Perpetual Private | Quarterly Market Update

# Resilience in the face of a minor setback

April 2023

Trust is earned.

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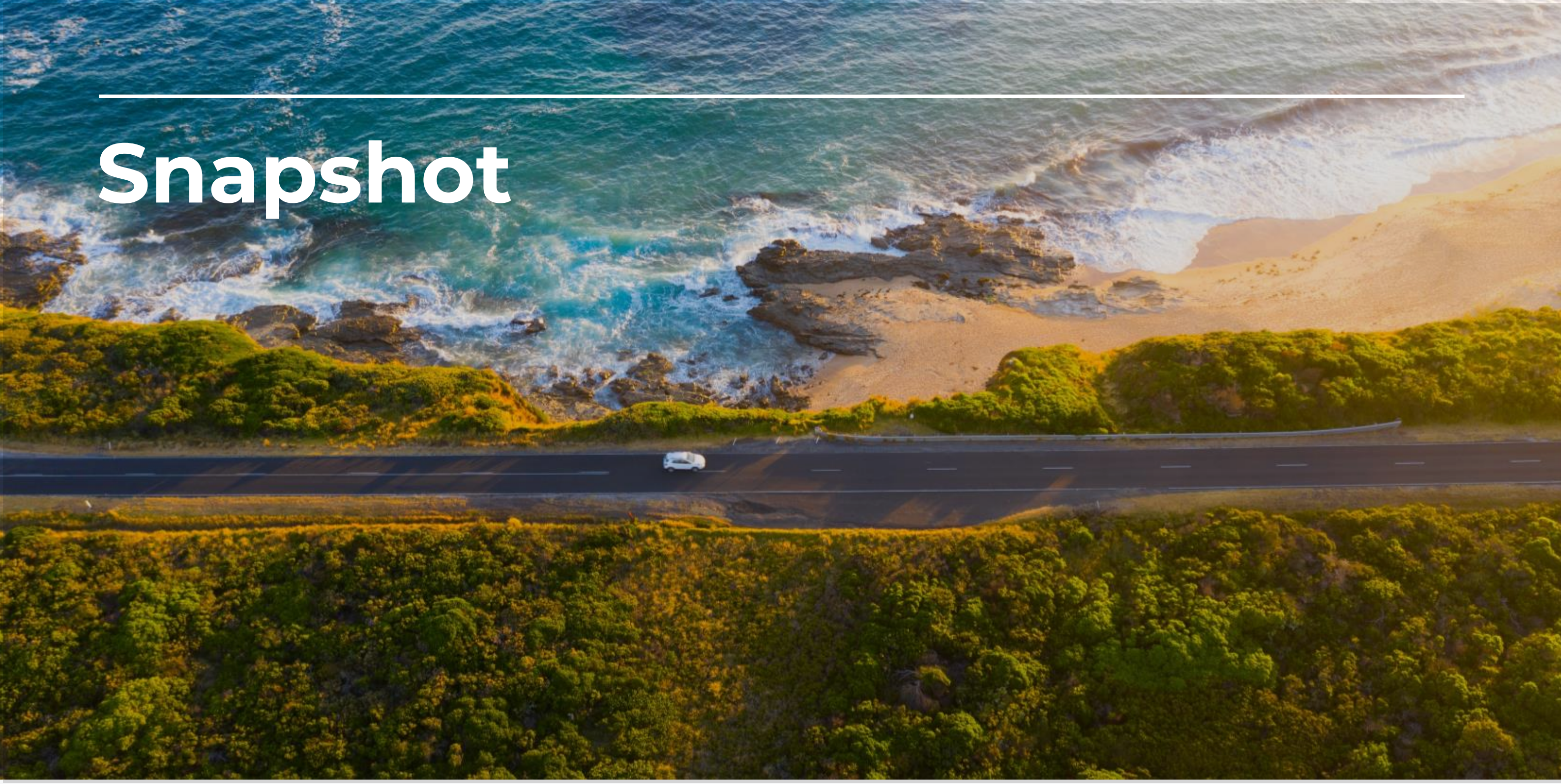
# Contents

# Snapshot



The first quarter of 2023 began strongly with equity markets rallying through January and into early February as economic data signalled inflation would continue easing, leading to hopes of rate cuts in mid to late 2023 and a successful soft landing by central banks. This optimism faltered once the lagged effects of central bank tightening begun to wobble the weaker corners of the banking sector, which led equity markets down through to the third week of March. Worry began to set in as investors contemplated the fallout of a financial contagion event. However, with central banks stepping in to provide credit facilities to guarantee deposits and brokering acquisitions to shore up the sector, fears have begun to ease.

When monetary policy is enacted with the speed and magnitude that was seen in 2022, it is not surprising to see stress in businesses and institutions that are disproportionately exposed to interest rates, especially those that do not implement adequate risk measures. The events over the last few months serve as a reminder that interest rates are a blunt instrument that can have undesirable outcomes. The path to stable price levels was never going to be linear and without a degree of discomfort.  The challenge remains on central banks to walk the tight rope of raising rates just enough to reduce economic activity but not too far as to cause unnecessary harm.

As we look out into 2023, investors should be cognisant that we have begun the year with interest rates 3% to 4% higher than the 12 months prior. Such a significant increase has, and is expected to continue to, cause structural changes to asset pricing and investor behaviour. It is also important to remember that interest rates have a lagged and variable impact on economic activity, which means we are likely to see volatility endure in investment markets as economies continue to digest this fundamental change. Whilst there is still a meaningful risk that we may experience an excessive slowdown in economic activity leading to a recession, we remain positive that other scenarios could play out. Whilst volatility remains, regardless of the economic outcome, there will be opportunities for investors.

# Asset class performance – April quarter

## Australian equities

Over the first quarter of 2023 Australian shares performed well with the S&P/ASX 300 Index returning +3.3%. Reflecting moves in global share markets, Australian shares rallied early in the quarter reflecting a less hawkish Reserve Bank of Australia (RBA) and signs inflation was easing, only to give back some of the gains over February and March when banking turmoil led risk assets down.

Sector performance was mixed over the quarter. The Consumer Discretionary[1] sector led the index with a gain of +10.8%, followed closely by Communication Services[2] up +9.5%. Not surprisingly, Financials[3] lagged the other sectors with a return of -2.7% on the back of fears around the global banking sector.

Although the two investment styles performed broadly in line with each other domestically, Growth[4] outperformed for the quarter returning +4.7% versus +3.6% for Value. Although, Value[5] remains ahead of Growth in the domestic market for all major time periods for the last five years.

## International equities

Major international share indices all had strong positive returns for the quarter when measured in local currency terms. Large tech names led U.S. indices as investors remain hopeful of rate cuts and see the Fed's expansion of its balance sheet throughout March as a sign of the end to tightening monetary policy. The tech heavy NASDAQ posted the strongest result with a return of +17.0%. The French CAC 40 Index and German DAX Index followed behind with returns of +13.3% and +12.2% respectively. Chinese[6] shares struggled on a relative basis, although still returning +3.5%, resulting from a contraction in inflation and slower than expected economic recovery following the easing of COVID restrictions.

Due to a broad weakening in the Australian dollar, all the major indices we analyse performed stronger in AUD terms. The ranking remained the same with the NASDAQ leading at +18.5%, followed by the French and German indices at +16.8% and +15.7% respectively. The Hang Seng Index still trailed the other indices but returned a meaningful +4.2%. Movements in currency more than doubled the FTSE 100 Index return from +3.5% in local currency to +7.8% in AUD terms.

