

Financial Markets Update September 2022

Market Moves and Performance

- Last week financial markets sold off - ASX200 (-2.4%), S&P AREIT (-5.3%), S&P 500 (-4.6%), Euro STOXX 50 (-4.6%);
- That week extends the selloff that has already occurred month to date - ASX200 (-6.4%), S&P AREIT (-11.8%), S&P 500 (-7.5%), Euro STOXX 50 (-4.9%);
- Medium and longer term returns (3 years+) remain much closer to long term expectations;
- Asset class returns to 26th of September 2022 are shown in the table below.

Trailing Returns <i>Change, Total Return Basis</i>	26-Sep-22	To 31 August					
	Current MTD	1 Month	3 mths to Aug	12 mths to Aug	3 yrs (p.a.)	5 yrs (p.a.)	10 yrs (p.a.)
Australian Shares	-6.4	1.2	-2.4	-3.7	5.6	8.2	9.3
Australian Small Caps	-11.5	0.6	-2.6	-14.7	4.1	6.9	6.3
Global Shares - All Country (Local)	-7.1	-3.0	-3.8	-11.8	9.1	8.1	10.2
Global Shares - All Country (Unhedged)	-3.4	-2.0	-1.3	-10.3	7.4	10.1	13.3
US Shares (USD)	-7.5	-4.1	-3.9	-11.2	12.4	11.8	13.1
Europe Shares (EUR)	-4.9	-5.1	-7.0	-14.0	3.1	3.0	6.4
Emerging Mkts Shares (Local)	-8.0	1.2	-3.3	-15.8	4.9	3.2	5.9
Global Property (Hedged)	-11.0	-5.7	-6.4	-13.8	-1.8	2.0	6.4
Australian Property	-11.8	-3.5	-3.2	-11.1	-1.5	5.8	9.4
Global Infrastructure (Hedged)	-6.9	-1.0	-1.6	5.1	4.4	5.9	10.1
Australian Fixed Interest Composite	-1.9	-2.5	-0.8	-11.5	-3.1	1.0	2.6
Global Fixed Interest Composite (Hedged)	-3.5	-2.7	-1.9	-10.5	-2.7	0.5	2.9
Cash - Bank Bills	0.1	0.2	0.3	0.4	0.4	0.9	1.7
Evidentia 70 Growth SAA Benchmark	-4.1	-1.0	-1.6	-6.8	3.8	6.4	8.5

What is causing the sell-off? Market themes

- Hawkish central banks remain the key driver of the downside in shares. While inflation is showing signs of peaking in the US, it's not enough for the US Federal Reserve (Fed), which hiked by another 0.75% and remains very hawkish. High inflation also drove rate hikes from numerous central banks over the last week – with another 0.5% hike from the bank and a 0.75% hike from the Swiss central bank (although these were both catchups). There were also rate hikes in South Africa, Norway, the Philippines, Indonesia, and Taiwan.

- While the Fed's 0.75% hike to 3-3.25% was expected, its post meeting statement and comments were very hawkish (meaning they advocate for aggressive tightening monetary policy). The Fed's interest rate expectations was revised up by 1% for this year to 4.25-4.5%, its inflation forecasts were revised up, its growth forecasts were revised down and its unemployment forecasts were revised up to 4.4% next year. While the Fed is not yet forecasting a recession, its forecast rise in unemployment would normally be consistent with one and it appears willing to tolerate a recession as its "*overarching focus*" is to bring inflation down to 2%. Fed Chair Powell said, "*we will keep at it until the job is done.*" To slow the pace of tightening, Powell wants to see a slowing labour market and more evidence inflation is slowing. Another 0.75% hike looks likely in November.
- The danger and risk to markets is that the Fed and other central banks make a policy error and tighten monetary policy too quickly and cause a severe recession.

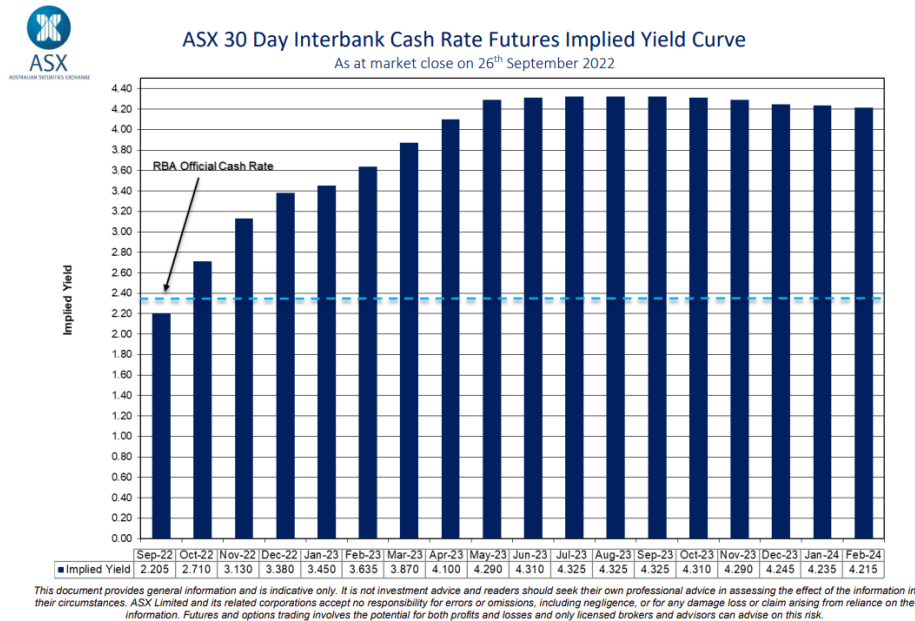
What does this mean for Australia?

