are more advanced along the reopening path (such as the US and the UK), are already showing a meaningful rebound.

Of course, just as The Great Lockdown saw winners (home delivery, electrical goods, internet services) and losers (tourism and hospitality), we can expect some of the same, only in reverse, as societies reopen. As it stands, it seems highly likely that large swathes of consumption will be redirected from the purchase of goods to the purchase of services. What this means, is that markets seem positioned to continue to gain in value at the top line (i.e. market indices) whilst beneath the surface (individual companies and sectors) will be turbulent, as for the second time in two years they are forced to adjust to a "new normal".

Where to from here

With economic support packages likely to continue to help both businesses and consumers, the outlook for financial assets over the coming months and years is largely positive. As supply disruptions begin to dissipate, emboldened consumers open their wallets and unemployment continues to fall, expect the emergence of 'animal spirits' driving a flurry of economic activity. Whilst we discussed above the supply driven nature of the current levels of inflation, just as these begin to dissipate, demand is likely to rise to meet the rising levels of supply. This in turn, should begin to generate a healthier level of long-term inflation, at or near central bank targets.

Given that levels have broadly failed to rise to these targets for over a decade, combined with comments from prominent central bankers that they are willing to allow some degree of "overshoot", it's quite possible that we'll see average consumer price increases at the high end of the 2-3% range. What this really means for investors over the period is that their savings are likely to lose spending power unless they are able to generate returns above this. This, in turn, will drive market participants to take on more risk than they otherwise might.

When we consider investments, we take a particular interest in their risk characteristics. Any attempt to overreach to meet our desired returns, can quickly becoming damaging, should market events not turn out as expected. A more appropriate and sustainable approach is to match the level of investment risk, with the level of risk capacity our investors can comfortably bear. Just as the old saying goes, "take care of the pennies and the pounds will take care of themselves", we believe that by taking care of risk, returns should take care of themselves.