Resembling share markets in Australia, although globally to a much greater degree, Growth outperformed Value for the quarter. Substantial outperformance of large tech names over the quarter resulted in Growth[7] returning +14.8%, well ahead of Value[8] at 0.6% in local currency terms. Value remains ahead out to two years, with Growth holding up from three years and beyond.

Turning to global sectors, as mentioned earlier Tech[9] posted the strongest return at +20.3% followed closely by Communication Services[10] at +17.1%. After reporting the strongest return last quarter, Energy[11] was the laggard returning -3.5% despite a surge in oil prices late in the quarter.

[1] Measured by the S&P/ASX 300 Consumer Discretionary (Sector) Index
[2] Measured by the S&P/ASX 300 Communication Services (Sector) Index
[3] Measured by the S&P/ASX 300 Financial Ex A-REIT (Sector) Index
[4] Measured by the MSCI Australia Growth Index
[5] Measured by the MSCI Australia Value Index
[6] Measured by the Hang Seng Index
[7] Measured by the MSCI World Growth Index
[8] Measured by the MSCI World Value Index
[9] Measured by the MSCI AC World Information Technology (Sector) Index
[10] Measured by the MSCI AC World Communication Services (Sector) Index
[11] Measured by the MSCI AC World Energy (Sector) Index

## Real estate

After a challenging calendar year 2022, domestic real estate markets saw continued volatility in the quarter with valuations continuing to be impacted by the actions and indications of central banks. Emulating equity markets, the quarter can be split into two distinct halves. A rally through January followed by a weaker performance in the back half of February and into March saw the index[12] fall -2.1% for the quarter, a result which ranked broadly in the middle of international peers.

Global real estate markets were challenged over the quarter. Ignoring the effect of currency, Singapore[13] and the U.S.[14] were the only two markets to deliver a meaningfully positive result, returning +5.4% and +3.6% respectively. Chinese[15] property was effectively flat with a +0.1% return. After a very difficult 2022, German[16] real estate markets continued to face headwinds returning -17.2% for the quarter and -24.5% for March, the lowest monthly return in nearly 15 years. This is in part the result of Germany's rent brake laws which put caps on rent increases of between 15% to 20% over a three-year period. For owners of property, if rental income can only increase at a capped rate, and the cost to service the debt on the property is not capped and increasing due to increases in interest rates, then this leads to an inevitable devaluing of the property price. Despite a strong fourth quarter in 2022, European property has resumed its downward trend returning -1.9%. European REITs are now in negative territory out to eight years on an annualised basis.

When analysed at a sector level, Industrial[17] REITs were the standout, leading the group with a return of +10.2% for the quarter, buoyed by a strong January return on the back of less hawkish central banks and temporary optimism around inflation concerns. Office[18] REITs continued to face headwinds, down -9.0% for the quarter as depressed utilisation rates, due to the rise in virtual work, and recession concerns continue to curb office demand.

## Fixed income

Despite the challenges faced in certain areas of the market, Fixed Income assets enjoyed relatively strong returns in the first quarter of the new year. Compelling performance in January and March offset weakness in February, resulting from tremors in the banking sector, with global[19] Fixed Income assets returning +2.4% for the quarter. Given the tighter regulatory requirements and higher capitalisation ratios for domestic banks, Australian[20] Fixed Income assets fared better than global peers through turbulence in February, returning +4.6% for the quarter. Unsurprisingly, domestic credit[21] markets underperformed the broader domestic Fixed Income market, although still returning a convincing +3.4%, resulting from the heightened focus on corporate balance sheets.

## Alternatives

Valuations in alternative assets continue to broadly hold up when compared to listed assets, underpinning the diversification benefits of the investment class. Whilst ultimately subject to the macroeconomic environment, managers in the unlisted space tend to be better placed to avoid the noise of publicly listed markets and focus on long-term performance. Managers also have a higher degree of control over the assets they invest in, giving them greater scope to influence change when the environment requires it. Our Opportunities funds continue to provide stable returns amidst the whipsawing of listed markets.

## Cash rate

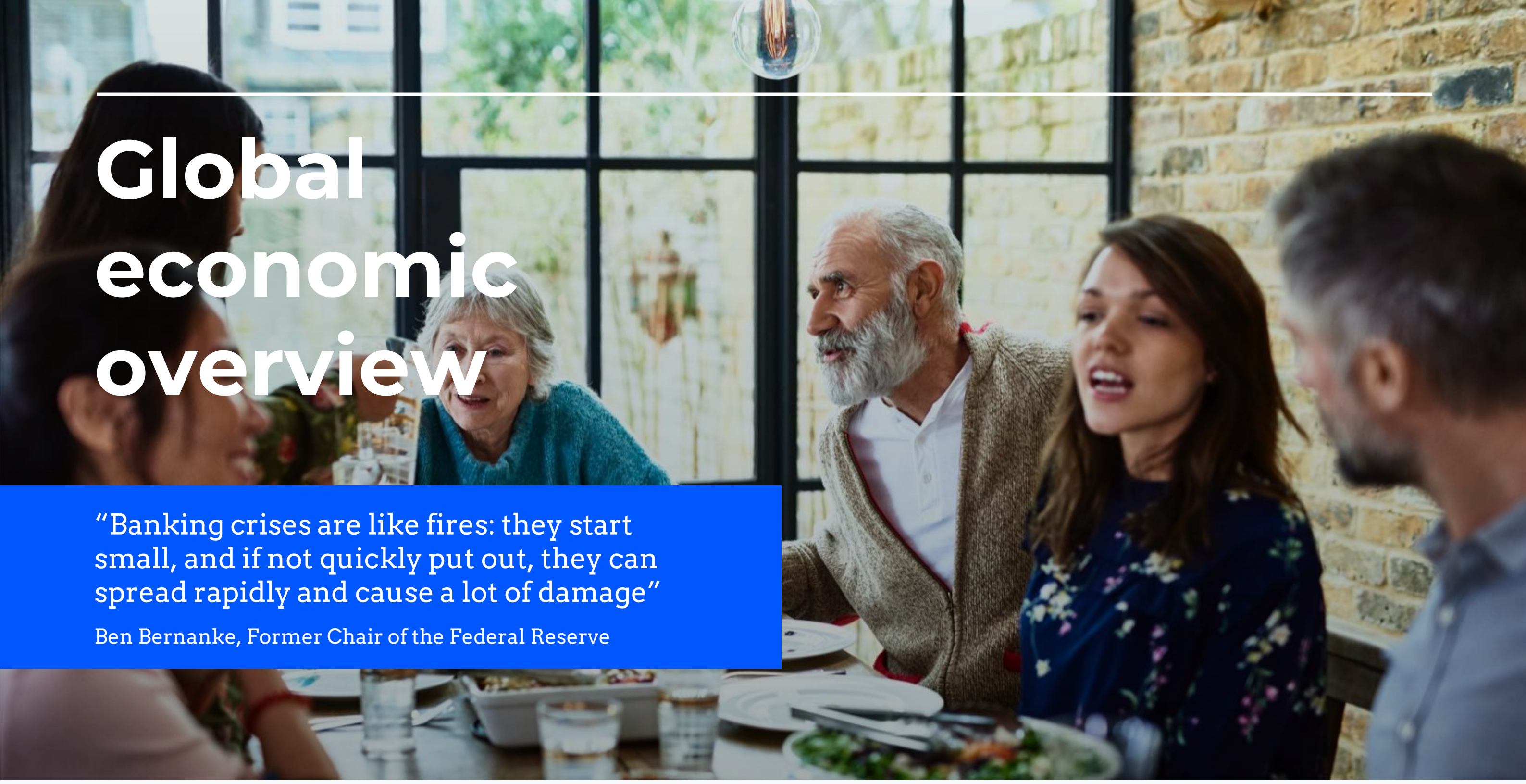
The Reserve Bank of Australia (RBA) continued tightening monetary policy through the quarter, marking ten consecutive rate hikes since April 2022 and taking the cash rate to 3.6% in March. The RBA has signalled that a pause may be necessary in the April meeting to assess the lagged impacts of previous tightening. Given the significant number of fixed rate mortgages rolling off into variable rates towards the back end of this year, and the reduction in economic activity this will likely bring, it seems prudent that the central bank be cautious in their policy moves going forward so as not to cause unnecessary slowing in economic growth.

