Private Capital Advisers

Market Report – December 2022

Market returns

The December quarter saw a recovery of sorts to complete a year which produced negative – but not disastrous – returns in most asset classes. The key driver of markets throughout the year was the surge in inflation worldwide and the rapid increases in interest rates as Central Banks sought to slow that inflation. We believe that the main causes of the inflation surge were the impact of the war in Ukraine on energy prices and the Covid driven shutdown of the Chinese economy causing shortages of many other goods. The unexpected persistence of inflation meant that Central Banks were forced to catch up with very rapid increases in interest rates which they hope will sufficiently slow the economy to take the sting out of inflation - without plunging the economy into a deep recession.

The various shocks to the system over the year and uncertainty about their impacts on the economy have led to generally volatile markets. At times markets have fallen on the back of expectations that the interest rate hikes would lead to a deep recession while, at other times, markets have rallied on the possibility that we were close to the end of the rising rate cycle.

As shown in Figure 1, the end result was modest losses in most asset classes over the year – most notably bonds which produced their worst returns for 50 years. Given that bonds normally produce solid returns during equity market downturns, this outcome has been unhelpful for portfolio performance. Nonetheless, your fixed interest portfolio has produced better outcomes than bonds on average so that this impact has been muted.

Figure 1: Performance (%pa) for periods ending 31 December 2022

	3mo	6 mo	1 year	2 years	3 years
Australian equities[1]	8.8%	9.6%	-3.0%	6.9%	5.8%
International equities[2]	3.0%	4.2%	-13.0%	6.1%	6.0%
Listed property[3]	11.5%	4.0%	-20.5%	0.2%	-1.5%
Bonds[4]	0.4%	-0.3%	-9.7%	-6.4%	-2.9%
Term deposits[5]	0.3%	0.6%	1.0%	1.2%	1.5%
Cash[5]	0.6%	0.8%	0.9%	0.5%	0.4%

1.ASX All Ords; 2. MSCI World Ex Aus Index; 3. ASX A-REIT Index; 4. Aust Comp Bond Index; 5. RBA data

Inflation and interest rates still the keys to the next year

The outlook for inflation and interest rates will still be critical for returns in 2023. Bringing inflation under control will almost certainly require a substantial economic slowdown, if not a recession. Central Banks have now flagged that they believe that the main driver of inflation in 2023 and 2024 has shifted from rapidly rising commodity prices to rising wages. While we are already seeing falls in the prices of both energy and food, which is slowing inflation for now, shortages in labour world-wide are likely to lead to substantial wage rises before too long which will again increase inflationary pressures. Until Central Banks are comfortable about wage pressures, they are likely to keep interest rates at relatively high levels slowing economic growth.

Whether the different economies around the world go down a path of generally soft landings or hard landings is too difficult to call at this point. Even more to the point, the biggest risk to markets is always the unknown factor that is not part of current market considerations. COVID in 2020 and the Russian invasion of the Ukraine are two prime examples of factors that were hugely influential in markets but were just not on the radar until they struck. What, if anything, will be the "X" factor in 2023? We don't know and for that reason our focus will be on remaining diversified and concentrating on the outlook for returns over longer periods where the "X" factors play a much smaller part.

The Long-Term Outlook for returns

The much longer term – five to ten years – is much easier to forecast than the short-term and the outlook remains positive. Lower equity prices and higher rates on fixed interest means returns going ahead are likely to be a good deal higher than our expectations a year ago as can be seen in Figure 2. In fact, the outlook for both growth and defensive assets are more attractive than they have been for some time.

Figure 2: Ten-Year Forecast Returns 31 December 2022

	Australian Equities[1]	Developed Markets[2]	Listed Property[3]	Infrastructure	HY Debt[4]	TDs[5]
Income	5.5%	2.2%	4.8%	3.8%	9.8%	4.1%
Currency gain/loss		0.1%		0.5%		
Earnings growth	-0.4%	1.5%	2.3%	4.0%	0.0%	0.0%
Valuation change	2.7%	1.9%	0.9%	0.2%	-1.2%	0.0%
Forecast 10 yr return	**7.8%**	**5.7%**	**8.0%**	**8.5%**	**8.6%**	**4.1%**
PE Now	13.0	15.5		8.8		
PE 2033 (f)	17.0	18.7		9.0		
Yield 2033 (f)			5.1%			
Forecast (31 Dec 2021)	5.1%	3.5%	3.5%	8.4%	4.3%	1.7%

1. All Ordinaries Index; 2. MSCI World Index; 3. ASX A-REIT Index; 4. Non investment grade credit; 5. Forecast return on Bank TDs over the next decade.

