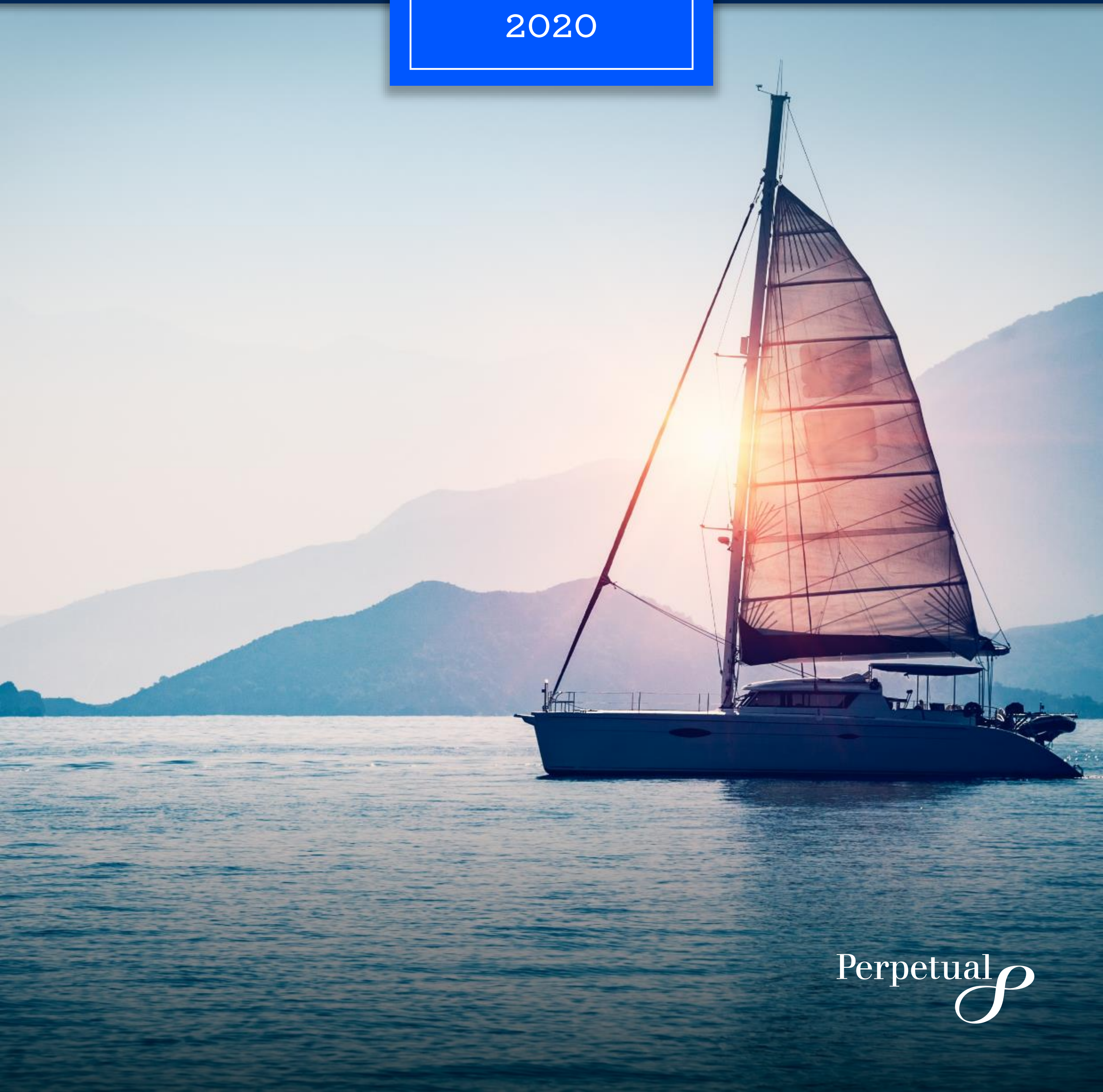
Quarterly Market Update

OPTIMISM ON THE HORIZON:
DRIVERS OF ONE OF THE BEST FOURTH QUARTER RETURNS IN HISTORY

DECEMBER 2020



Perpetual

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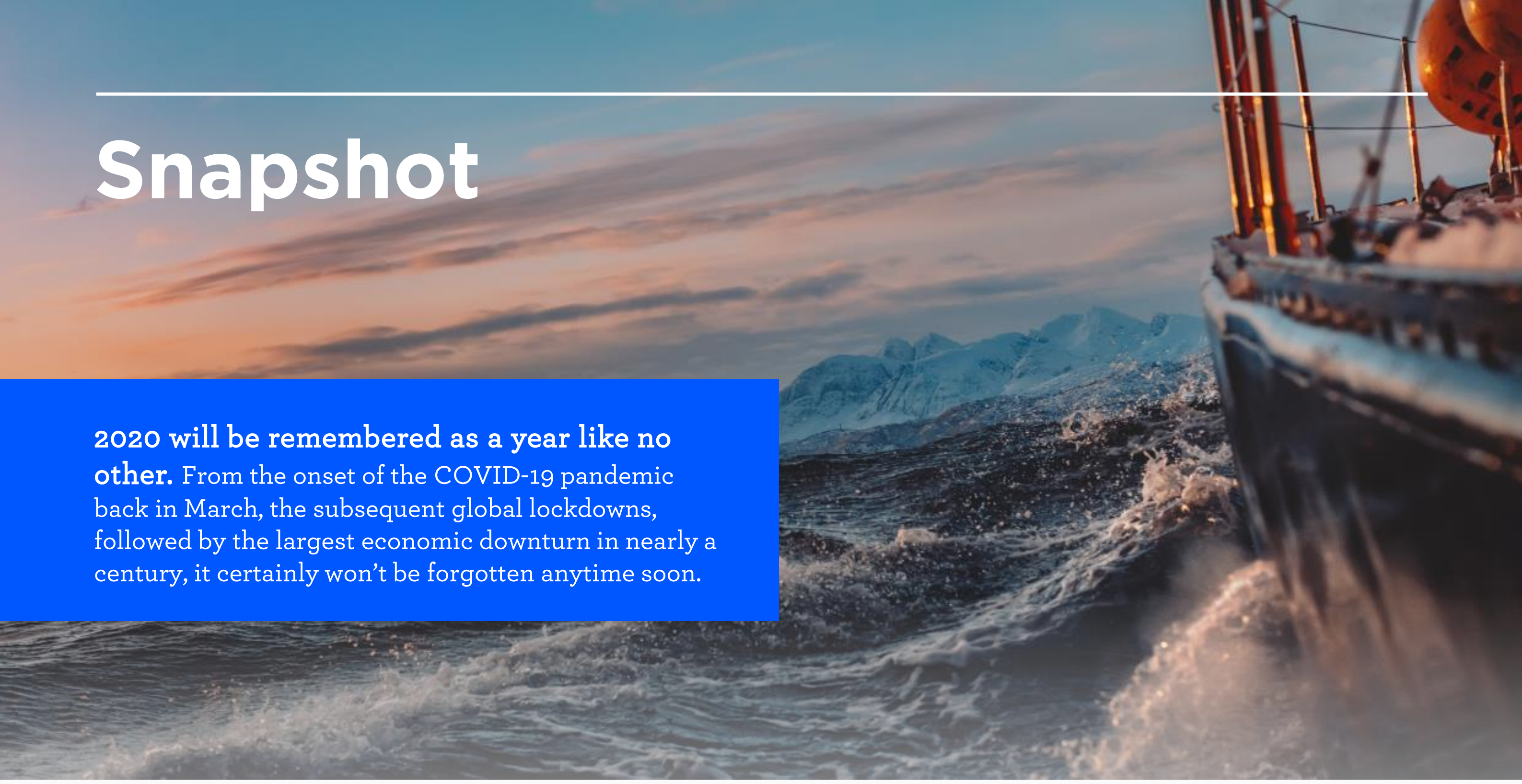