## Australian dollar

The Australian dollar experienced broad based weakness over the quarter, receding against all the major currencies, stemming from expectations that the RBA won't raise rates much further, if at all, and that the domestic interest rate would finish the tightening cycle below peer countries. The Australian dollar weakened against the pound sterling by 3.9%, due in part to a recovery in political confidence in the UK after turmoil in late 2022. The AUD also weakened against the euro, Swiss franc and Chinese renminbi by 3.0%, 2.5% and 2.4% respectively.

12 Measured by the FTSE EPRA Nareit Australia Index
13 Measured by the FTSE EPRA Nareit Singapore Index
14 Measured by the FTSE EPRA Nareit USA Index
15 Measured by the FTSE EPRA Nareit Hong Kong Index
16 Measured by the FTSE EPRA Nareit Germany Index
17 Measured by the MSCI World Industrial REITs (sector) Index
18 Measured by the MSCI World Office REITs (sector) Index
19 As measured by the Bloomberg Global Aggregate Index
20 As measured by the Bloomberg AusBond Composite (0+Y) Index
21 As measured by the Bloomberg AusBond Credit (0+Y) Index

# Global economic overview



"Banking crises are like fires: they start small, and if not quickly put out, they can spread rapidly and cause a lot of damage"

Ben Bernanke, Former Chair of the Federal Reserve

## Striking a new path

The first quarter of 2023 started strongly with equity markets rallying over the course of January, following signs global inflation had peaked. This fuelled an expectation that central banks would become less hawkish, increasing the probability of an economic soft landing and thereby avoiding a global recession. As we transitioned into February and early March, volatility was back with periods of both positive and negative returns. As with previous months, this was driven by differing macroeconomic data points and subsequent central bank commentary.

Then came problems with the banks. This led to a global stock market selloff starting in February.

It began with FTX's closure (a crypto exchange) on the 11th of November 2022. This shook the volatile crypto market which lost billions, but at the time had a limited impact on markets more broadly. However, volatility in the crypto market alongside statements of concern issued by U.S. regulators, led to the collapse of Silvergate Capital in early March. Silvergate was a small crypto-friendly lender who had been struggling for months. The final straw was the exodus of customers which forced the bank to sell a significant amount of its bond portfolio at a loss to provide liquidity for its customers.

Silicon Valley Bank (SVB), a larger bank but still classified as a regional bank, had different issues. SVB was forced to close by U.S. regulators after mass withdrawals. Its customers, predominantly tech start-ups, have been hit harder than most by the rising interest rate environment. Many of these companies have had substantial falls in their valuations driven by profitability concerns and increasing costs. Alongside this, venture capital (VC) funding had been drying up and so, to survive, these companies began withdrawing money. At first this wasn't a big issue; however, as request for withdrawals increased, the bank, like Silvergate, was forced to sell some of its bond portfolios at a loss. These losses added up to the point that SVB became effectively insolvent.

Next was Signature Bank, collateral damage of the SVB collapse. Like Silvergate, Signature was a crypto-friendly lender and so higher risk than most banks. Its collapse was driven by its customers withdrawing billions of dollars following the SVB closure. Like SVB and Silvergate, it was forced to sell bonds at a loss to meet customers' withdrawals.

A few days later, shares in Credit Suisse plunged after news that its auditor identified "material weaknesses" in its financial reporting controls and its largest shareholder, the Saudi National Bank, made public that it would not inject any more capital into the bank. This sparked fears that deeper problems existed in the world's banking system. However, there were material differences between Credit Suisse and Silicon Valley Bank.

Firstly, the loan and asset exposure of Credit Suisse was materially different to the American banks. Credit Suisse is classified as a "global systemically important bank" and so operates under a much stricter regulatory environment than the U.S. regional banks. Credit Suisse was also not wound up. It continued to operate, supported by the Swiss National Bank which extended a CHF 50 billion (AUD 81 billion) line of credit, until a merger was agreed with UBS. In addition to this, the Swiss banking regulators have said the bank "meets the higher capital and liquidity requirements applicable to systematically important banks."

## No need to panic

Whilst recent turmoil across the banking sector has led to fears of a contagion, the risk that financial difficulties at one or more bank(s) spill over to other banks and the financial system as a whole, is very low – there is no reason to panic.

Firstly, issues experienced by the banks so far this year in no way reflect the issues experienced during the Global Financial Crisis (GFC). Only a handful of banks have been impacted and all for unique reasons unlikely to affect the sector more broadly. In the GFC, nearly all financial institutions, big and small, got caught up in the downturn which was driven by the collapse of the U.S. subprime mortgage market. This led to a reduction in liquidity in the global banking system and a sharp fall in bank lending.

Following the GFC, the U.S., as well as other major economies, implemented far-reaching reforms to the financial system — one major reform was the Dodd-Frank Act which was implemented to prevent the excessive risk-taking that led to the financial crisis. Because of this, banks are now required to hold much more capital, be much more liquid and engage in stress tests to determine how much capital they need to weather very dark economic scenarios. This makes them much less likely to collapse.

Central bankers and governments have also been much quicker to react. Within days of the SVB crisis, the Federal Reserve introduced a new credit facility for banks to guarantee deposits for their customers. It also helped broker a quick acquisition by First Citizens BancShares which was announced towards the end of March, providing further reassurance. The Swiss National Bank reacted equally quickly to instil confidence in the market. In comparison, during the GFC the U.S. took weeks to agree to a bailout sum and other major regulations weren't signed into law until years after the initial crisis.

The aim of this action has been to quickly calm nervous investors and deposit holders putting a stop to further bank runs. As the former Federal Reserve Chair Ben Bernanke noted in a speech in 2008, "Banking crises are like fires: they start small, and if not quickly put out, they can spread rapidly and cause a lot of damage." Central banks and governments will do everything in their power to stop this.

## What happens next

As at the end of March, we do not believe the issues experienced by the few banks impacted to date will spread to the broader banking sector. There could be some pockets of instability, as seen with the recent selloff across many banks' shares, notably Deutsche Bank, but we do not think it will become systemic. Indeed, Deutsche Bank shares rallied in the last few days of the quarter.

SVB was large, but it was unique in that it serviced nearly exclusively the technology world and VC-backed companies. Credit Suisse, whilst larger and more diversified, had a raft of regulatory and management issues and it had publicly lost support from its largest investor. Other banks are far more diversified across multiple industries, customer bases and geographies. They also have much stronger risk management frameworks in place.

However, there could still be economic ripple effects. Over the past 18 months, central banks have had a primary objective – get inflation under control and regain price stability. Banks may now need to balance financial stability with price stability. Financial stability is often implemented through interest rate cuts, whereas price stability with interest rate rises – a clear conflict. Whilst it's unlikely we'll see any banks cutting interest rates anytime soon, it could lead to a pause in further rate hikes. On a positive note, this could take some of the pressure off consumers and companies with higher levels of debt.

