Private Capital Advisers

Market Note – July 2023

Market returns

The June quarter saw mixed returns amid the growing realisation that inflation is proving stickier than most – ourselves included - had anticipated. In response, Central Banks around the world have surprised markets by the extent of their cash rate increases. The end result of the worsening outlook for inflation is that interest rates world-wide are now expected to remain higher for longer than most had previously thought.

The negative sentiment caused by these surprises have unevenly impacted markets. The biggest impact has been on bonds where yields have risen leading to negative returns for the quarter.

Nonetheless, once again, we see the value of diversification. As we see in Figure 1, over three months, one year and two years, there has been a large dispersion of returns between the different asset classes. Because we cannot pick these short-term dispersions, we remain well diversified and concentrate on avoiding any over-valued markets where we expect long-term returns to be poor.

Figure 1: Performance (%pa) for periods ending 30 June 2023

	3mo	6 mo	1 year	2 years	3 years
Australian equities[1]	1.0%	4.5%	16.6%	4.9%	12.5%
International equities[2]	7.3%	17.9%	22.9%	6.9%	13.5%
Listed property[3]	3.4%	3.9%	8.1%	-2.6%	8.1%
Bonds[4]	-2.9%	1.2%	-4.8%	-3.5%	0.5%
Term deposits[5]	0.4%	0.8%	1.4%	1.2%	1.4%
Cash[5]	0.9%	1.7%	2.5%	1.3%	0.9%

1.ASX 200 inc Franking; 2. MSCI World Ex Aus Index; 3. ASX A-REIT Index; 4. Aust Comp Bond Index; 5. RBA data

Australian equities

A subdued quarter for Australian equities where the greater than expected increases in interest rates have dimmed market enthusiasm. The resources sector was weaker than the market as a whole in response to sagging commodity prices.

International equities

In contrast, after a difficult 2022, International equities continued their very strong performance and have had a bumper first half of the year. The increases have not just been in the United States where the market returned 17% for the first half but also in Europe where the market was up 11% and in Japan where the market was up by a remarkable 23% so far this year (in local currency terms).

The Australian dollar was flat relative to the US Dollar and the Euro for the quarter but up against the Yen (which reduced Australian dollar returns on the Japanese share-market somewhat.)

Listed Property

A-REITS continue to hold up reasonably well despite poor market sentiment and rising bond rates which normally cause them to be revalued down. However, most of the bad news in this sector is now well known and as a result further news is having little impact on returns.

Bonds

Most fixed interest securities gave back some but not all of their gains for the first quarter as interest rates rose across the board. (The value of bonds with interest rates that have been fixed at lower than market levels fall in value when interest rates rise. Similarly, when interest rates fall, fixed interest securities with higher than market rates rise in value.)

Cash

The RBA continued to lift cash rates which benefited returns from short-term investments. We believe that the RBA may have one or two more rate increases still to come before beginning a very gradual easing of rates back to more normal levels.

Inflation and interest rates remain the key

As we have said many times over the past year, the outlook for inflation and interest rates remains critical for returns. While we have no doubt that Central Banks are determined to bring inflation under control, it is becoming more apparent that this will be a more difficult task than we had previously thought and there is a growing risk that inflation may be with us for a few years yet.

Because inflation is generally a negative for markets, we are actively looking for assets that are likely to give better than expected returns in the event that inflation is even stickier than now appears to be the case. Some of these include Global Infrastructure, High Yield Debt and Inflation linked Bonds.

The Long-Term Outlook for returns

While the short-term remains uncertain, the much longer term – five to ten years – is much easier to forecast and the outlook remains positive as can be seen in Figure 2 where our expectations for long-term returns have changed only marginally over the past quarter, even taking into account higher interest rates and inflation risks.

