Private Capital Advisers

Market Update – October 2023

Market returns

The major development in the September quarter was a sharp increase in interest rates paid on government bonds in response to the growing expectation that Central Banks will need to keep cash rates at the current high levels for much longer than had previously been anticipated. This contributed to flat returns in equity markets and falls in real assets such as property and infrastructure.

Nonetheless, as we see in Figure 1, over longer periods of say 3 to 5 years, growth assets have outperformed Cash and Term Deposits. As always, short-term moves are not a useful guide to longer term performance.

Figure 1: Performance (% per annum) for periods ending 30 September 2023

	3mo	6 mo	1 year	2 years	3 years	5 years
Australian equities[1]	0.8%	1.8%	15.2%	4.0%	12.5%	8.1%
International equities[2]	0.0%	7.3%	21.4%	4.9%	12.0%	9.8%
Listed property[3]	-2.9%	-3.2%	12.5%	-6.0%	4.7%	2.5%
Global Infrastucture[4]	-6.3%	-6.6%	2.2%	1.6%	8.0%	4.0%
Bonds[5]	-0.3%	-3.2%	-5.1%	-3.9%	0.3%	0.3%
Term deposits[6]	0.5%	0.9%	1.6%	1.3%	1.4%	1.8%
Cash[6]	1.0%	1.9%	3.3%	1.8%	1.2%	1.1%

1.ASX 200 inc Franking; 2. MSCI World Ex Aus Index; 3. ASX A-REIT Index; S&P Global Infra (hedged); 5. Aust Comp Bond Index; 6. RBA data

Australian equities

Following positive returns in July and August, September saw a sell-off in Australian equities due to the increases in bond interest rates and an accompanying decline in market sentiment. Overall, returns were flat for the quarter.

International equities

Similarly, International equities paused after a very strong performance in the first half of the year. The main driver was the rise in bond yields in the United States. These flat returns were experienced in both the US and most other markets around the world. The returns were boosted somewhat by the 3.5% fall in the Australian dollar during the quarter.

Listed Property and Infrastructure

Both A-REITS and Infrastructure are particularly sensitive to rising interest rates and have sold off this quarter despite the underlying income produced by these sectors remaining steady. They are now priced to deliver very attractive returns going ahead.

Bonds

Another negative quarter for bonds due, again, to the rise in bond interest rates. (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.)

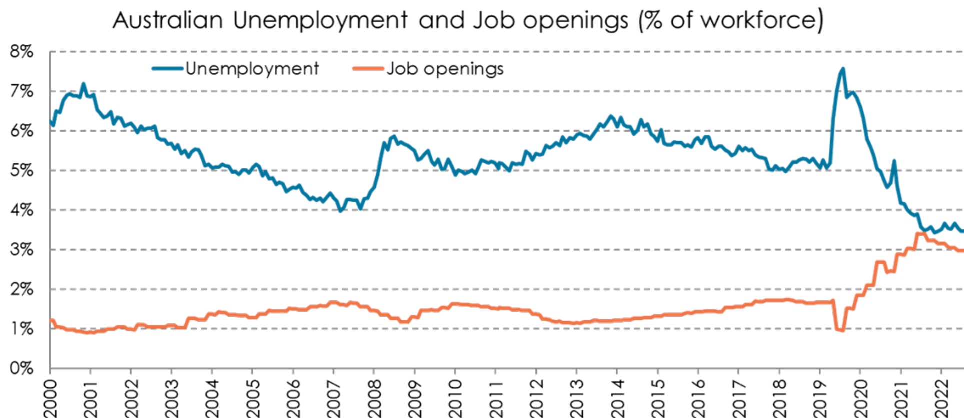
Cash

The RBA maintained cash rates at 4.1% with the new Governor, Michelle Bullock, leaving rates unchanged in her first meeting at the helm of the RBA. Most believe that we are close to the peak in rates with the main change in expectations being how long cash rates will need to remain at these levels in order to bring inflation under control. As discussed at the outset, this change in sentiment was reflected by the increase in bond rates.

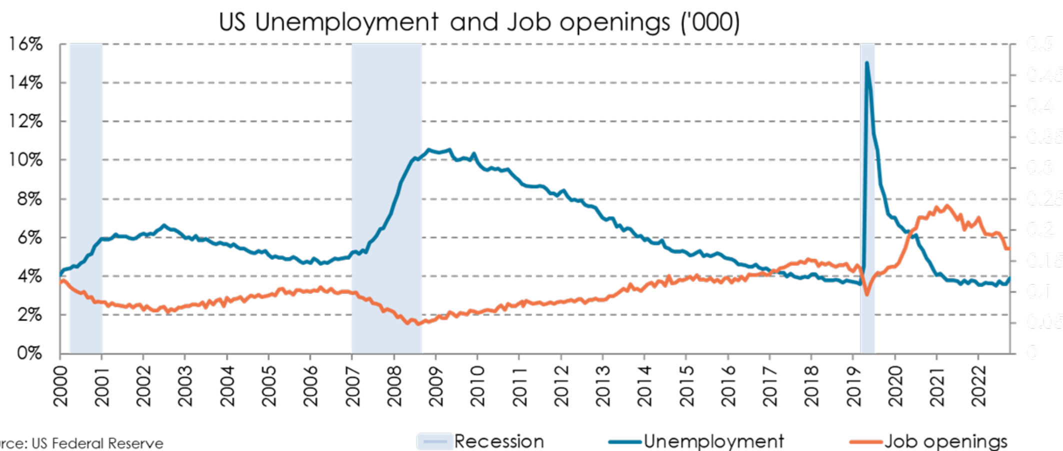
Inflation and interest rates remain the key

