Private Capital Advisers

Market Report – June 2022

Market returns

For some time, we have been warning that the very high returns of recent years are unlikely to be repeated in the years ahead. The first half of this year has given us a look as to how that may unfold in the coming months and years. Typically, lower returns going ahead does not mean low and steady but rather periods of strong increases followed by nasty selloffs, such as those we have experienced since December.

In Figure 1, we see the sell-off in the first half of the year has reduced average three-year returns to a range of 4% pa to 8% pa for equities and negative for listed property. A far cry from just three months ago where three-year average returns from equities were well above 10% pa.

Figure 1: Performance for period ending 30 June 2022

	3mo	6 mo	1 year	2 years	3 years
Australian equities[1]	-12.9%	-11.5%	-7.4%	9.8%	3.8%
International equities[2]	-9.1%	-16.5%	-7.0%	9.1%	7.7%
Listed property[3]	-17.7%	-23.5%	-12.3%	8.1%	-2.8%
Bonds[4]	-3.8%	-9.5%	-10.5%	-5.8%	-2.6%
Term deposits[5]	0.2%	0.4%	1.1%	1.4%	1.8%
Cash[5]	0.0%	0.1%	0.1%	0.1%	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

While the returns from growth assets for the three years to June are modest, they are still ahead of the returns from defensive assets such as cash, term deposits and Government bonds. Despite undergoing two sharp sell offs; the current downturn and the pandemic induced one in early 2020, investors in growth assets have nonetheless been rewarded over the past three years.

Amongst defensive assets, bonds have been severely marked back in what is now the biggest down-turn in the bond market for 50 years. A full report on this bond bear market by Investment Committee member Tim Farrelly is available on request.

Concerns about inflation have been driving the downturn

Inflation has spiked world-wide, initially as a result of shortages of the supply of goods caused by post-Covid bottlenecks. These shortages have been compounded by further Covid related shutdowns in China and of course, the war in the Ukraine which has seen food and energy prices increase dramatically. Finally, we have seen wage pressures in the US and, to a lesser extent, here in Australia. The end result has been the highest level of inflation that the developed world has seen in decades.

Keeping inflation under control is the responsibility of Central Banks such as the Reserve Bank of Australian (RBA) and the US Federal Reserve (the Fed) who typically respond to inflation by lifting interest rates in order to slow the economy and thus relieve inflationary pressures. The market worries that interest rates will be lifted so sharply so as to cause a recession, which is bad for company profits and the share prices. An additional concern is that, despite Central Bank efforts, inflation becomes ingrained in the system and we will move to a higher level of interest rates in the longer term. This would impact valuations of growth assets as higher interest rates on risk free assets means that investors demand higher returns from growth assets – they get these higher returns by paying lower prices. As always, the less we pay the better returns we earn.

Now, some of these fears are already reflected in the lower share prices we see today – but short-term uncertainty remains. Future market behaviour will depend on how the outlook for inflation and interest rates unfold from here.

The outlook for inflation and Interest rates

Everything that Central Banks have said so far this year strongly suggests that they will bring inflation back to their targets over the next two to three years – and that they are quite ready to put their economies into recession if that is what is required. More importantly, they have backed up their words with actions, repeatedly increasing short-term interest rates. While they would prefer a so-called soft landing, they view a brief recession as preferable to the spectre of ongoing inflation. In other words, they will do whatever it takes to bring inflation under control.

That suggests that the long-term outlook for inflation is clear even if the short-term outlook remains cloudy. The short-term outlook for interest rates also remains uncertain; will the RBA have to lift cash rates to 3%, 3.5% or even 4% in order to slow inflation? We do not know. However, once inflation is back within targets, we can expect cash rates to settle at lower levels, most likely around 2%.

For Australia, cash rates at 2% are historically very low. Many fear – or hope - that we are going back to the old days of 5% interest rates or even the 10% rates that prevailed in the 1990's. We believe these levels are very unlikely because of the huge increase in housing debt we have seen since the 90's. Simply put, semi-permanent interest rates at around 4% in Australia would mean dramatic cuts in household spending – the lifeblood of the economy - and a semi-permanent recession in Australia. We think it very unlikely that the RBA will pursue that path.

The Long-Term Outlook for returns

There is an up-side to all of this. Lower equity prices and higher interest rates means returns going ahead are likely to be a good deal higher than our expectations six months ago, as can be seen in Figure 2. In fact, following these price corrections, the outlook for both growth and defensive assets are more attractive than they have been for some time. This is despite the short-term uncertainties – in fact, it is because of the uncertainties that these more attractive returns are on offer.