## Outlook

We expect volatility to persist in both equity and bond markets driven by macroeconomic factors, such as inflation and interest rate rises. Dispersions within asset classes and sectors are also forecast to continue. In other words, there will be winners and losers and unlike the last ten years, fundamental analysis and security selection will become increasingly important.

Looking forward, with a potential recession on the horizon, company defaults are expected to increase. This will impact the shares and debt (bonds) of these companies.

At present, S&P Global are estimating default rates to reach 4% to 5% by December 2023. As the credit market is not currently pricing this in, fundamentals are at risk and credit spreads could blow out. We are therefore recommending clients reduce their credit exposure and increase their allocation to government bonds - this has already been actioned in the Fixed Income Implemented Portfolio. Higher allocations to credit have been beneficial to portfolios over the past few years but we believe now is the time to increase the defensiveness within this asset class.

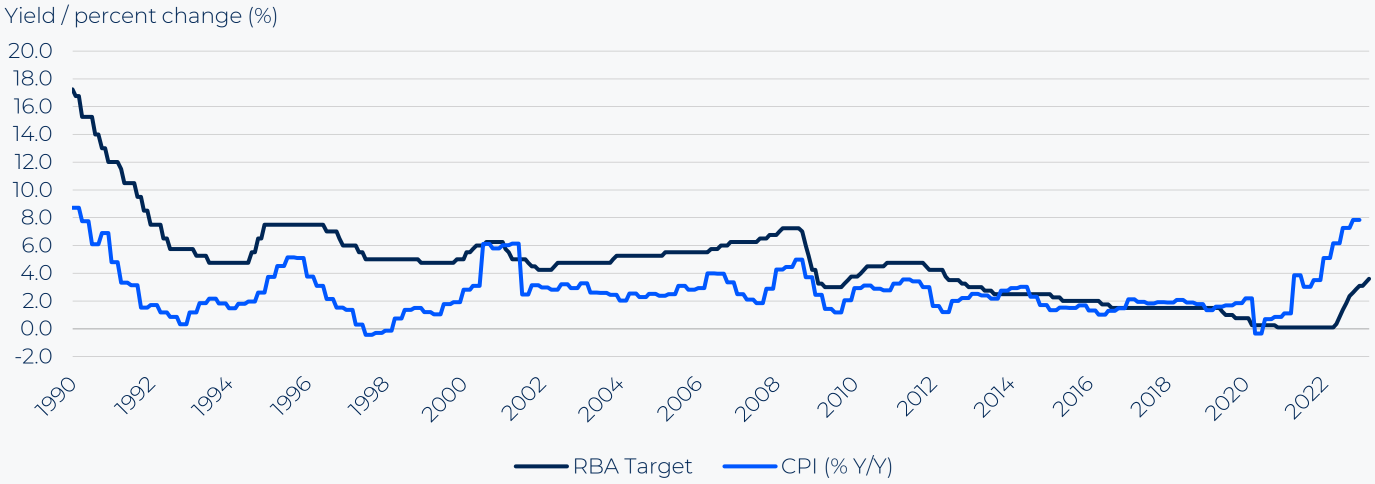
With significant shifts in the economic landscape over the past 18 months and a vastly different outlook for the future, the tailwinds enjoyed by passive investors may become headwinds and we believe active management may be better placed to drive outperformance and manage risk. At Perpetual Private we believe a well-structured blend of different investment styles across multiple markets and geographies can achieve better portfolio diversification, reduce downside risk, and deliver better risk-adjusted outcomes over the long term.

# Australian cash rate and dollar

## Australian cash rate

Interest rate increases by the RBA at the February and March meetings this quarter round out an unprecedented ten consecutive monthly rate hikes by the central bank in its efforts to tame inflation. Given the RBA's decision to go hard and go early with raising interest rates, the lagged and variable impacts of previous tightening are still working their way through the economy. Although domestic banks are very well capitalised and not as exposed to the stress seen in the regional U.S. banks over the quarter, we do expect this instability to feed into the decision making of the RBA at the April meeting. With the significant number of fixed rate mortgages rolling into variable rates in the back half of 2023 and softening domestic economic data coming into the end of the quarter, the RBA has adopted a more dovish tone when assessing the potential for further rate hikes. In a speech to the AFR Business Summit following the March meeting, Governor Lowe indicated that the central bank is "closer to the point where it will be appropriate to pause interest rate increases", although still noting that "further tightening of monetary policy is likely to be required".[22]

Figure 1: Australian long-term cash rate vs inflation




Source: FactSet, Perpetual Private.

[22] Speech by Philip Lowe, Governor: Keynote Address to the Financial Review Business Summit 2023, 8th March 2023.

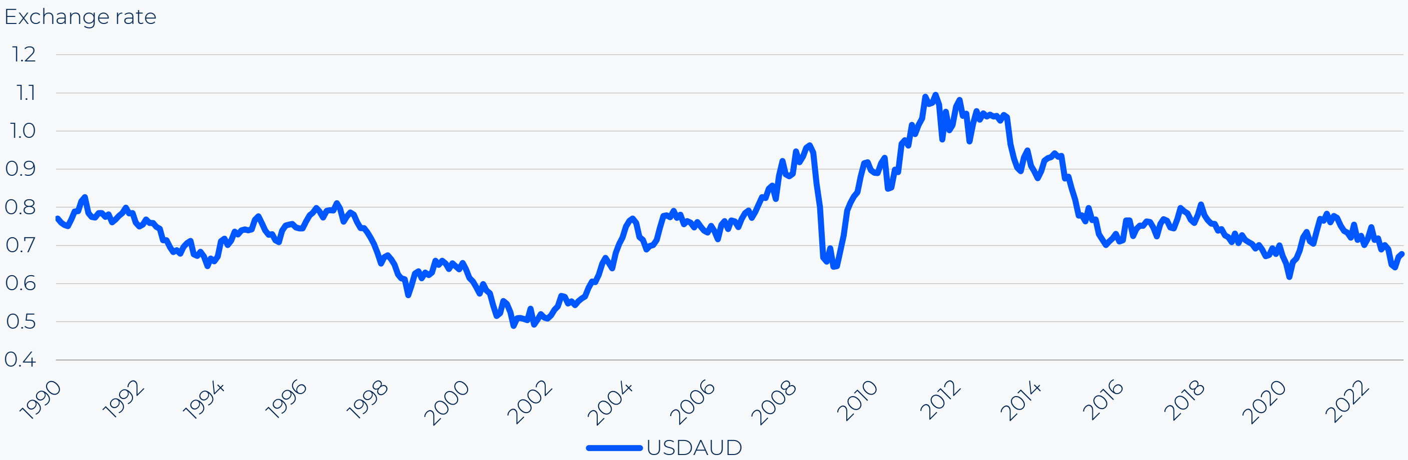
## Australian dollar

The Australian dollar (AUD) weakened against all major currencies over the quarter on the back of lower terminal interest rate expectations following dovish commentary from the RBA. The largest currency move over the quarter for the Australian dollar was a weakening against the pound sterling by 3.9%, partly due to a recovery in political confidence in the UK after turmoil in late 2022. Despite the positive risk sentiment in equity markets over the quarter, the US dollar continued to benefit from its safe haven status and higher interest rate expectations, resulting in the AUD retracting -1.2% for the quarter. Similarly, the AUD weakened against the Swiss franc by -2.5% in the quarter, following a 50 basis point increase in the Swiss cash rate and the currency's safe haven status. Aggressive monetary tightening by the European Central Bank over the quarter saw the AUD retrace -3.0%. The AUD also lost -2.4% against the Chinese renminbi after weaker economic data opened the door for future interest rate increases by the People's Bank of China (PBoC).