At the risk of sounding like a broken record, the outlook for inflation and interest rates remains critical for returns. While Central Banks remain determined to bring inflation under control, it is becoming more apparent that this will be a more difficult task than we had previously thought in particular because of very tight labour markets throughout the developed world. In the charts below we see how, traditionally, there have been many more unemployed people (the blue line) than available jobs for those people (the orange line) but that position has changed dramatically in recent years.

Now there is little difference between available jobs and people available to fill those jobs. The concern for Central Banks is that this narrow gap (the tight labour market) gives employees the power to demand outsized pay increases which will translate into cost increases for employers which translates into further price increases and inflation. This is every Central Bankers worst nightmare – the dreaded wage price spiral. Their answer to this concern is to raise interest rates until the economy slows, unemployment rises and the number of new jobs falls. We see in the US chart that this is exactly what happens during recessions.



Source: ABS, farrelly's analysis



Source: US Federal Reserve

This is a concern for investors because inflation is generally a negative for markets. As a result, we are still actively looking for assets that are likely to give better than expected returns in the event that inflation remains high for some time. Some of these assets include Global Infrastructure, High Yield Debt and Inflation linked Bonds.

The Long-Term Outlook for returns

While the short-term remains uncertain, the 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 (% per annum) as at 30 September 2023

	Australian Equities[1]	Developed Markets[2]	Listed Property[3]	Infrastructure	HY Debt[4]	TDs[5]
Income	5.7%	1.9%	4.9%	4.7%	9.6%	4.5%
Currency gain/loss		0.0%		0.4%		
Earnings growth	1.4%	3.0%	2.6%	4.0%	0.0%	0.0%
Valuation change	1.3%	0.1%	0.3%	1.4%	-1.2%	0.0%
Forecast 10 yr return	**8.4%**	**5.0%**	**7.7%**	**10.5%**	**8.4%**	**4.5%**
PE Now	15.0	18.1		7.6		
PE 2033 (f)	17.0	18.3		8.7		
Yield 2033 (f)			0.0%			

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 7,249.7	10 yr F'cast return	S&P500 4,288.05	10 yr F'cast return	FTSE World Ex US 305.5	10 yr F'cast return	ASX REIT 1305.5	10 yr F'cast return	MSCI Global Infra (H) 2829.83	10 yr F'cast return	Bof A HY Spread 4.09%	10 yr F'cast return
10000	3.6%	4700	2.0%	550	0.6%	2300	0.1%	5000	2.8%	0.5%	4.2%
9750	4.0%	4500	2.5%	525	1.2%	2200	0.6%	4800	3.3%	1.0%	4.7%
9500	4.3%	4300	3.0%	500	1.8%	2100	1.2%	4600	3.9%	1.5%	5.2%
9250	4.7%	4100	3.6%	475	2.4%	2000	1.8%	4400	4.4%	2.0%	5.7%
9000	5.1%	3900	4.1%	450	3.0%	1900	2.5%	4200	5.0%	2.5%	6.2%
8750	5.5%	3700	4.7%	425	3.7%	1800	3.2%	4000	5.7%	2.8%	6.5%
8500	6.0%	3500	5.4%	400	4.4%	1700	4.0%	3800	6.3%	3.0%	6.7%
8250	6.4%	3300	6.1%	375	5.2%	1600	4.8%	3600	7.1%	3.3%	7.0%
8000	6.9%	3100	6.8%	350	6.1%	1500	5.7%	3400	7.9%	3.5%	7.2%
7750	7.3%	2900	7.6%	340	6.5%	1450	6.2%	3300	8.3%	3.8%	7.5%
7500	7.9%	2700	8.5%	330	6.9%	1400	6.7%	3200	8.7%	4.0%	7.7%
7250	8.4%	2500	9.5%	320	7.3%	1350	7.2%	3100	9.2%	4.3%	8.0%
7000	8.9%	2300	10.6%	310	7.7%	1300	7.8%	3000	9.6%	4.5%	8.2%
6750	9.5%	2100	11.8%	300	8.2%	1250	8.4%	2900	10.1%	5.0%	8.7%
6500	10.2%	1900	13.1%	290	8.6%	1200	9.0%	2800	10.6%	6.0%	9.7%
6250	10.8%	1700	14.7%	280	9.1%	1150	9.7%	2700	11.2%	7.0%	10.7%
6000	11.5%	1500	16.5%	270	9.6%	1100	10.4%	2600	11.8%	8.0%	11.7%

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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