Snapshot

2020 will be remembered as a year like no other. From the onset of the COVID-19 pandemic back in March, the subsequent global lockdowns, followed by the largest economic downturn in nearly a century, it certainly won't be forgotten anytime soon.

The last quarter of the year left nothing unturned, with the Australian equity market rallying to deliver one of the best fourth quarter returns in history. Globally, we saw equity markets continue their push higher as well, with both the S&P 500 and Nasdaq reaching record highs in November.

Fuelling the optimism, was the relief that the 2020 Presidential election was behind us, and the promising news of not one but three potential vaccines to prevent the coronavirus, would be approved and distributed as we move into 2021.

Australian equities

The Australian equity market, as measured by the S&P/ASX 300 Accumulation index, powered ahead in the December quarter returning 13.8% after a flat September quarter. The strong end to the calendar year was well received by investors with the benchmark closing the year up 1.7% after steep losses earlier in the year. Domestically, as one would expect, sector returns were broadly positive with Utilities and Healthcare the only sectors to generate a negative return over the quarter. Leading sectors were Energy, Financials and Information Technology which generated gains of 26.1%, 22.8% and 22.8% respectively.

International equities

Global equity markets surged higher in Q4, bolstered by multiple new stimulus measures, and several COVID-19 vaccine trials showing 90% efficacy or higher, prompting the vaccine rollout to commence. Emerging markets stocks outperformed developed markets—with Asia excluding Japan performing particularly strongly and non-US stocks outperformed US stocks in major currency terms. Other signs of style rotation appeared as Value beat Growth and small caps topped large caps.

Fixed income

Australian bonds continued to benefit from both fiscal and monetary support. In the domestic bond market, the Bloomberg AusBond Composite Index returned 0.10% during the December 2020 quarter, whilst the Bloomberg AusBond Bank Bill Index was relatively flat, returning 0.02%. Australian 10 year bonds were yielding 0.97% at the end of the quarter, whilst its US counterpart was yielding 0.91%. In addition, credit spreads enjoyed improving business conditions and growing confidence of ongoing fiscal support.

Real estate

Australian Real Estate Investment Trusts (as measured by the S&P/ASX300 A-REIT index) have continued to benefit from positive market conditions, gaining 13.2% in the quarter, however underperforming the broader Australian equity market. Meanwhile, Global Real Estate Investment Trusts (G-REITs) gained 10.2% on a hedged basis, as fading US political tensions and positive COVID-19 vaccine announcements boosted confidence.

Cash rate

At its November 2020 meeting, the Reserve Bank of Australia ('RBA') cut the cash rate to an historic low of 0.1%. Governor Phillip Lowe said 'with Australia facing a period of high unemployment, the RBA is committed to doing what it can to support the creation of jobs'. He reiterated the view that whilst economic data has been better than expected, the recovery is still expected to be bumpy and drawn out and the outlook remains dependent on successful containment of the virus[1]. The RBA continues its narrative that they intend to keep rates on hold for at least the next three years.

Aussie dollar

The Australian dollar strengthened over the quarter, as the US presidential election and uncertainty about its outcome dragged on the US dollar. Surging iron ore prices, and strong demand from China also supported the AUD over the quarter.

Alternatives

An improving economic environment, coupled with increasing access to vaccines is presenting us with an attractive opportunity set within Alternative asset markets. Whilst this is not without risk, it plays to our strengths in conducting detailed and comprehensive due diligence.

[1] Statement of Monetary Policy – November 2020, Phillip Lowe, Governor, RBA

Global Economic Overview

A year like no other

2020 was grim on many levels. Whilst the economic fallout of the global lockdown measures taken by governments to contain the spread of COVID-19 was severe, the social toll of the virus has been just as damaging, forcing people to be isolated from family and friends for extended periods. The divergence between “main street” and “wall street” continued to expand, as the S&P500 and Nasdaq rallied to reach record highs in November.

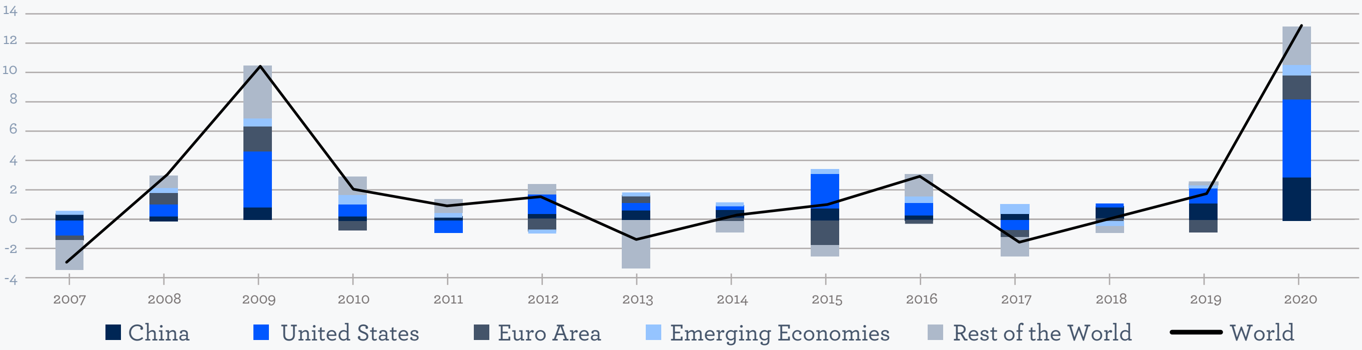
The tone of the last quarter of the year though was one of optimism. Even though daily case numbers in the US and UK rose exponentially throughout November and December, the news that three promising vaccines, two with efficacy rates upwards of 90%, pushed equity markets to record highs, aided by the support of Central banks who continued to flood markets with liquidity.

In Fixed income, bond markets continued to benefit from such accommodative fiscal and monetary support. Credit markets continued their recovery over the quarter again supported by the broad policy stimulus. Spreads have compressed considerably from their peak back in March off the back of the U.S. Federal Reserve (‘The Fed’) continuing their corporate bond purchasing program, and will enter 2021 slightly above where they closed before the pandemic began.