The Reserve Bank of Australia (RBA) has also been raising rates aggressively from close to zero up to its current rate of 2.35%. However, there are a number of reasons that we believe the RBA should be less hawkish than the Fed;

1. Household debt to income ratios in Australia are almost double US levels – at 187% in Australia v 102% in the US;
2. Household debt interest costs in Australia are far more responsive to rising interest rates – as most borrowers are on variable rates tied to the Reserve Bank of Australia's (RBA) cash rate and the rest are on relatively short dated fixed terms many of which mature next year, in contrast to the US, where most mortgages are 30-year fixed, so only new borrowers are impacted by rising rates. Combined with the first point, this means that a given sized rate hike in Australia will be more potent in slowing consumer demand than in the US;
3. Inflation is lower in Australia, at least for now.
4. Wages growth (a much stickier part of the inflation number) is running around half what it is in the US.

So how high do we expect rates to move to in Australia?

Rather than guess or try to predict where the cash rate will move to the below chart from the ASX provides the cash rate future implied yield curve (how the futures market is currently pricing the cash rate). It should also be noted that mortgage rates would typically be 2-3% higher than the cash rate.



What opportunities does this give rise to?

The good news for long term investors is that historically market selloffs present an

Year	Date Enter Correction (When Equities - 15% drawdown)	Date of Trough	Date Market Reaches New Highs	Severity (Previous Peak to Trough)	12m Return from time of -15% drawdown	12m Return from Trough
1970	15/05/1970	10/07/1970	29/01/1971	-20.3%	29.5%	36.2%
1973	16/11/1973	4/10/1974	13/10/1978	-44.2%	-28.3%	30.5%
	6/08/1982	13/08/1982	15/10/1982	-17.0%	51.6%	52.7%
1987	23/10/1987	15/01/1988	17/02/1989	-26.9%	15.6%	31.3%
1990	24/08/1990	28/09/1990	28/05/1993	-27.5%	8.7%	26.9%
1998	4/09/1998	2/10/1998	8/01/1999	-16.7%	34.2%	28.6%
2001	16/02/2001	7/03/2003	13/10/2006	-47.8%	-15.3%	42.3%
2008	8/02/2008	6/03/2009	10/05/2013	-54.5%	-33.6%	62.4%
2016	12/02/2016	12/02/2016	25/11/2016	-16.2%	26.5%	26.5%
2018	21/12/2018	21/12/2018	19/04/2019	-15.6%	30.6%	30.6%
2020	13/03/2020	20/03/2020	28/08/2020	-31.0%	48.0%	65.9%
2022	20/05/2022	?	?		?	?
Average				-28.9%	15.2%	39.4%

opportunity to buy assets at cheaper valuations and therefore produce higher expected returns going forward. The following chart shows 12 month returns from the start of an equity market correction (defined as a 15% market sell-off). This means any investor that purely buys shares after a 15% sell-off has historically benefited by generating an outsized 15.2%p.a return. Also, of note is how aggressively the market has

historically bounced from the trough. 12 month returns following the trough of a market are on average 40%. To take advantage of this opportunity involves us increasing the weighting in portfolios to growth assets (principally shares and property).

What about my defensive assets (bonds are selling off)?

The current financial market sell off has been highly unusual so far year to date in that both growth assets (shares and property) and defensive assets (bonds) have sold off in unison. However, as with shares, for bond investors there is again a silver lining – while aggressively rising interest rates cause existing bond prices to go down the good news is that these same higher interest rates mean improved returns on bonds from an investor standpoint today.

In our view this is making bonds start to look attractive as forward returns (yield to maturity) in many cases are now 3%+ higher than they were before interest rates started to lift. This is a meaningful uplift from where they were.

What are we doing in portfolios?