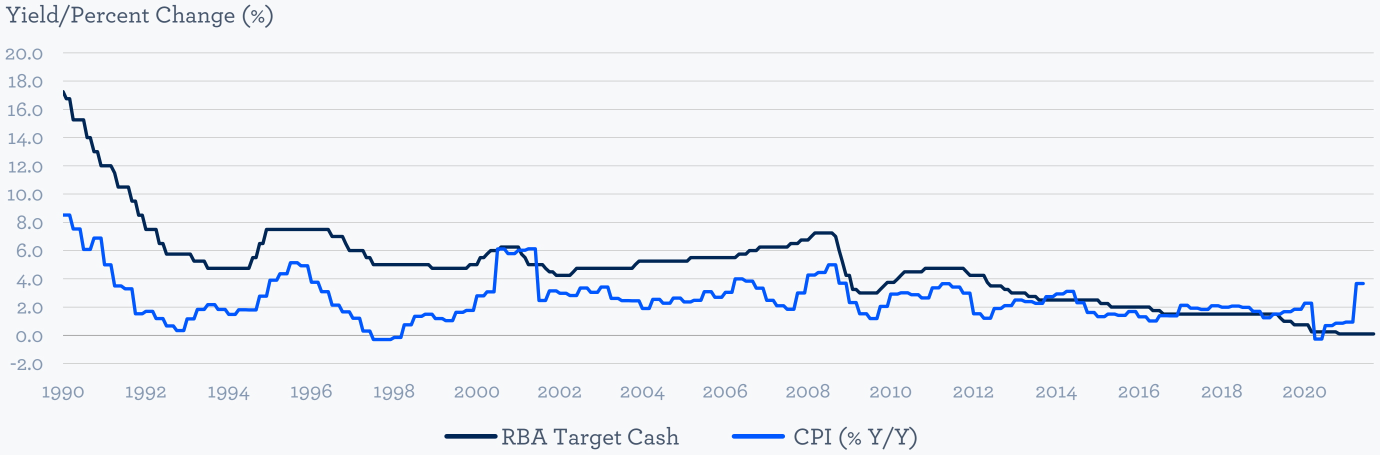
Australian cash rate and dollar

Australian cash rate

The RBA maintained its cash rate target at 0.1% at its October meeting, with the same target for the April 2024 3-year Australian Government bond. Despite growing confidence in our economic recovery, Governor Lowe noted that the "Delta outbreak has interrupted the recovery of the Australian economy and GDP is expected to have declined materially in the September quarter"[4]. This setback though, appears temporary with many businesses now planning for the easing of restrictions and consumer savings in rude health. Whilst it is believed that consumer confidence is robust, it would not be surprising if the experience of the past 18 months did not encourage some degree of caution.

With some degree of uncertainty remaining, alongside a multi-speed recovery (some sectors performing significantly better than others) it is likely that monetary conditions will remain supportive. Indeed the RBA closes its October Monetary Policy Statement with the following comment "will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024. Meeting this condition will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently."[5]

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

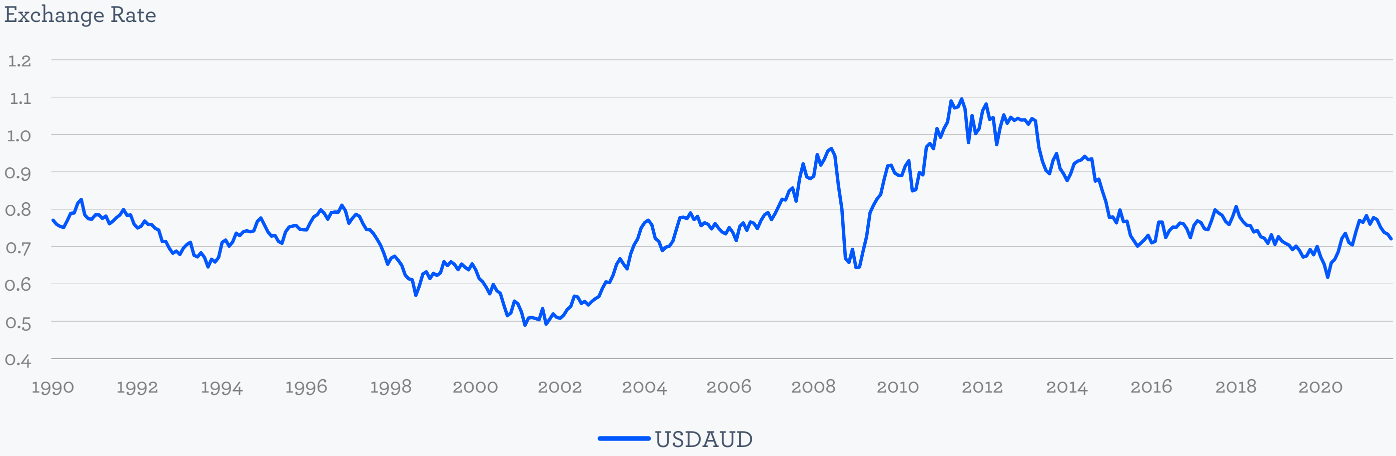


Source: FactSet, Perpetual Private

[4] Statement by Philip Lowe, Governor: Monetary Policy Decision, Reserve Bank of Australia, 5th October 2021
[5] Statement by Philip Lowe, Governor: Monetary Policy Decision, Reserve Bank of Australia, 5th October 2021

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

USD Per AUD Long-Term Exchange Rate



Source: FactSet, Perpetual Private

Australian dollar

Considered a "risk" currency, the Australian dollar experienced a significant weakening during the unfolding of the covid crisis in 2020. As the world has worked through the experience, vaccines were developed and economies reopened, the Australian dollar (AUD) has returned to strength. From it's depths in March 2020, the AUD has gained 17.3% in U.S. dollar terms. However, with the waning success of our "covid zero" approach due to the challenging characteristics of the Delta variant, our dollar has weakened 8.2% since it's near-term peak in February of this year. Fortunately, with an increasingly vaccinated population, the exchange rate has begun to again find stability, softening only 1.6% in the past quarter.