Whilst there is almost no trace of the pandemic in risk asset returns, it is evident everywhere else, especially the underlying economy.

The pandemic forced governments to adopt a “do whatever it takes” mentality, and it’s no doubt that rising government debt will be monitored closely over the coming years. The International Monetary Fund (‘IMF’) projects that gross government debt for the G7 economies will rise by 23% of gross domestic product (GDP) in 2020[2]. Large debt makes governments highly vulnerable to rising interest rates but on the plus side, the prospects of low interest rates, alongside the projected rebound in growth, will help alleviate the debt service burdens in many countries.

Figure 1. Contributions of the Global Government Debt Change, 2007 – 20, % of GDP



Source: IMF, October 2020

[2] World Economic Outlook, IMF, October 2020

USA

The 2020 US presidential election was only somewhat overshadowed by the chaos of the ongoing COVID-19 pandemic. In early November, markets responded favourably to an increasingly likely Democratic win but with Republicans retaining control of the senate. Critical states, like Georgia and Pennsylvania were too close to call, and political unrest in the US reached breaking point.

In early January, the runoff elections tipped the balance of power in the Senate to the Democrats, giving the incoming Biden administration a clean sweep of the House of Representatives, the Senate and the Presidency. Whilst the market had initially priced in the Republicans retaining control, the democratic sweep has set the stage for a significantly larger US$1.9tr in stimulus, paid for through higher taxation on corporations and the wealthy. It also paves the way for possible increased regulation of the Tech sector and Biden's promised US$2tr on "green" Infrastructure spending.

For US households, two significant stimulus deals were struck in the quarter after lengthy delays in the nation's capital. Congress finally approved a second economic stimulus package in response to the pandemic late December, after Trump threatened to veto the package.

The US unemployment rate was 6.7% for December which, whilst lower than the peak it reached in April of 14.7%, is still almost double the rate pre-pandemic. Whilst the US labour market has improved over the year as businesses reopened, the surge in COVID-19 cases in the US, particularly in November and December, has led to re-imposed lockdown measures, including closure of businesses, so spare capacity in the labour market is expected to remain for some time.

As the year ended, investors had a chance to catch their breath as certainty about the outcome of the presidential election and positive news on the COVID-19 vaccine front gained momentum. The approval by the Food and Drug Administration ('FDA') of two vaccines to prevent COVID-19, by Pfizer and Moderna, using new mRNA technology, was a highlight of the quarter. The base case is that the current vaccination programs will allow for a progressive reopening of the economy over the course of 2021, should lead to further improvement in employment, consumer and business sentiment, increasing aggregate demand.

UK and Europe

Fractious Brexit negotiations slowed growth for another year in the UK. However, the UK and EU narrowly met the deadline to agree on a post-Brexit trade agreement in the final days of December. Michael Barnier, the EU's chief negotiator in the deal, called the Brexit "an act of mutual weakening". Post-Brexit, the E.U has lost one of its largest members, accounting for about a sixth of the European economy. While the U.K regains some political control, its residents can no longer live or work in much of Europe as easily as they have been able to in the past and the overarching risks to the UK economy and financial markets remains uncertain, with large parts of the UK economy not specifically covered by the deal.

As the UK entered the northern hemisphere winter, regions went back into lockdown as a second and more infectious strain of COVID-19 ripped through the country.

The FTSE 100 index closed the quarter up 8.9% but still nowhere near its pre-COVID19 levels. Brexit aside, this is largely due to the fact that the index is predominately made up of banks, energy companies and miners, who have lagged their tech counterparts during the pandemic.

In Europe, equities gained sharply in Q4, again driven by the positive news of effective vaccines to contain the virus. Sectors that had previously struggled through the crisis, such as energy and financials, rebounded strongly. However, rising COVID-19 infections saw many European countries tighten restrictions once again, which will continue to hurt the underlying economy. The European Central Bank ('ECB') approved a landmark €1.8tr budget package late in the quarter which will provide support to the region over coming months.

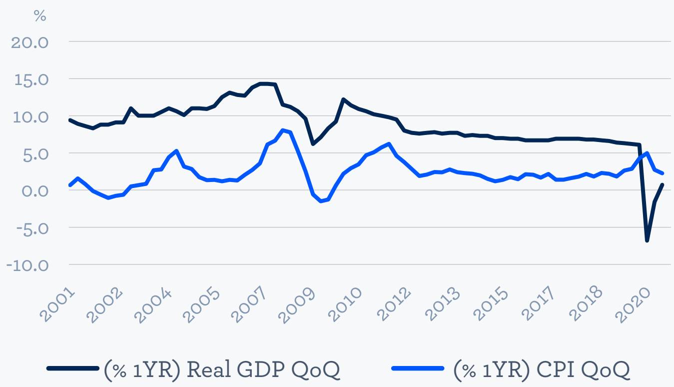
China

Even though the novel coronavirus first emerged in Wuhan in early January 2020, China's policies to contain the pandemic appear to have largely mitigated the crisis seen across the globe in terms of both infections and deaths.

Whilst the Chinese economy experienced the same sharp decline in the first three months of the year as the rest of the world, its economy held up better than all others by the year end. China avoided a technical recession, as the government rolled out a raft of both fiscal and monetary policy measures to help boost the recovery over the year.

However, the recovery has been uneven with some exports rising over the year from demand for medical supplies and other goods, offset by reduced domestic consumption. Giving people confidence to start spending again remains a challenge, and there is an expectation that this shift in consumer behaviour will continue to drag on consumption for a while to come.