- Despite the sell-off and acknowledged outsized returns available after a market sell off we are taking a cautious and prudent approach this cycle and haven't yet increased our allocation to shares from their broadly neutral position. We have however formulated our plan for when we will do this by analysing previous market cycles and identifying 4 key signposts. These signposts are central bank policy, earnings cycle, valuations, momentum. For brevity we won't go into these indicators in this note.
- We have however been increasing the duration of our fixed interest assets (bonds). Increasing duration means buying longer dated bonds. Longer dated bonds:
 - Have higher interest rates meaning higher increased expected returns;
 - Will provide capital gains if interest rate expectations come down (if interest rates don't rise as much as what is priced in or the economy enters a recession);

Key messages for clients:

Stay focused

As you know all our clients have a structured investment plan that is specially crafted for your situation and takes into account your timeframe, risk profile, goals and objectives. Nothing in these markets causes us to re-think the foundations of our advice but I thought I would recap a few relevant messages for investors at this point that we may have previously discussed below.

Take a long-term perspective

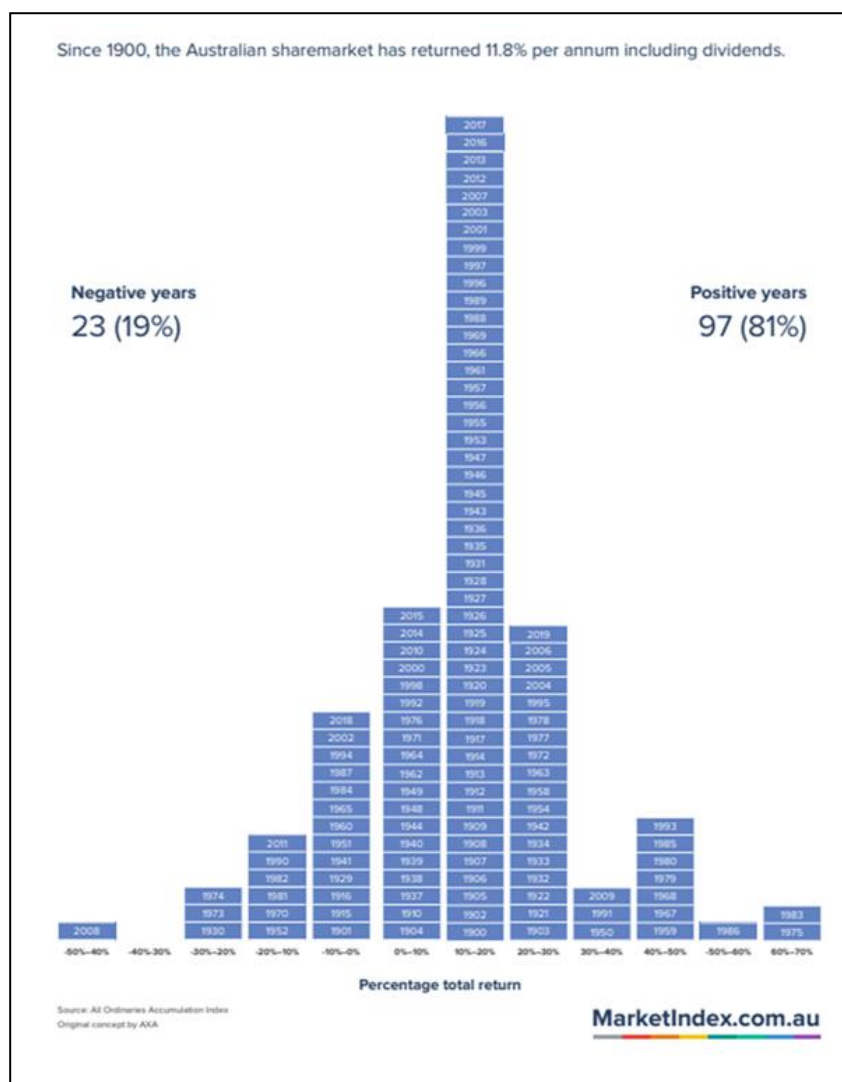
Take a long term perspective and trust that over the long term markets work. A famous quote from Warren Buffet is “*In the short run, the market is a voting machine but in the long run it is a weighing machine.*” What Warren Buffet means by this is that in the short term market prices are determined by buying and selling often reacting to short term problems (such as rising interest rates, wars, pandemics etc). However, over the long run asset prices are determined by the quality of the asset to produce returns and income for its asset owners. The chart below is part of our investment philosophy of “investing differently”.

Market	Investor
Short term focus	Long term focus
Momentum driven	Valuation driven
Upgrade / Downgrade mania	Disciplined focus on 'quality'
Daily information flow	In-depth research

We are investors rather than speculators. Research shows that making investment decisions based on fundamental analysis and empirical evidence rather than short term noise delivers better long-term investment outcomes;

Markets Work

The table below shows the annual returns for Australian shares over the past 120 years sorted by total return. There are a number of key takeout's from this table:



While there are negative years the overwhelming majority of yearly returns 81% are positive (it doesn't pay to bet against the market);

The most common return is for 10%-20% but there is a lot of movement around this median (markets don't go up in straight lines);

Average annual returns have been 11.8%pa (and have outpaced inflation maintaining purchasing power of your wealth);

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Should you wish to discuss your personal circumstances please our office on 07 4783 3944.