## Australian dollar outlook

We expect ongoing volatility in exchange rate movements over the short term as central banks navigate the economic impacts of previous monetary tightening both domestically and abroad. We would posit that the USD is likely to face headwinds as the US economy reaches its peak interest rate for the cycle and positive growth stories in China and other emerging economies divert investment away from the US. These trends may favour the AUD in the long run as a commodity exporter and major trade partner with the East. However, we expect short-term currency moves to be dominated by interest rate differentials and central bank behaviour, which remain difficult to predict with any certainty.

Figure 2: Australian dollar-U.S. dollar daily long-term exchange rate




Source: FactSet, Perpetual Private.

# Australian and international equities

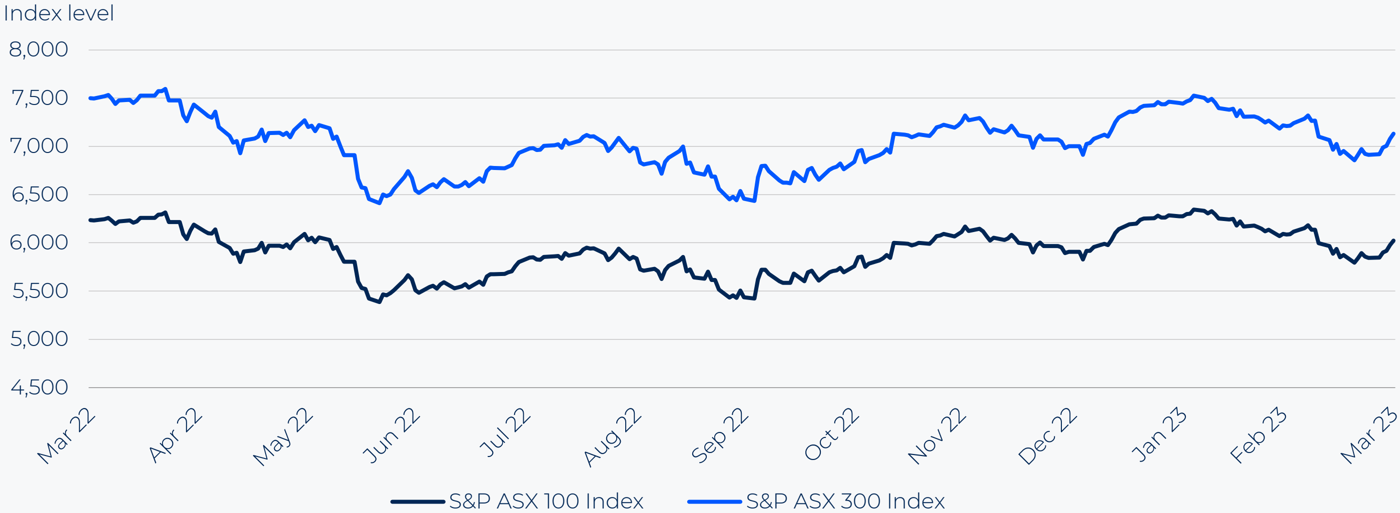
## Australian equities

It was a decent March quarter for Australian equities, with the S&P/ASX 300 Accumulation Index increasing by 3.3% over the period. Australian equities underperformed global equities, with the MSCI All Country World Index by comparison increasing 7% in local currency terms (8.6% in AUD terms) over the same period.

Despite broader concerns around the economic and geopolitical global outlook and future corporate earnings, domestically there were some indicators over the quarter that inflation levels may have peaked, with the February 12-month inflation figure falling to 6.8% (vs 7.4% in January). In March we also saw cracks start to appear following the unprecedented pace of interest rate hikes to date, which led to the collapse of several overseas banks – most notably Credit Suisse, Silicon Valley Bank and Signature Bank of New York.

Over this period, we saw Growth stocks outperform Value stocks and Large Cap names outperform Small Cap companies. The best performing sectors were Consumer Discretionary (+10.8%), closely followed by Communication Services (+9.5%), Consumer Staples (+7.5%), Materials (+7.3%) and Information Technology (+6.6%). By far the weakest performing sector was Financials (-2.7%). The only other negative sector for the quarter was Energy (-1.0%).

Figure 3: Australian shares – large companies




Source: FactSet , Perpetual Private.

## Australian equities outlook

We expect movements in the Australian equity market will continue to be influenced primarily by inflation data and forecasts, as well as the path and pace of interest rates both domestically and abroad. The market will continue to pay close attention to rhetoric from the RBA and central banks globally, as investors look for indications from central banks as to whether interest rate hikes are taming inflation, which should dictate future rate hikes.

Following ten consecutive interest rate hikes and what has been the fastest tightening cycle in Australia on record, the RBA have hinted they may pause rates at the April meeting to assess the lagged effects of prior rate hikes. Especially given the large number of mortgages rolling off fixed rates into variable rates in the back half of 2023. A pause would also allow the RBA more time to assess inflation and labour market data throughout April. Looking ahead we expect further rate hikes if inflation remains above target, but there are signs we may be at peak inflation and nearing peak rates.

We believe there are still risks surrounding the outlook for certain sectors of the market. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which together will weigh on consumer spending and should become more pronounced as consumers roll off fixed rate mortgages and are faced with substantially higher minimum repayments. In particular, the downward pressure on corporate earnings from higher interest rates and a slowing economy has further to play out. Companies with elevated debt levels are particularly vulnerable, which stresses the importance of investing in managers that have a strong focus on balance sheet strength.

We expect volatility in markets to continue for some time, against the backdrop of economic and geopolitical uncertainty and an acute focus on inflationary signals and the path of interest rates. We are in a stock picker's market, and this should present bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations as markets gyrate. With the various macroeconomic forces in mind, we see benefits in allocating towards managers that have a stronger regard for valuations and those that are focused on investing in businesses with strong pricing power or thematic tailwinds.

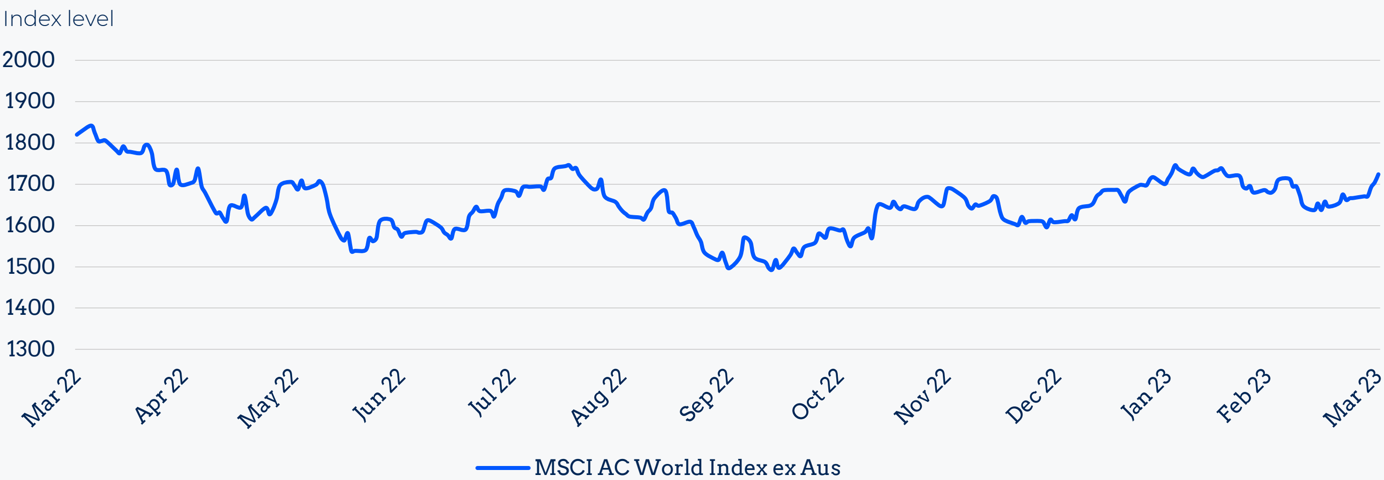
## International equities

The MSCI ACWI Index continued its rally through the first quarter of 2023, with the benchmark returning 7.0% in local currency and 8.7% in AUD terms. The AUD fell relative to the USD during the quarter helping returns.