Australian dollar outlook

As a "risk" currency, the Australian dollar looks set to continue strengthening as the world opens up again. In turn, the "safe-haven" currencies are likely to soften, providing relative support. Ignoring the dramatic falls driven by the economic shock of The Great Lockdown, the AUD has traded between 70 and 80 U.S. cents for over 6 years now. Should the world continue to plot a course out of the dramatic events of last year, and fiscal measures remain supportive, it is considerably likely that the rate will trend towards the upper end of this band over the near term.

Australian and international equities

Australian equities

The Australian equity market crawled higher over the quarter, with the S&P/ASX 300 Accumulation Index delivering a 1.8% return for Q3 in AUD terms, which was broadly in line with global equity markets: the MSCI All Country World Index delivered a higher 2.8% return in AUD terms.

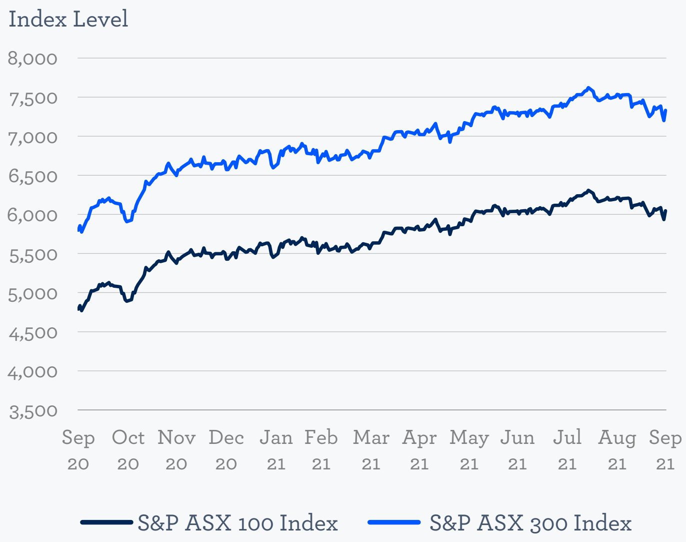
The Australian share market faced a number of headwinds towards the back end of the quarter, noting the ASX300 was down nearly 2% for the month of September. In particular, there have been signs of tightening monetary policy from central banks globally, with some economists forecasting interest rate hikes may come as early as 2022 amidst concerns inflation may not be transitory – many central banks have adopted more hawkish stances and some emerging markets banks have already raised rates to prevent runaway inflation.

Despite these inflationary concerns and some other global political uncertainties; Australia has intensely focused on the vaccination rollout and is currently on track to achieve target vaccination rates in October 2021. This should see the easing of lockdown restrictions and the reopening of the economy. This proved supportive of the Australian equity market over the quarter, alongside strong corporate earnings, employment data and the current low-interest rate environment.

The best performing sector for the quarter was Energy stocks (8.0%), benefitting from a strong surge in energy commodity prices (gas, oil and coal) through September due to increased demand from Europe and China. Industrials (6.3%), Financials (5.0%), Consumer Staples (4.5%), Technology (4.8%), A-REITs (4.8%), Communication Services (5.3%) and Utilities (5.1%) also posted strong returns.

The only negative sector for the quarter was Materials (-9.58%). This was primarily caused by iron ore prices which plummeted through the back half of the quarter, with substantially reduced demand from China. This had a significant impact on our iron ore producers over the quarter, namely BHP (-22%), Rio Tinto (-21%) and Fortescue Metals Group (-37%), all of which form a large component of the ASX300 index and Materials sector.

Figure 3. Australian Shares
Australian Shares – Large Companies



Source: FactSet, Perpetual Private

Australian equities outlook

Solid but uneven near-term economic growth, both domestic and globally, has been supported by sustained ultra-low interest rates, enormous government fiscal stimulus to date and the acceleration of the COVID vaccination rollout and global re-opening of economies. In particular Australia is on track to achieve their double-dose vaccination targets by October 2021, which will see the easing of restrictions and favours the return to growth for Australian businesses.