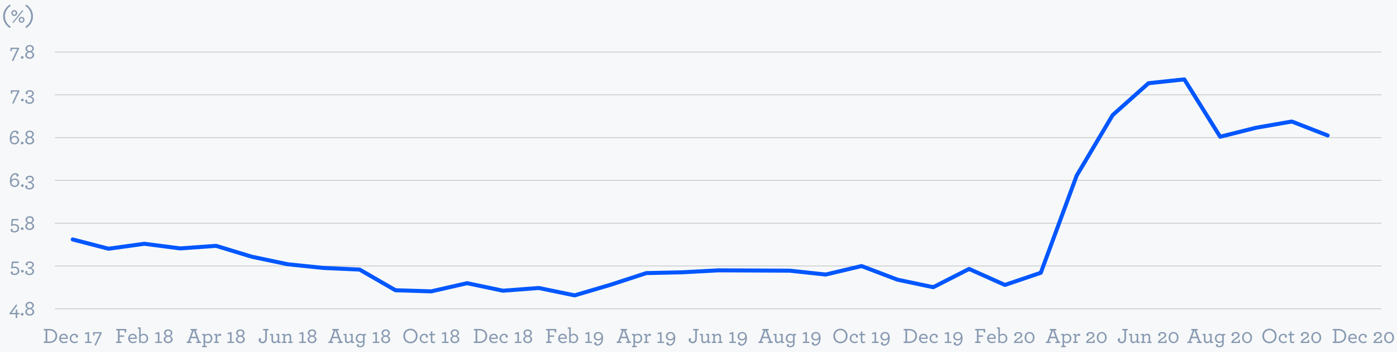
Figure 2. China Real GDP and CPI



Source: Factset, Perpetual Private, January 2021

[3] Bureau of Labour Statistics

Figure 3. The Australian Unemployment Rate



Source: Factset, Perpetual Private, January 2021

Australia

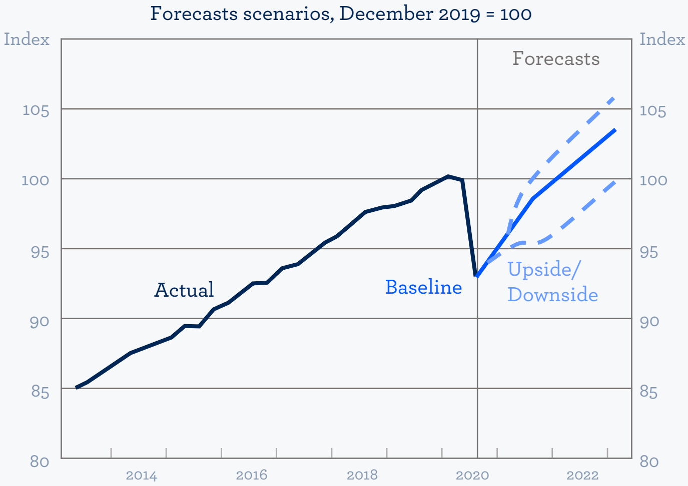
Australia has been relatively successful in handling the COVID-19 pandemic. Following the sharp economic slowdown we saw earlier in the year, the recovery seems set to continue, despite the re-emergence of hotspots and localised lockdowns. Although the recovery across the country has been somewhat varied. Victoria experienced some of the strictest lockdown measures in the world, inducing a setback in its economic recovery relative to other states. Whilst we have seen a general recovery in most activity, some industries, particularly hospitality and tourism remain constrained by social distancing, border closures and lockdown measures.

The Australian unemployment rate fell to 6.8% in November, off its high in June, but still well above the RBA target. Pleasingly, more than half of the jobs lost in the initial downturn have been regained, however significant spare capacity remains in the labour market.

Despite the ongoing uncertainty, and localised lockdowns, the economic recovery during the last two quarters of the year pulled Australia back out of the deepest contraction seen since the Great Depression. As Federal Treasurer Josh Frydenberg said, 'Technically the recession is over, but the recovery is not'. We anticipate that the road to recovery may be bumpy and uneven. Supporting the recovery is the further anticipated easing of restrictions and gradual reopening of both state and international borders, along with substantial monetary and fiscal policy stimulus.

As such, the RBA slightly upgraded its GDP growth forecasts in its November 2020 Statement on Monetary Policy, based on stronger than expected household consumption and additional policy support. The RBA notes that, despite the GDP forecast upgrade, the severity of the downturn in the first half of the year indicates that GDP may not return to pre-pandemic levels until the end of 2021.

Figure 4. Australian GDP



Source: RBA Chart Pack, January 2021

The base case for a positive recovery is that Australia experiences no additional large outbreaks of the virus while restrictions continue to be gradually lifted, albeit with restrictions on international travellers at least until the end of 2021.

Risks in the near term have eased off the back of favourable health outcomes, but in the medium term, the outlook remains highly uncertain and there are a number of risks and uncertainties that could play out. A downside scenario would be one in which Australia experiences further large and significant outbreaks, leading to renewed distancing measures and further curbs on business activity. Additionally, further lack of control in other countries of the virus could slow down international border re-openings which would also hinder the recovery.

Outlook

Following the largest contraction in decades, the global economy is in the early stages of recovery. Importantly, the level of GDP is expected to remain below pre-pandemic levels for a number of major economies over the next couple of years.

Central banks across the globe continue their rhetoric of "we'll do whatever it takes", which is likely to support risk assets in the short term. The near universal view that interest rates will remain at record low levels leaving investors with no option but to hunt for higher yield assets, pushing them further up the risk curve.

Significant uncertainty remains, with both the US and the UK continuing to see the highest number of daily cases of COVID-19 since the start of the pandemic and hospitalisations at capacity, placing their healthcare systems under severe pressure. This will continue to sap the energy out of any meaningful recovery in both regions. We continue to see a daily tug of war between the successful rollout of vaccines and increasing daily case numbers during the Northern Hemisphere winter. The longer this continues, the greater the risk that the damage to the global economy will prove harder to repair.

Continued stimulus is going to be an important focus for investors in 2021. Governments reducing fiscal spending too soon could hurt the recovery. There is no doubt that the heavy debt burdens taken on by most governments raises the question of how it will be dealt with in the years to come. Can central banks continue their support indefinitely? With such accommodative monetary and fiscal policy, is the prospect of higher inflation on the horizon?

There is a lot of optimism around the likelihood of a successful rollout of vaccination programs with less focus on what could happen on the downside. Nevertheless, the market remains driven by positive sentiment and the likelihood that a vaccine enabled economy will see some level of return to normality by year's end.

Australian cash rate and dollar

At its November 2020 meeting, the RBA cut its cash rate to 0.1%. Governor Lowe said 'with Australia facing a period of high unemployment, the RBA is committed to doing what it can to support the creation of jobs'. Both monetary and fiscal support has been guaranteed until the unemployment rate is back below 6%, which is not forecast until at least 2022.

Governor Lowe also reiterated the view 'that whilst economic data has been better than expected, and the near term outlook is better than it was three months ago, the recovery is still expected to be bumpy and drawn out and the outlook remains dependent on successful containment of the virus'. The RBA reinforced its narrative that they intend to keep rates on hold for at least the next three years.

The RBA also announced that it would buy $100 billion of government bonds with maturities of 5 to 10 years. In November 2020, the unemployment rate fell to 6.8% from 7.0% the month prior as businesses gradually reopened and people returned to work.

The Australian dollar strengthened over the quarter as the US presidential election and uncertainty about its outcome dragged on the USD. The AUD gained an impressive 9.8% against the USD over the course of the year as the Australian economy gained steam driven by a mix of rising commodity prices and better than expected economic indicators.