The quarter was marked by a number of notable events: (1) the failure of several banks in the northern hemisphere collapsing of which the most notable were Credit Suisse, Silicon Valley Bank and Signature Bank of New York; (2) a shift in position from the US Federal Reserve indicating a more nuanced approach to interest rate rises in the coming month. Pleasingly, regulators acted quickly in light of the issues facing the banking systems, which to date, has increased stability across financial markets.

Against the backdrop, markets saw a change in leadership with Growth stocks, and mega caps materially outperforming Value stocks. At the sector level, Information Technology and Communication Services were the strongest performers delivering 21.9% and 18.6% respectively. Elsewhere, Industrials and Materials delivered 8.1% and 6.6% respectively. The laggards through the quarter were Energy and Health Care which delivered negative returns. Finally, Developed Markets outperformed Emerging Markets.

Figure 4: International shares (local currency terms)




Source: FactSet , Perpetual Private.

## International equities outlook

Equity markets continue to be driven by macroeconomic forces – specifically inflation data and forecasts, as well as the path and pace of interest rates. While uncertainty remains around the outlook for economies globally, we expect volatility to continue.

Our main areas of focus include:

### Central banks and the path and pace of interest rates

Investors are acutely focused on the rhetoric from central banks with regards to proposed and future rate hikes needed to stem inflation. As we saw over the March quarter, there were some indicators that inflation levels had peaked, which subsequently contributed to a strong recovery in equity markets on the presumption that central banks are successfully taming inflation and could therefore slow the pace and size of further rate hakes in the near future. That said however, any further tightening through higher rates is likely to limit the upside for equities as markets begin to reassess appropriate forward-looking valuations.

### The earnings outlook for corporates

It is the earnings expectations or outlook that has declined amid weakening business conditions. It is our view that the 'real economy' is facing the combined pressure of inflation and rising interest rates, which together will likely weigh on consumer spending, and subsequently future corporate earnings. That said, many corporates were able to expand their margins through the COVID-19 period, and as such there is room for some margin contraction – this likely only buys time, rather than changes the outcome.

### Valuations across most markets and sectors are near or around their post GFC averages

At this point in time we do not see a strong valuation signal to drive an overweight position to equities across portfolios. Any volatility should present our bottom-up fundamental active managers with opportunities to deploy capital to quality and possibly oversold companies at more attractive valuations.

We expect the macroeconomic outlook to continue driving equity markets over the near term, with higher volatility expected to continue. The coming earnings season should provide a guide as to how corporates are coping with this dynamic.

Over the remainder of 2023, we expect inflation to fall, however we do not believe that the path will be linear and its impact will continue to be felt across the corporates. As such, we expect financial markets to focus on fundamentals later this year, specifically, earnings growth, margin sustainability, cost control, free cash flow conversation and balance sheet strength. Managing investment portfolios in this environment poses multiple challenges for investors, however we believe that focusing on quality (as defined in the previous sentence) and valuation will provide investors with the right levers to navigate the environment successfully.

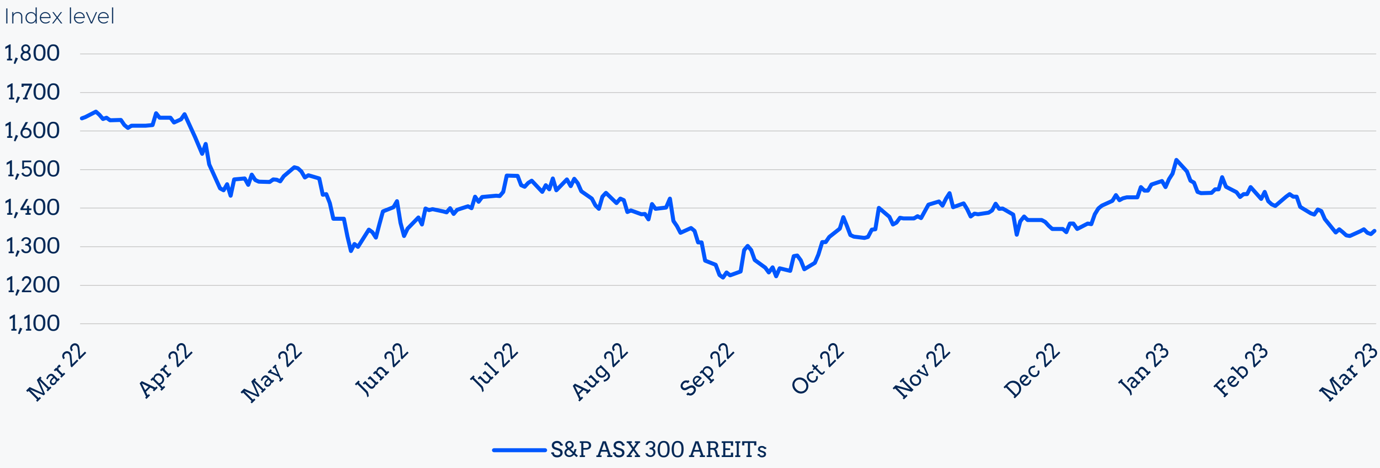
# A-REITs and G-REITs
## (listed property securities)

Despite a decline in bond yields of major markets, Real Estate lagged broader equity markets along with Financials as banking troubles raised the risks for companies with greater leverage. Australian Real Estate Investment Trusts (A-REITs), represented by the S&P/ASX 300 A-REIT sector index, rose 0.3% over the quarter while the S&P/ASX 300 Index rose 3.3%. Similarly, Global Real Estate Investment Trusts (G-REITs), as measured by the FTSE EPRA/NAREIT Developed Index (Unhedged), rose 2.0% in AUD terms compared to 9.1% for the MSCI World Index.

REIT markets are trading at discounts to net asset value (NAV) reflecting lower valuations as a result of rising cap rates. A recession may result in further declines as earnings growth slows. Uncertainty remains elevated as transaction levels have declined with this lack of price discovery particularly apparent in unlisted markets leading to a disconnect between buyers and sellers. This spread may converge, with a consequent appreciation of REIT prices but the catalysts and timing of such an event are unclear.