Looking beyond the short-term disruptions from COVID, economic momentum both home and abroad remains strong and the Australian recovery remains one of the most advanced in the world and well ahead of 2020 forecasts. Cheap money and excess liquidity are still the dominant factors driving extreme valuations and support for corporate activity.

However, global inflationary pressures (and the possibility of future rate rises) have emerged and are being monitored closely: we are seeing surging commodity prices (iron ore aside); post-COVID supply chain issues and reduced capacity; reduced labour force mobility and increasing wage pressures; and the 'on-shoring' or 'de-globalisation' of company workforces.

Generally, companies appear to be less focused on shorter-term lockdowns and more focused on the longer-term challenges, including potential for higher embedded inflation. A combination of factors suggests a return to a sustained global recovery with the possibility of higher inflation and higher bond yields.

International equities

Global equities reported mixed performance over Q3, with the first quarterly decline since the onset of the pandemic, a stark contrast to the all-time highs of Q2. Significant drawdowns in emerging markets were the key driver of losses, with developed markets advancing slightly and Growth outperforming Value for the quarter.

Ongoing fear around governments tightening monetary policy, coupled with political uncertainty around the globe were the main contributors to relatively muted equity performance. The MSCI ACWI[6] returned 2.84%; and Emerging Markets -4.48%, in AUD terms. Many central banks have furthered their hawkish stance on monetary policy with Fed Chairman Jerome Powell, who previously labelled the elevated inflation as transitory, conceding that heightened prices could be here for longer than originally anticipated. This prompted some Fed members to bring forward their forecast interest rate increases to as early as 2022. When considered against the backdrop of interest rate hike estimates being brought forward to 2023, from 2024 last quarter, the shift in central bank signalling is becoming apparent.

The United States has reached it's sixth debt ceiling standoff in the last 10 years following political tensions around two potential landmark bills: the $1.2 trillion infrastructure deal and the $3.5 trillion social spending package. Despite these tensions, US equities advanced for the sixth consecutive quarter with the S&P 500 returning 4.17%, however curtailed by a steep decline of -3.64% for September.

Figure 4. International Shares (Local Currency Terms)

Source: FactSet, Perpetual Private

[6] MSCI All Countries World index

Strong sectors included Financials, Utilities and Communications with the main detractors being Industrials, Materials, and Energy. US corporate earnings growth nearly doubled expectations with revenue and net profit margins both setting new highs since 2008.

Chinese authorities introduced numerous restrictions on the Technology sector over the quarter, this was compounded with market volatility instigated by concerns around financial contagion relating to the potential collapse of real estate developer Evergrande. As a result, Pacific (excluding Japan) equities declined in Q3, trailing all other developed markets, driven mostly by sell-offs in Hong Kong equities.

Economies across the Eurozone continued re-opening with economic confidence remaining stable at all-time highs. European equities gained but slightly underperformed broader developed markets. Europe ex UK lagged its UK counterpart for only the second time since the end of 2018, despite economic headwinds in the UK due to inflationary pressures. Japanese equities experienced the largest growth, outpacing all other developed countries and regions on the back of the central bank reinforcing expectations that it will continue the country's stimulus program.

International equities outlook

Global equity markets appear to be exiting the early stage of the macro recovery, typically categorised by an extended period of strong gains with minimal drawdowns. As we move into the next phase of the economic expansion the outlook hinges on inflationary pressures and political uncertainty. If inflation continues to exceed expectations, central banks may continue to bring forward their forecasts for interest rate hikes and begin tapering asset purchases in attempts to prevent runaway inflation. This may have the effect of lowering equity returns and increasing volatility, moving global equity markets into a 'bumpier' period of returns.

Political tensions in both the US and China, coupled with the looming collapse of real estate developer Evergrande, and the ensuing financial fallout, have exposed some underlying market uncertainty, however we expect equities to continue their upward trajectory in the short-medium term, and we maintain an overall positive outlook for global equity markets.