Figure 5. Australian long-term interest rates
Long-Term Cash Rate VS Inflation

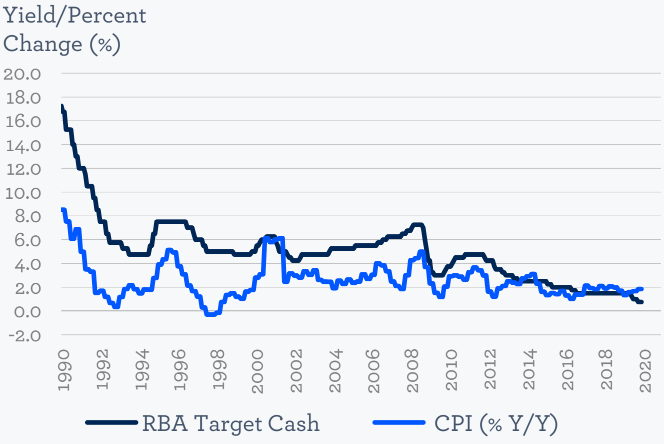
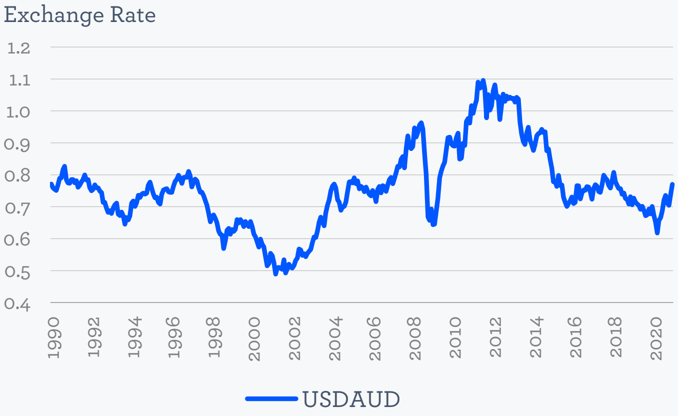


Figure 6. Australian Dollar U.S. Dollar (Daily) Long Term
USD Per AUD Long-Term Exchange Rate



Source: FactSet, Perpetual Private, January 2021

Figure 7. Bulk Commodity Prices

*Iron ore 62% Fe Fines Index; Newcastle thermal coal and premium hard coking coal

Source: RBA Chart Pack, January 2021

The Chinese economy has almost returned to pre-pandemic output levels, which has helped prop up the Australian economy, supporting commodity prices in the fourth quarter and strengthening the AUD. Iron ore is Australia's largest export, and this continues to surge following its steep sell off from the March induced panic. Despite Chinese trade actions limiting a widening array of Australian exports, the high price for iron ore has more than offset the other trade impacts at a broader economy level.

Australian Dollar Outlook

The Australian dollar is poised to continue to outperform its major counterparts as we move into 2021, especially as commodity exports surge off Chinese demand. Providing there is no escalation in the trade spat between China and Australia, we expect the dollar to continue to remain strong.

Australian and international equities

Australian equities

The Australian equity market, as measured by the S&P/ASX 300 Accumulation Index, powered ahead in the December quarter returning 13.8% after a flat September quarter, outperforming global equities and Australian Real Estate Investment Trusts in local currency terms. Despite the strong quarter, S&P/ASX 300 closed just up 1.7% over the 12 months, highlighting the steep losses earlier in the year. Sector returns were broadly positive with Utilities and Healthcare the only sectors to generate a negative return over the quarter. Leading sectors were Energy, Financials and Information Technology which generated gains of 26.1%, 22.8% and 22.8% respectively.

The economy officially dipped into recession for the first time since 1991, with negative GDP growth in the March and June quarters. To offset the severe economic hardship caused by the pandemic and subsequent shutdowns, governments at all levels provided large stimulus and support packages to soften the economic and social impact. These initiatives along with the easing of restrictions and state border closures saw the economy rebound with the Australian Bureau of Statistics national accounts data showing that GDP grew by 3.3% in the September quarter. Despite the encouraging economic data, unemployment remains excessively high with 960,900 Australian officially listed as unemployed.

Australian equities outlook

The domestic share market finished the year on a very strong note to post a slightly positive return for the calendar year; a remarkable result considering the extreme volatility seen earlier in the year. After the September quarter's breather, the local market picked up the pace into the end of the year with growth-oriented sectors like Information Technology rallying, alongside cyclical sectors like energy and financials.

Figure 8. Australian Shares
Australian Shares – Large Companies

Source: Factset, January 2021

With the pandemic continuing to wreak havoc on the world, the outlook remains decidedly uncertain, the first quarter market sell-off gave fundamental stock pickers the opportunity to establish well weighted positions in high quality companies. While the rotation into cyclicals over the last quarter gave more value-oriented stock pickers an opportunity to catch up to growth orientated managers, "value" still significantly underperformed the benchmark and "growth" over the 2020 calendar year.

2021 looks set to be a year of recovery, however markets are already priced for perfection. Despite the recent rotation into cyclicals, divergence between growth and value companies remains at historic highs, providing some support for a further rally in undervalued stocks.

Should the recovery lead towards the possibility of higher inflation, this rotation has the potential to accelerate. However, the prospect of higher inflation remains distant for now, as unemployment levels are elevated and certain sectors of the economy, such as tourism, education, airports and airlines, will continue to face challenges for many months to come.

International equities

Global equity markets surged higher in Q4, bolstered by multiple new stimulus measures, and several COVID-19 vaccine trials showing 90% efficacy or higher. Continuing outbreaks and high infection rates, particularly across Europe and the US, has fast tracked the vaccine rollout around the world.

Emerging markets stocks outperformed developed markets over the quarter, with Asia (excluding Japan) performing particularly strongly, while non-US stocks broadly outperformed US stocks in local currency terms. Other signs of style rotation appeared as value beat growth and small caps topped large caps.

The MSCI All Country World index delivered 12.8% in local currency terms; MSCI Emerging Markets, 16.0%; MSCI Europe, 10.3%; while MSCI North America retuned 12.8%. Leading from a sector standpoint were Financials (21.2%), Energy (20.7%) and Materials (14.4%), while Consumer Staples (5%), Healthcare (6%) and Real Estate (7.1%), lagged. However, in AUD terms, these strong returns were offset in part by the strengthening off the AUD against the USD, with the MSCI All Country World index returning just 6.5% for unhedged Australian investors.