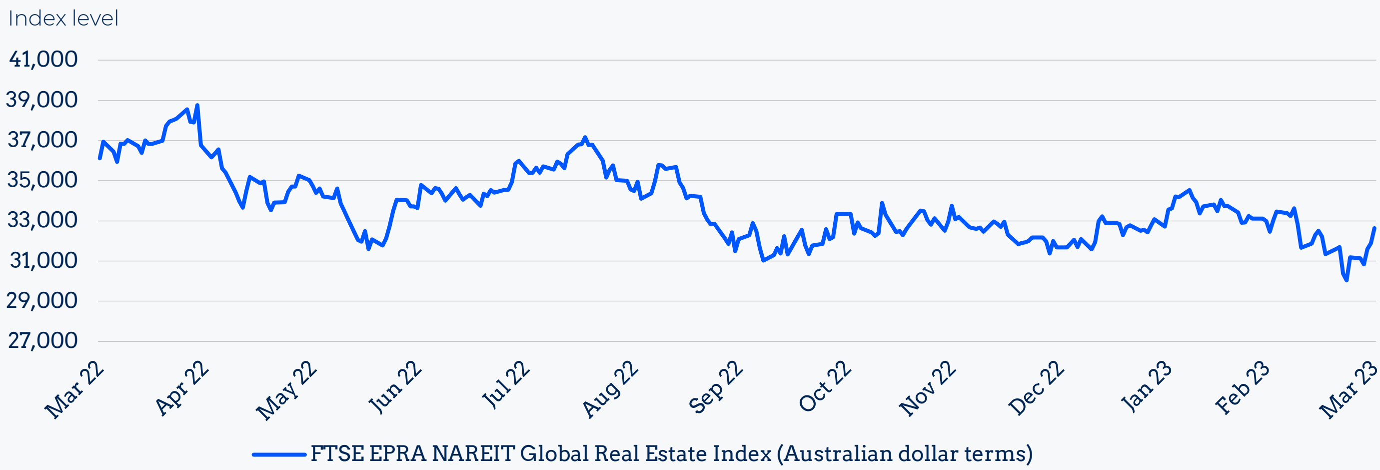
Office, Health Care and Retail were the weakest performing sectors over the quarter, while Industrial was the standout sector. On a regional basis, the US outperformed, while Europe and major Australasian developed markets were weaker in local currencies.

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




Source: FactSet , Perpetual Private.

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




Source: FactSet , Perpetual Private.

## REITs outlook

We expect both domestic and global REITs to experience heightened volatility, with heightened inflation driving elevated interest rate volatility. This continues to have an impact on the cost of debt for refinancing and acquisitions.

Those REITs with near-term debt expiry are likely to face higher ongoing servicing costs resulting in a drag on earnings. We expect those securities with more highly leveraged capital structures and poor interest coverage ratios to underperform. Sector and geographic allocation also remain important, with valuations and growth prospects differing across markets and segments.

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. Our active managers are focused on those assets with strong and/or improving balance sheets and improving earnings prospects. We remain of the view that 'quality' real estate with access to capital markets remain the most attractive investments.

Valuations across REIT markets are now at multi-year lows, trading at considerable discounts to fair value. This provides a degree of support for prices should economic conditions worsen or allow for some price appreciation when we begin to see a resumption of asset transactions.

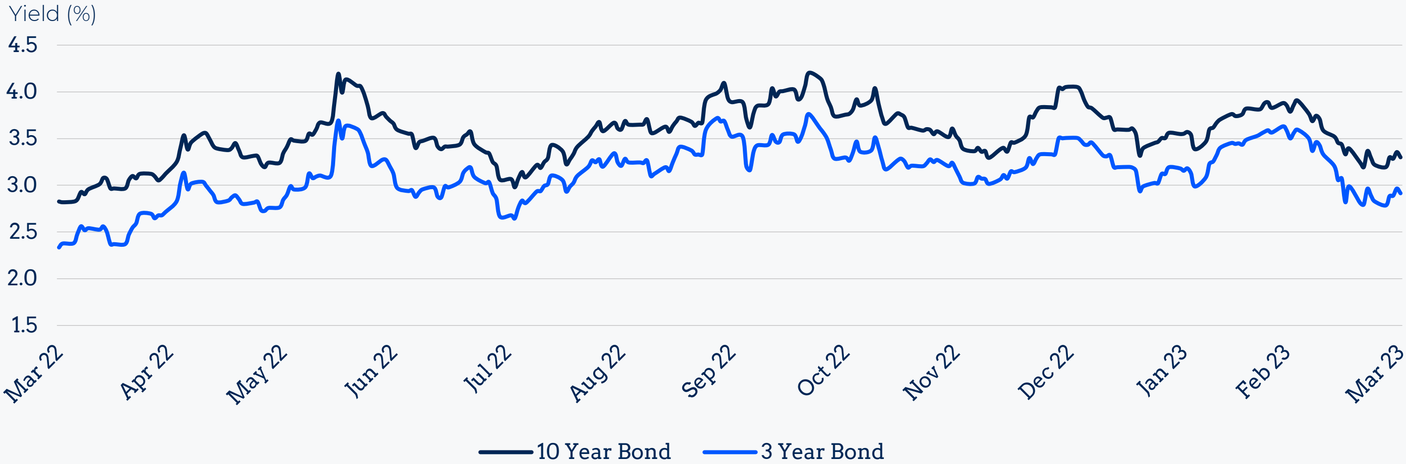
# Fixed income

In the domestic bond market, the Bloomberg AusBond Composite Index returned 4.6% during the March 2023 quarter. The Australian yield curve was volatile over the quarter, rising in February then falling in March. The Australian 10-year bond yield fell from 4.1% to 3.3% over the quarter off the back of slowing inflation and the possibility of the RBA taking a pause on rate increases in its April 2023 meeting.

On the global front, the Bloomberg Barclays Global Aggregate Bond Index (Hedged) returned 2.4%. Credit marginally outperformed the general market, with the ICE Bank of America Global Corporate Index (Hedged) returning 2.5% over the quarter. High yield debt as measured by the Bloomberg Global High Yield Index (Hedged) underperformed investment grade credit, returning 2.3% for the period.

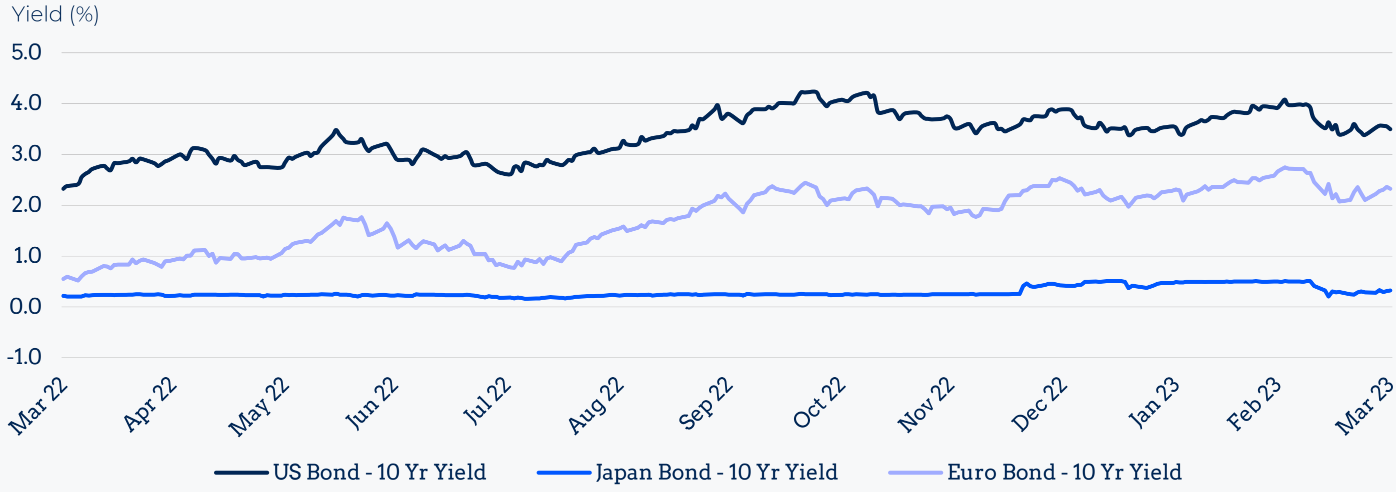
AUD/USD fell to 0.67 at the end of the quarter versus 0.68 at the end of 2022. The US Federal Reserve has continued tightening policy rates, albeit at a slower rate this quarter. At its March 2023 meeting, the Federal Reserve increased rates by 25 basis points, bringing their target range to 4.75%-5.0%. The 25 basis points move versus 50 basis points was partly in recognition of the recent bank failures and the pressure that rising rates are having on the financial system. The US 10-year yield fell from 3.9% to 3.5% over the quarter as the market priced in the possibility of less rate rises.