These forecasts for the next ten years are built up from assessing what we earn from dividends, how fast we expect company profits and property rents to grow and how much we expect future investors will pay for those profits and rents. While they are obviously based on estimates and are far from perfect, they generally come out within a few percent of the original estimate.

Another way of looking at these forecasts is via the Tipping Point Tables in Figure 3 below which shows whether different markets are Overpriced, Cheap or somewhere in between.

Figure 3: The Tipping Point Tables

Australian Equities		
All Ords 7,221.7	10 yr F'cast return	Status
10000	3.0%	Overpriced
9750	3.3%	Overpriced
9500	3.7%	Overpriced
9250	4.1%	Fully priced
9000	4.5%	Fully priced
8750	4.9%	Fully priced
8500	5.3%	Fully priced
8250	5.8%	Fully priced
8000	6.2%	Fully priced
7750	6.7%	Fair value
7500	7.2%	Fair value
7250	7.7%	Fair value
7000	8.3%	Fair value
6750	8.9%	Fair value
6500	9.5%	Cheap
6250	10.1%	Cheap
6000	10.8%	Cheap

US equities		
S&P500 3,839.50	10 yr F'cast return	Status
4700	0.9%	Overpriced
4500	1.4%	Overpriced
4300	1.9%	Overpriced
4100	2.4%	Overpriced
3900	3.0%	Overpriced
3700	3.6%	Overpriced
3500	4.3%	Fully priced
3300	5.0%	Fully priced
3100	5.8%	Fully priced
2900	6.6%	Fair value
2700	7.5%	Fair value
2500	8.5%	Fair value
2300	9.6%	Cheap
2100	10.8%	Cheap
1900	12.2%	Cheap
1700	13.8%	Cheap
1500	15.7%	Cheap

World Ex US		
FTSE World Ex US 287.4	10 yr F'cast return	Status
550	0.5%	Overpriced
525	1.0%	Overpriced
500	1.6%	Overpriced
475	2.2%	Overpriced
450	2.8%	Overpriced
425	3.5%	Overpriced
400	4.2%	Fully priced
375	5.0%	Fully priced
350	5.9%	Fully priced
340	6.3%	Fully priced
330	6.7%	Fair value
320	7.1%	Fair value
310	7.5%	Fair value
300	7.9%	Fair value
290	8.4%	Fair value
280	8.9%	Fair value
270	9.4%	Cheap

A REITs		
ASX REIT 1333.4	10 yr F'cast return	Status
2300	0.6%	Overpriced
2200	1.2%	Overpriced
2100	1.8%	Overpriced
2000	2.4%	Overpriced
1900	3.1%	Overpriced
1800	3.8%	Overpriced
1700	4.5%	Fully priced
1600	5.4%	Fully priced
1500	6.3%	Fully priced
1450	6.8%	Fair value
1400	7.3%	Fair value
1350	7.8%	Fair value
1300	8.4%	Fair value
1250	9.0%	Fair value
1200	9.6%	Cheap
1150	10.3%	Cheap
1100	11.0%	Cheap

Global Infrastrcuture		
MSCI Global Infra (H) 3027.71	10 yr F'cast return	Status
5000	2.1%	Overpriced
4800	2.6%	Overpriced
4600	3.1%	Overpriced
4400	3.7%	Overpriced
4200	4.2%	Fully priced
4000	4.9%	Fully priced
3800	5.5%	Fully priced
3600	6.2%	Fully priced
3400	7.0%	Fair value
3300	7.4%	Fair value
3200	7.8%	Fair value
3100	8.2%	Fair value
3000	8.7%	Fair value
2900	9.1%	Cheap
2800	9.6%	Cheap
2700	10.2%	Cheap
2600	10.7%	Cheap

In the Red Zone of the Tipping Point Table the expected returns are less than those from fixed interest and it is time to start heading for the exits. Only the US market is currently rated as Overpriced, other markets are at Fair Value.

This market update has been prepared inconjunction with farrelly's Investment Strategy without taking into consideration any of your objectives, financial situation or needs. Therefore, you should carefully consider the appropriateness of the information contained in this market update based on your personal circumstances, needs and objectives before acting on it. We strongly recommend you seek personal advice from Private Capital Advisers Pty Ltd and its representatives prior to acting on the information contained in this market update. Personal advice is advice that is given after having considered your relevant objectives, financial situation and needs. If you choose to act on this information without first seeking personal advice, you risk making a decision that may result in a financial loss.