International equities outlook

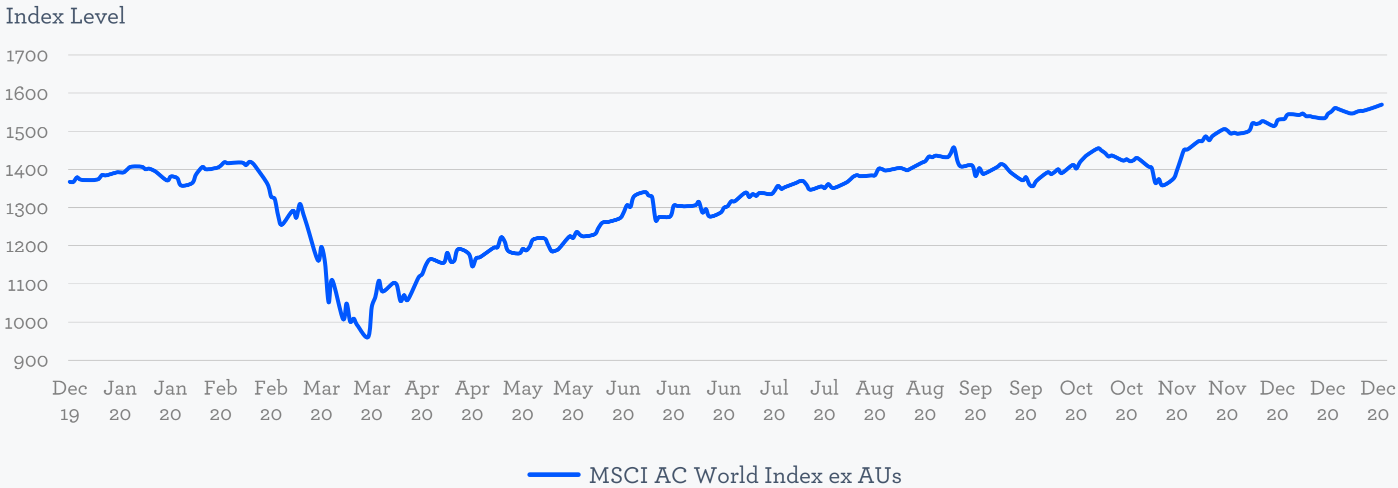
Global markets, particularly the U.S., are pricing in a rapid recovery – markets are looking through the current record level of COVID-19 infections and grievous record daily death rates towards strong expected economic growth as global communities are vaccinated and the world comes out the other side of the current crisis. Given current valuations, any risks to the recovery, such as longer and more severe lockdowns or disruptions to the vaccine rollout, could result in periodic sell-offs. Investors will need to remain patient in order to navigate more uncertainty and volatility through 2021.

Divergence in stock valuations across countries, industries and individual companies remains greatly elevated and at historically wide levels. We need to acknowledge that the crisis has precipitated a fundamental shift in regimes, from the domination of monetary policy as the sole stimulus tool to a world where significant government stimulus and fiscal spending has come back to the fore. This potentially leads to ever more highly indebted governments, ultra-low cash rates for the medium term and, as the world goes through this crisis and moves towards recovery, the potential for a very different inflationary and growth regime going forward.

Just pointing to the change in U.S government and focus under Biden vs Trump, a post-Brexit U.K. and Europe, and a strengthening, more assertive China – future global growth already looks very different compared to the last decade. There are many reasons to assume that yesterday's winners may struggle to continue to outperform, particularly given their eye-watering valuations.

If there was ever a time where 'past returns are not reflective of future returns', there are multiple reasons to indicate we have reached that point in the cycle.

Figure 9. International Shares (Local Currency Terms)



Source: Factset, January 2021

A-REITS and G-REITS

(Listed property securities)

In Australia, A-REITs rose 13.2% over the quarter, underperforming the broader equity market (S&P/ASX 300 Accumulation Index) which rose 13.8%. A-REITs trailed Australian equities over the 12 months to the end of December. Retail stocks, Scentre and Vicinity underperformed, coinciding with the COVID-19 outbreak in the Northern Beaches of Sydney and the subsequent lockdown. The quarter was characterised by a steady stream of capital raisings including APN, Charter Hall and Home Consortium. The most notable real estate transaction of the quarter was a Charter Hall consortium's acquisition of the David Jones Sydney store on an initial yield of 5%.

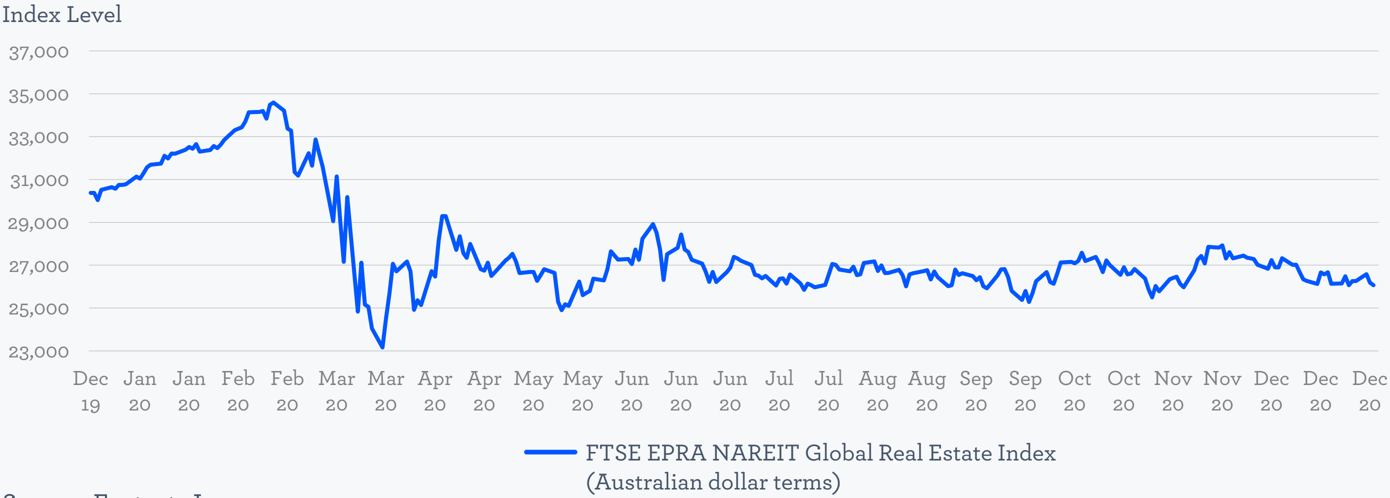
In AUD terms, Global Real Estate Investment Trusts (G-REITs) rose 5.2% over the quarter to the end of December 2020 (as measured by the FTSE EPRA/NAREIT Developed Index). On a currency hedged basis, the FTSE EPRA/NAREIT Developed Index rose by 10.2%. During the quarter, the stocks that had been hardest hit by the pandemic rallied the most on the back of what was then considered 'fading' US political tension and positive announcements regarding COVID-19 vaccine trials. The hotel, retail and office sectors were the best performers, while data centres, cell towers and self-storage were the weakest.

Figure 10. Australian Real Estate Investment Trusts (A-REITs)

Property

Source: Factset, January 2021

Figure 11. Global Real Estate Investment Trusts (G-REITs)
Property



Source: Factset, January 2021

REITs outlook

The COVID-19 pandemic continues to result in significant disruption and uncertainty across real estate markets. Until markets have 'certainty' around government policy (e.g. travel restrictions, vaccinations) and an economic recovery becomes self-sustaining, we expect markets to be less focused on real estate fundamentals and more focused on having exposure to less affected sectors of real estate or sectors that have thrived because of the crisis, such as Industrial and logistics assets.

While many REITs were in good shape coming into the crisis, operating conditions have changed meaningfully for sectors like Hotels, Retail and Office, with the operating and earnings environment unclear. For corporates, it's likely that management teams will use this crisis to further 'right-size' their retail footprints. With working from home, 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. 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. 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'. We remain of the view that 'quality' real estate with strong balance sheets and access to capital remain the most attractive investments.

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. The current environment should provide an opportunity for our managers whose focus is on 'stock-picking' to generate excess returns. 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, in turn supporting real estate values.