Figure 2: Ten-Year Forecast Returns 30 June 2022

	Australian Equities[1]	Developed Markets[2]	Listed Property[3]	Infrastructure	HY Debt[4]	TDs[5]
Income	5.7%	2.2%	4.9%	3.8%	10.0%	3.7%
Currency gain/loss		0.3%		1.1%		
Earnings growth	-0.5%	1.2%	1.8%	4.0%	0.0%	0.0%
Valuation change	3.0%	2.0%	1.2%	0.2%	-1.2%	0.0%
Forecast 10 yr return	**8.2%**	**5.6%**	**7.9%**	**9.1%**	**8.8%**	**3.7%**
PE Now	12.9	16.1	0.0%	4.5%		
PE 2032 (f)	17.4	19.6	0.0%	0.0%		
Yield 2032 (f)			5.1%	5.9%		
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 these forecasts give us a very good guide to the longer term, they tell us very little about returns over the next one to three years. And, as we have seen over the past three years, short-term returns can fluctuate enormously. The next bout of fear driven price falls is always around the corner and is tremendously difficult to predict; which is why we always focus on the long-term in our decision-making.

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

Figure 3: The Tipping Point Tables

Australian Equities		
All Ords 6,746.5	10 yr F'cast return	Status
10000	2.5%	Overpriced
9750	2.8%	Overpriced
9500	3.2%	Overpriced
9250	3.6%	Overpriced
9000	4.0%	Fully priced
8750	4.4%	Fully priced
8500	4.8%	Fully priced
8250	5.2%	Fully priced
8000	5.7%	Fully priced
7750	6.1%	Fully priced
7500	6.6%	Fair value
7250	7.2%	Fair value
7000	7.7%	Fair value
6750	8.3%	Fair value
6500	8.9%	Cheap
6250	9.5%	Cheap
6000	10.2%	Cheap

US equities		
S&P500 3,785.38	10 yr F'cast return	Status
4700	-0.2%	Overpriced
4500	0.2%	Overpriced
4300	0.8%	Overpriced
4100	1.3%	Overpriced
3900	1.9%	Overpriced
3700	2.5%	Overpriced
3500	3.1%	Overpriced
3300	3.8%	Fully priced
3100	4.5%	Fully priced
2900	5.3%	Fully priced
2700	6.2%	Fair value
2500	7.2%	Fair value
2300	8.2%	Fair value
2100	9.4%	Cheap
1900	10.8%	Cheap
1700	12.3%	Cheap
1500	14.1%	Cheap

World Ex US		
FTSE World Ex US 281.2	10 yr F'cast return	Status
550	0.5%	Overpriced
525	1.1%	Overpriced
500	1.6%	Overpriced
475	2.2%	Overpriced
450	2.8%	Overpriced
425	3.5%	Overpriced
400	4.3%	Fully priced
375	5.0%	Fully priced
350	5.9%	Fully priced
340	6.3%	Fair value
330	6.6%	Fair value
320	7.0%	Fair value
310	7.5%	Fair value
300	7.9%	Fair value
290	8.3%	Fair value
280	8.8%	Cheap
270	9.3%	Cheap

A REITs		
ASX REIT 1314	10 yr F'cast return	Status
2300	0.3%	Overpriced
2200	0.9%	Overpriced
2100	1.5%	Overpriced
2000	2.1%	Overpriced
1900	2.8%	Overpriced
1800	3.5%	Overpriced
1700	4.3%	Fully priced
1600	5.1%	Fully priced
1500	6.0%	Fully priced
1450	6.5%	Fair value
1400	7.0%	Fair value
1350	7.5%	Fair value
1300	8.1%	Fair value
1250	8.7%	Cheap
1200	9.3%	Cheap
1150	10.0%	Cheap
1100	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, despite recent sharp falls. Other markets are Fair Value or Cheap.

Portfolio moves

In the coming quarter we will be focussed on ensuring that portfolios are close to fully invested in growth assets, rebalancing where necessary. We will continue to look closely at emerging opportunities in the High Yield space. And, as always, we will be carefully monitoring the long-term outlook for markets.

Points made in earlier quarterly reports that remain valid

- **Diversification remains vital**. The two-year returns show that, among the growth assets where we would expect similar returns in the long-term, we can get large divergences in the shorter term. In particular, Listed Property, with its focus on offices and shopping malls, was deemed by the market to be a long-term casualty of the pandemic and has returned negative returns over the past three years, while International Equities returned 7.7% pa.
- **Markets over-react**. Two years ago, the bond markets were predicting cash rates below 1% for a decade or more, today those same markets are predicting cash rates of 4% or so for even longer. Both seem like over-reactions. Market over-reactions give rise to opportunities for investors with a long-term focus.
- **Even secure investments are capable of producing negative returns over shortish time periods**. Government bonds have had a negative return over the past year, however, over longer time frames, returns are more reliable. This, of course, is why we always focus on the long-term.
- **These type of equity returns are absolutely unsustainable.** We are delighted when we do earn these sorts of returns but also need to recognise that even the seemingly more modest two-year returns are much higher than we are likely to earn in the longer-term.

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