In the US there is substantial support for economic growth through heightened household wealth and supportive fiscal and monetary policy. Furthermore, strong Japanese and Eurozone economies, backed by accommodating monetary and fiscal policy, should add to positive investor sentiment. Fuelled by the economic recovery, we expect cyclicals to outperform, and we maintain a slight overweight to these sectors in the portfolio accordingly.

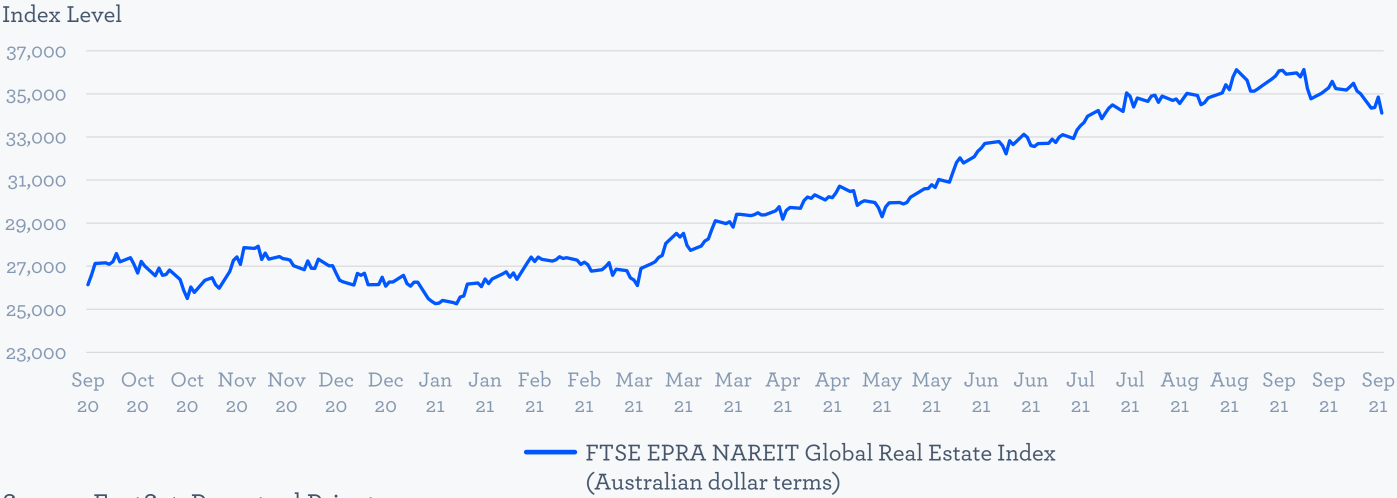
A-REITS and G-REITS
(Listed property securities)

In AUD terms, Global Real Estate Investment Trusts (G-REITs) rose 3.0% over the quarter to the end of September 2021 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index fell by 0.2%. In Australia, A-REITs rose 4.8% over the quarter, outperforming the broader equity market (S&P/ASX 300 Accumulation Index) which rose 1.8%. Across both global and domestic REIT markets, the quarter began strongly, however September saw negative returns as investors became concerned about the potential for rising interest rates and inflation. Within the domestic market, the main themes were: i) acquisitions of office and industrial properties by both large and small cap REITs, and ii) capital raisings by small cap REITs to fund various acquisitions. Late in the quarter, China's Evergrande found itself in the midst of a solvency issue, which has had flow on impacts across China's residential property market.

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

Over the quarter, we saw a shift in the market's focus away from the COVID-19 pandemic, towards the outlook for inflation and the path of interest rates, namely in the US. Despite this, COVID-19 continues to result in significant disruption; many corporates are still 'working from home', retail foot traffic remains below pre-COVID-19 levels, and hotel vacancy rates while improving remain below pre-COVID-19 levels.

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

- '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. However, the market is now beginning to incorporate a scenario where central bank interest rates rise over the course of the next 12 – 24 months. This may cause some volatility in markets. Those REITs with the ability to grow rental earnings or maintain development margins will likely be best placed to weather any rate rise. Sector and geographic allocation remain important with valuations and growth prospects differing across markets and segments.

Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned 0.3% during the September 2021 quarter. The Australian 10-year bond yield was little changed at the end of September, relative to June. However, bond yields experienced a lot of volatility during the period. At the end of June, the Australian 10-year bond yield was 1.5%. In August, it fell to 1.2% and by the end of September, it finished at 1.5%. Concerns about growth in July and August gave way to concerns about inflation.

In August 2021, the seasonally adjusted estimate for Australian unemployment was 4.5%, down from 5.1%. However, the Participation rate dropped to 65.2% from 66.2%. The June reading for CPI was high, rising 3.8% for the 12-months ending June 2021 led by a 6.7% increase in automotive fuel. The RBA says that the underlying inflation remains subdued and expects to hit its 2% inflation target some time in 2024.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned 0.05% for the period after posting a -0.97% for the month of September. Credit did not fare as well, with the ICE Bank of America Global Corporate Index (Hedged) returning -0.02% over the quarter. High yield debt as measured by the ICE Bank of America High Yield Index (Hedged) was relatively flat, returning 0.07% for the period.

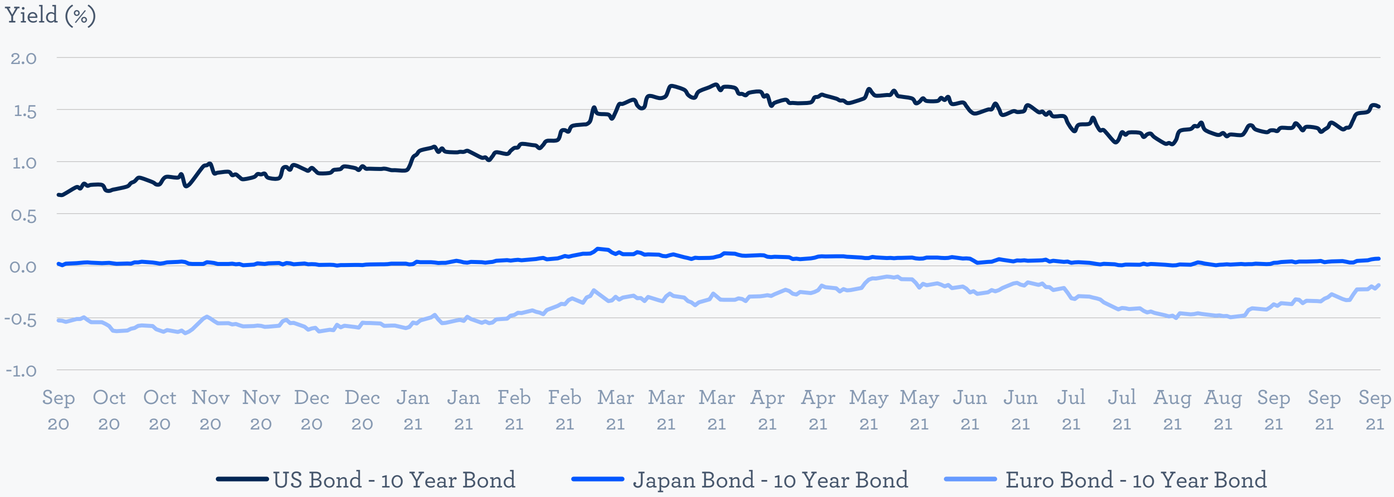
US inflation has been running hot for the last few months with CPI up 5.3% for the 12 months to the end of August. The Personal Consumption Index (PCI), the Federal Reserve's preferred inflation gauge was up 4.3% over the same period, up from 4.2% in July. Not including food and fuel, the PCI was up 3.6%.

The Federal Reserve (the Fed) is committed to its targets of full employment and 2% inflation. In their September statement, they explained that they are happy for inflation to run higher than 2% in the short term because 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.