Fixed interest

In the domestic bond market, the Bloomberg AusBond Composite Index returned -0.10% during the December 2020 quarter, whilst the Bloomberg AusBond Bank Bill Index was relatively flat, returning 0.02%. Australian 10 year bonds were yielding 0.97% at the end of the quarter, whilst its US counterpart was yielding 0.91%. The RBA dropped the official cash rate to 0.10%. In the November 2020 statement, the RBA was worried about the higher unemployment and was committed to supporting the creation of new jobs.

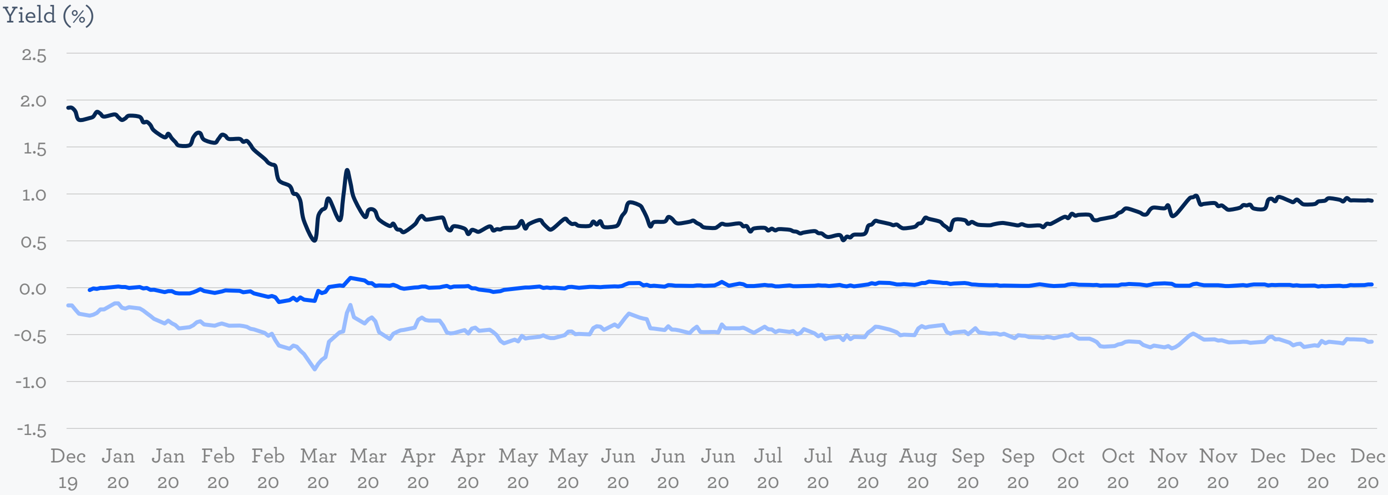
In November 2020, the Australian seasonally adjusted estimate unemployment rate fell to 6.8% from 7.0% the month prior. The All Groups seasonally adjusted Consumer Price Index (CPI) increased 1.6% in the September quarter with Childcare being the strongest contributor.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (AUD Hedged) returned 0.79% for the period. The Federal Reserve also maintained its target rate in a range of 0.00-0.25%. In their December meeting, the Federal Reserve Committee expected to maintain an accommodative stance of monetary policy until inflation is anchored at around 2% and maximum employment achieved. In November 2020, annual US inflation was 1.2%, up from 0.6% in June 2020. The US unemployment rate was 6.7% in December 2020, down from the near-term peak in April 2020 of 14.8%.

Figure 12. Australian Government Bonds

Source: Factset, January 2021 * Note: Bond prices are inversely correlated with bond yields

Figure 13. Global Government Bonds



Source: FactSet, January 2021 * Note: Bond prices are inversely correlated with bond yields

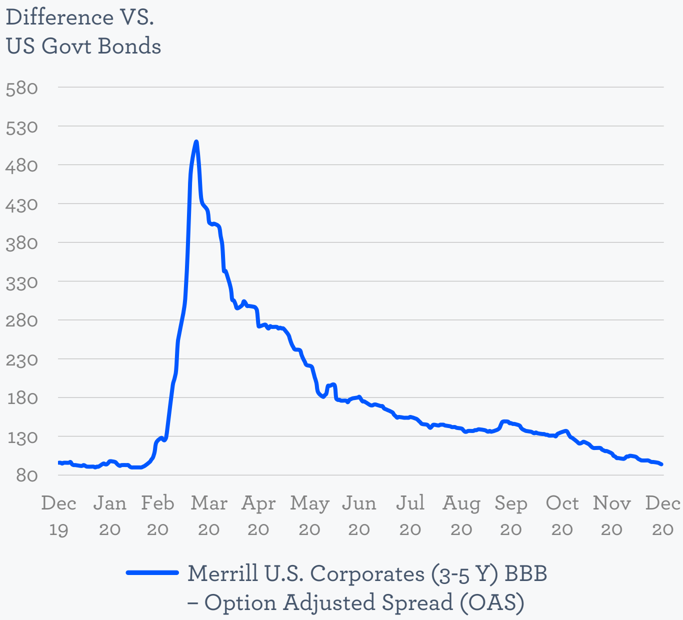
Fixed interest outlook

We expect monetary policy to remain accommodative globally until economic growth is re-established. It is unlikely central banks will allow for government bonds yields to move materially higher from current levels to ensure debt affordability until growth and inflation expectations are normalised.

We have a positive view on investment grade credit. After the short spike in credit spreads in March, spreads have fallen to more normal levels. This was fuelled by asset buying programs from the ECB, Bank of England and the Federal Reserve. The eased flow of credit to the consumer and businesses have contributed to the improved US growth forecasts by the Federal Reserve and the improved inflation expectations of the ECB. We expect central banks to maintain their accommodative policies in the near future.

There are some potential risks that may change our view of credit. These include a further deterioration in economic activity from COVID-19 and the deterioration of US-Chinese relations.