Figure 2: Ten-Year Forecast Returns (%pa) as at 30 June 2023

	Australian Equities[1]	Developed Markets[2]	Listed Property[3]	Infrastructure	HY Debt[4]	TDs[5]
Income	5.5%	1.8%	4.7%	4.4%	9.4%	4.0%
Currency gain/loss		0.0%		0.5%		
Earnings growth	0.1%	2.6%	2.9%	4.0%	0.0%	0.0%
Valuation change	2.3%	-0.4%	-0.7%	0.5%	-1.2%	0.0%
Forecast 10 yr return	**8.0%**	**4.0%**	**6.9%**	**9.4%**	**8.2%**	**4.0%**
PE Now	13.5	19.0		8.3		
PE 2033 (f)	17.0	18.3		8.7		
Yield 2033 (f)			0.0%			
Forecast (31 Mar 2023)	7.7%	4.6%	7.6%	8.1%	7.4%	3.3%

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 which shows whether different markets are Overpriced, Cheap or somewhere in between.

Figure 3: The Tipping Point Tables

Australian Equities		US equities		World Ex US		A REITs		Global Infrastructure		Hi Yield Debt	
All Ords 7,401.5	10 yr F'cast return	S&P500 4,450.38	10 yr F'cast return	FTSE World Ex US 308.6	10 yr F'cast return	ASX REIT 1354.7	10 yr F'cast return	MSCI Global Infra (H) 3049.2	10 yr F'cast return	Bof A HY Spread 4.33%	10 yr F'cast return
10000	3.5%	4700	1.4%	550	0.4%	2300	-0.1%	5000	2.9%	0.50%	3.8%
9750	3.9%	4500	1.8%	525	0.9%	2200	0.4%	4800	3.4%	1.00%	4.3%
9500	4.2%	4300	2.4%	500	1.5%	2100	1.0%	4600	3.9%	1.50%	4.8%
9250	4.6%	4100	2.9%	475	2.1%	2000	1.6%	4400	4.5%	2.00%	5.3%
9000	5.0%	3900	3.5%	450	2.7%	1900	2.3%	4200	5.1%	2.50%	5.8%
8750	5.4%	3700	4.1%	425	3.4%	1800	3.0%	4000	5.7%	2.75%	6.0%
8500	5.8%	3500	4.7%	400	4.1%	1700	3.8%	3800	6.4%	3.00%	6.3%
8250	6.3%	3300	5.4%	375	5.0%	1600	4.6%	3600	7.1%	3.25%	6.5%
8000	6.8%	3100	6.2%	350	5.8%	1500	5.5%	3400	7.9%	3.50%	6.8%
7750	7.2%	2900	7.0%	340	6.2%	1450	6.0%	3300	8.3%	3.75%	7.0%
7500	7.8%	2700	7.9%	330	6.6%	1400	6.5%	3200	8.7%	4.00%	7.3%
7250	8.3%	2500	8.8%	320	7.0%	1350	7.0%	3100	9.2%	4.25%	7.5%
7000	8.8%	2300	9.9%	310	7.4%	1300	7.6%	3000	9.7%	4.50%	7.8%
6750	9.4%	2100	11.1%	300	7.9%	1250	8.1%	2900	10.2%	5.00%	8.3%
6500	10.1%	1900	12.5%	290	8.3%	1200	8.8%	2800	10.7%	6.00%	9.3%
6250	10.7%	1700	14.1%	280	8.8%	1150	9.4%	2700	11.2%	7.00%	10.3%
6000	11.4%	1500	15.9%	270	9.3%	1100	10.1%	2600	11.8%	8.00%	11.3%

CHEAP :Returns >5% above bonds	FAIR VALUE : Returns 2.5% to 5% above bonds	FULLY PRICED : Returns 0% to 2.5% above bonds	OVERPRICED : Returns less than bonds

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. Most other markets are at Fair Value.

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. And, as always, we will be carefully monitoring the long-term outlook for markets. In particular, we will still be focussing on assets which are likely to be resilient in the event that inflation remains high.

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