Figure 7. Australian Government Bonds

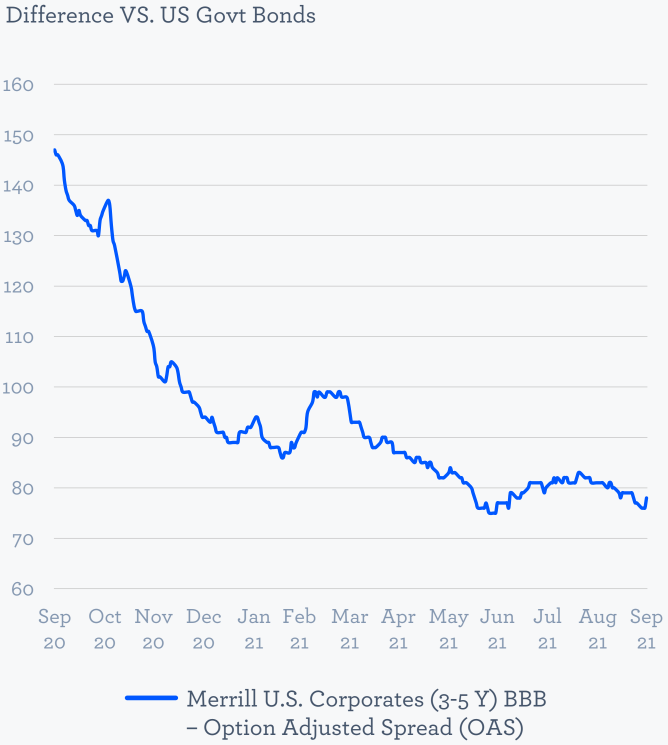
Source: Factset. * Note: Bond prices are inversely correlated with bond yields

Figure 8. Global Government Bonds



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

Figure 9. Global Credit Markets



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

Fixed interest outlook

After some very good economic news and the strong fiscal support proposed by most developed market governments, inflation expectations remain high. Enthusiasm for policy overshoot and rate hiking at a quicker pace than expected has again become an issue. Higher energy costs, supply bottlenecks and expectations of wage growth have contributed to these concerns. 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.

Alternatives

Growth alternatives

Private Equity, Real Estate and Infrastructure markets remain buoyant, supported by unprecedented and coordinated fiscal and monetary policy action and the reopening of economies. This resulted in continued strong performance for the Growth Alternatives portfolio with all sectors contributing to performance in the 3 months to the end of August 2021.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. Regulated and contracted assets remain well bid and valuations have increased with demand from institutional investors remaining strong. Our focus has been adding to exposure in volume-linked infrastructure sectors, across both private and public markets.

Distressed Debt exposures with 'tradable' securities have seen a rebound in net asset valuations as liquidity continues to flood markets over recent quarters, however we have begun to see the pace slow. We continue to see greater opportunity in other Private Equity sectors such as LBO and Co-Investment strategies. With the reopening of economies, borrowing costs remaining low, we are optimistic that the transaction environment will improve.

Sector dispersion remains wide within Real Estate markets, with Industrial and Logistics assets continuing to be 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. Domestically, we believe the dynamics favour East Coast markets, with CBD locations being most attractive.

Across hedge fund strategies and in line with our views for 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

Debt focused alternatives strategies have performed slightly above our expectations for the year. Defaults post the COVID-19 recession have been limited and restructurings at historic lows, against a backdrop of companies experiencing improved cash flows. Those sectors where issues are prevalent are concentrated in Retail, Hospitality and Energy sectors.

Our expectations of an uptick in default rates continues to moderate, supported by the desire of governments globally to underwrite the economic recovery. We continue to look for opportunities and yield across investment grade, sub-investment grade and high yield bonds as well as structured credit. Yields in investment grade and high yield markets are tight, pushed by the global appetite for yield. Leveraged Loans and CLOs offer a better spread, and with default expectations falling, better risk adjusted returns.

The slowing in the pace of deployment across corporate private debt strategies continues. We hope to see the pace of investments and 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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