Figure 11. Global Credit Markets



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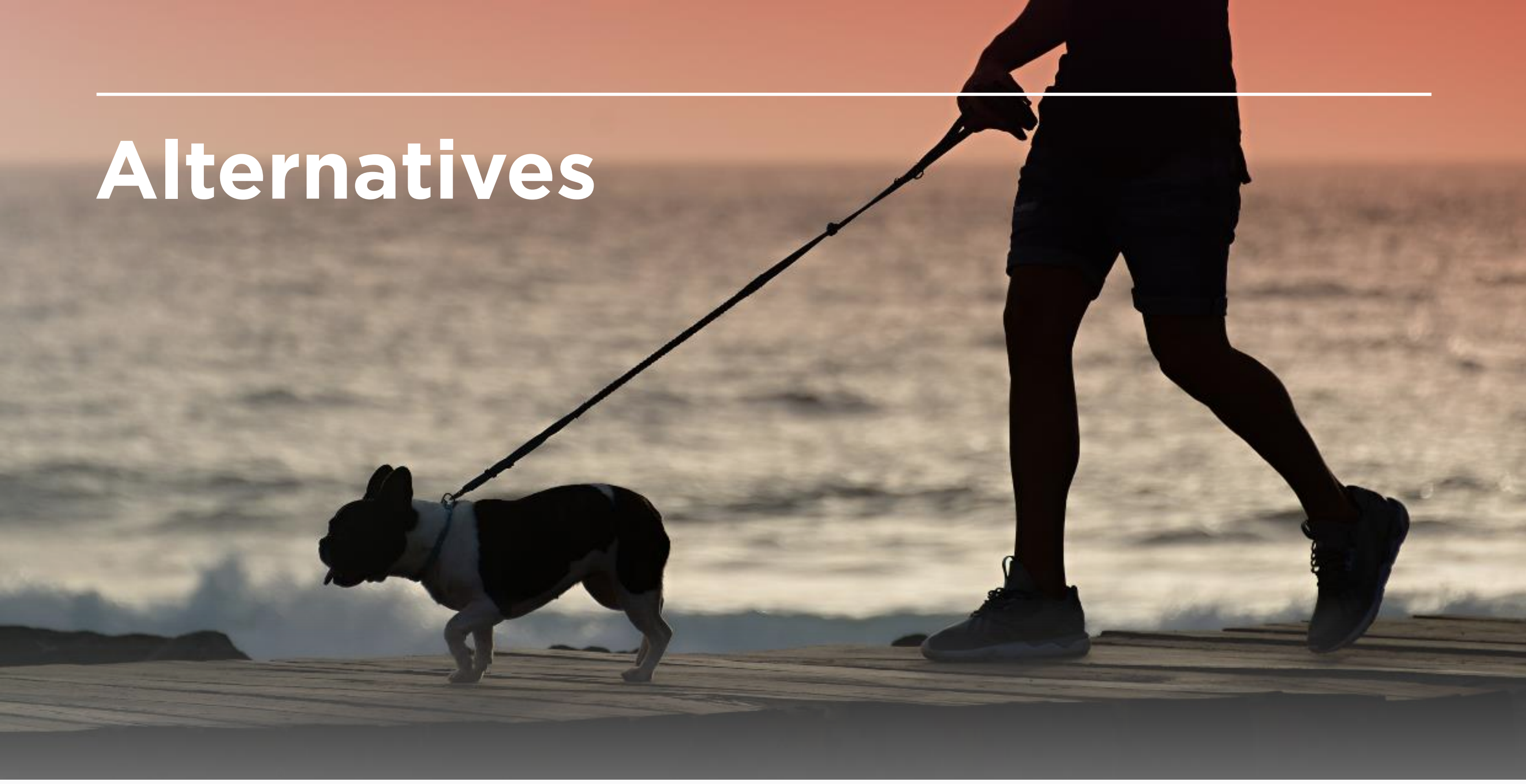

Alternatives

Growth alternatives

Throughout the first three quarters of 2020 we saw private market managers mark down asset valuations without transaction evidence, acknowledging the top and bottom line impacts of COVID-19. Through the final quarter of 2020, we have seen the pace of asset mark downs slow dramatically across a number of sectors, namely Real Estate, Infrastructure and the less cyclical exposures within Private Equity as valuations have begun to recover. These valuations have been supported by unprecedented and coordinated fiscal and monetary policy action and the reopening of economies, despite COVID-19.

Within Unlisted Infrastructure, regulated and contracted assets have been well bid and valuations have remained stable or increased with demand from institutional investors remaining strong. We have witnessed the valuations of volume-linked assets, namely airports, fall modestly over the past 9 months in line with significantly reduced traffic volumes due to COVID-19. While we do not consider the current valuations to be ‘cheap’ we do see better relative value and have actively sought to add to our existing exposure. At the aggregate level, listed infrastructure is still trading below pre-COVID-19 peaks. We have sought to add exposure to our listed infrastructure investments to take advantage of attractive relative valuations.

Throughout late 2018 and CY2019, we maintained a cautious approach towards Private Equity, notably Leveraged Buy Out and Niche Buy Out strategies. Instead we had made a call to overweight exposures in Distressed Debt and Special Situations. The opportunity set for Distressed Debt has been smaller than expected due to the policy actions of governments and central banks globally. We remain cautiously optimistic on Special Situations and acknowledge that these types of investments tend to have longer lead times before coming to fruition. On a forward-looking basis we are more focused on adding lower cost Leveraged Buy Out strategies within the Private Equity space.

With Real Estate markets, sector dispersion has been wide with Industrial and Logistics assets well bid, while values for Retail and Hotel/Hospitality remain uncertain. Our portfolio has been overweight debt focused strategies, which have underperformed equity focused strategies over recent periods. Where we do have exposure to equity-based strategies, we have been pleased with acquisition activity and the valuations managers are paying for assets, while a number of realisations have generated strong returns. We have recently made significant commitments to income producing, US real estate strategies which we expect to increase the velocity of capital within the portfolio. We continue to monitor the market and continue to look for opportunities to deploy capital.

We see near term opportunities to close underweight positions across Infrastructure and Opportunistic Property and reduce cash within the portfolio. Furthermore, we expect to reduce what might be described as a ‘structural’ underweight to Absolute Return style investments. We remain more selective than ever but expect to make meaningful commitments to our highest conviction ideas.

Income alternatives

Generally speaking, debt focused alternatives strategies have performed inline with our expectations. Pleasingly, we have had very few defaults and restructurings across the portfolio. Where we have seen issues, they have been concentrated in Real Estate Debt (Retail and Hospitality) and Corporate Debt, namely in the Energy and Materials sectors.

Despite central bank initiatives globally, we expect an uptick in default rates over the coming periods as it becomes increasingly evident that they are not willing or able to bail out everyone and stimulus winds off. We expect this environment to provide opportunities across investment grade, sub-investment grade and high yield bonds as well as various types of asset backed securities and structured products. In such an environment, we remain focused on managers where we have the highest confidence in the manager's credit analysis and security selection.

We continue to monitor the Leveraged Loan market looking to take advantage of lower prices, after adjusting for higher expected default rates and lower expected recovery rates. We expect capital gains in the Leveraged Loan market to moderate, given current pricing, but the yield remains attractive on a relative basis, albeit with lower liquidity.

Across the portfolio we saw the pace of deployment in our corporate private debt strategies slow during the final quarter of last year, following a short acceleration between May and August. Within real estate lending, we have seen the pace of deployment increase, with pricing improving in both senior and mezzanine markets. Infrastructure debt remains challenging for our portfolios with demand from European financial institutions pushing pricing to a point where we do not see value.

Within Private Debt, and consistent with our historical approach to private debt, we remain focused on managers who have a conservative and disciplined approach to credit underwriting, irrespective of whether they target senior or subordinated positions in the capital structure. In line with our recent shift in investment strategy, we are now looking to incorporate Core Real Estate and other tradable credit strategies into our investment pipeline to improve the liquidity and consistency of yield from the portfolio.

Perpetual