Figure 7: Australian government bonds



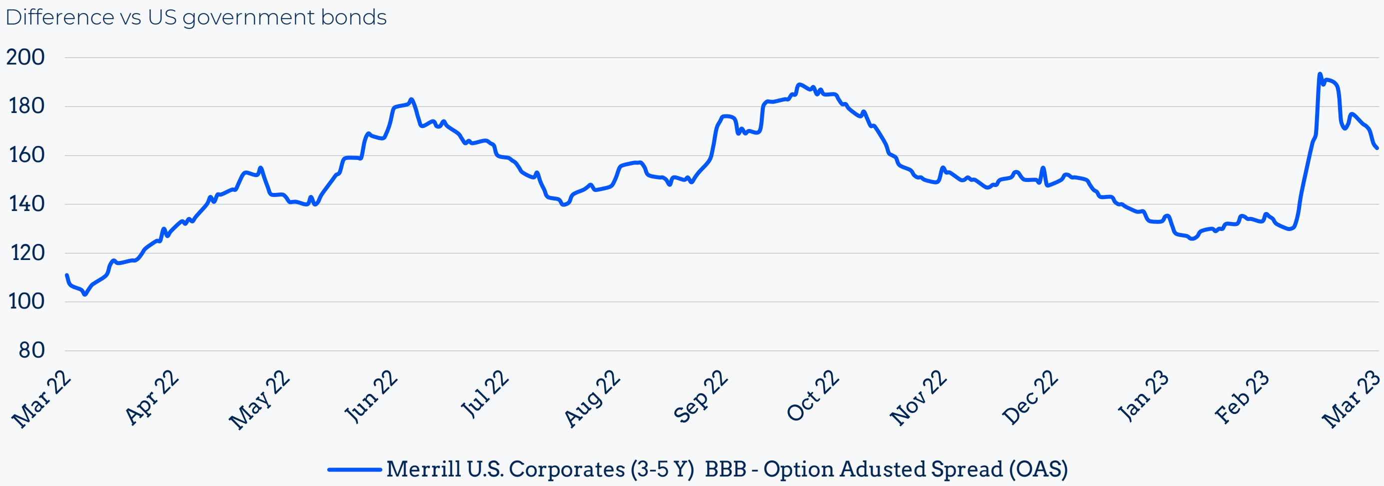

Source: FactSet, Perpetual Private.
Note: Bond prices are inversely correlated with bond yields.

Figure 8: Global government bonds




Source: FactSet, Perpetual Private.
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 income outlook

Up until the end of February 2023, we had the view that an overweight to shorter duration credit was a strong position for fixed income portfolios. This positioning performed well against traditional fixed interest benchmarks, retaining value during the aggressive rate hikes in developed markets in 2021 and 2022.

Moving into March 2023, we feel portfolios are better positioned to be more in line with traditional fixed interest markets. That is, higher allocations to government bonds and more interest rate risk. Government bond yields have risen substantially on a historical valuation basis and look cheap when compared to the previous five years, even after the more recent yield moves in March.

Going forward, a more benchmark-aware government bond allocation and lower credit risk should help performance during periods of market turmoil, like the one caused by the fall of SVB and Credit Suisse. Our view of credit is neutral but leaning to negative at this stage as it is susceptible to higher defaults in a recessionary environment, but at the time of writing, does have a reasonable spread over the risk-free rate.

# Alternatives

## Growth alternatives

Traditional asset classes rallied strongly through Q1 2023, while unlisted asset classes saw more modest movements. Transaction volumes across all asset classes (Private Equity, Real Estate and Infrastructure) remain soft in light of uncertainty around the cost of debt and the macroeconomic outlook. We expect to see some valuation weakness within Private Equity, and specifically Venture Capital. More recently, talk has shifted to the outlook for Real Estate, specifically Office, and we expect to see some valuation weakness.

Demand for Infrastructure remains strong, with institutional investors placing a premium on consistent and stable cash flows, and more recently, their 'inflation hedging' properties. The regulated assets within the portfolio are positioned well to deliver returns through the current inflationary environment with the ability to pass inflation-linked cashflows through to investors. A number of the energy transmission assets are well-positioned to benefit from the energy transition as renewables connect into the grid. Despite higher long bond rates, our portfolio appears to be well-insulated with most external valuations carried out on a 'through the cycle' basis resulting in limited movements in valuation assumptions.

Within Private Equity (PE), Leveraged Buy Out (LBO) transaction volumes have slowed, reducing the pace of deployment and realisations in Q1 2023. We do not expect volumes to rebound strongly, short of an improved economic outlook. Holding values are also beginning to retreat, with the largest expected pockets of weakness likely to be in Venture Capital (VC) and large-mega cap LBO. Fortunately, we have a very modest allocation to VC at ~3% of NAV and have a bias to 'middle market PE'. Despite the changing market dynamics, we remain steadfast in our approach to Private Equity, giving credence to acquisition valuation multiples, costs of debt and the manager's operational capability. We are optimistic that 2023 will be a fruitful investing environment.

Sector and geographical dispersion have increased within Real Estate markets. The most notable dynamic over the past quarter is the anticipation that US multi-family rental growth rates will begin to soften and depending on the unemployment outlook (among other things), may even fall, while Office valuations has become an increasing area of concern. Domestically, the cost of debt combined with the uncertainty about the outlook for rental growth has stymied several transactions. Our focus remains on the nexus between availability of capital and valuations. Of note, we are seeing the cost of debt rise in the US which is slowing transaction volumes and dampening prices. Finally, we have seen cap rates begin to widen in the Industrial sector, which the portfolio is underweight.

Changing market dynamics – inflation, path and pace of interest rates, weakening economic environment – warrants continued reassessment of our thinking and outlook. For now, our focus remains on central bank policy decisions and on the health of the 'real economy'. We are responding to what we expect a market environment more akin to that of the environment prior to the GFC (interest rate cycles and greater focus on fundamentals) by adding hedge fund strategies with a focus on security selection within equities and credit. Where we make commitments to Private Equity, we are particularly focused on operational capability, as opposed to balance sheet optimisation.

## Income alternatives

Both High Yield and Leveraged Loans printed a positive return for the quarter, with Leveraged Loans outpacing High Yield. Returns came from a combination of higher yields and spread tightening. The Bloomberg Global High Yield Index posted a 2.3% return and the Morningstar LSTA US Leveraged Loan 100 Index returned 3.0%.

Asset-backed and credit strategies saw good returns over the period. In asset-backed strategies, European property debt added most value. Leveraged Loans and CLO equities were the best performers over the period.

Going forward, we expect an increased number of downgrades by ratings agencies and the possibility of higher defaults. This will weigh mostly on the value of some of the market-linked assets such as High Yield, Leveraged Loans and CLOs. Private Debt is somewhat shielded from the mark to market because of its illiquidity, but we still expect higher delinquencies and defaults there. We expect first-lien unlevered Private Debt investments to underperform more recent vintages of Private Debt. In light of this, we view more liquid securities as better able to support distribution and rebalancing requirements in the short term. Liquid investments also provide some optionality of allocating to private assets, such as Private Debt or insurance-linked strategies, when the outlook is more favourable.

## More Information

1800 631 381
perpetualprivate@perpetual.com.au
www.perpetual.com.au/advice



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