Private Capital Advisers

Market Report - September 2022

Market returns

The September quarter was another period of volatility with markets rising in the first part of the quarter before tumbling during the month of September. By the end of the quarter, we were back close to where we started in all markets except listed property. For all the doom and gloom and large one day falls, surprisingly little damage was done this quarter as we see in Figure 1. Yet another reminder that the mainstream media is not the best place to get our investment information.

We also see that, over the past two and three years, returns from shares have been better than returns from fixed interest and cash – despite two substantial sharemarket downturns; the Covid 2020 panic and the longer lasting downturn we are currently experiencing.

Figure 1: Performance (%pa) for periods ending 30 September 2022

	3mo	6 mo	1 year	2 years	3 years
Australian equities[1]	0.8%	-12.2%	-8.6%	9.6%	3.1%
International equities[2]	1.2%	-8.0%	-9.3%	7.6%	6.5%
Listed property[3]	-6.7%	-23.2%	-21.5%	1.0%	-5.3%
Bonds[4]	-0.6%	-4.4%	-11.4%	-6.6%	-3.4%
Term deposits[5]	0.3%	0.5%	1.0%	1.3%	1.6%
Cash[5]	0.2%	0.2%	0.3%	0.2%	0.3%

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

Amongst defensive assets, bonds have continued to provide negative returns but we expect that, going ahead, the outlook is far more positive. We can invest in 10-year government bonds yielding 3.9% and, over the medium term, that is what they will return; a much better outcome than the past three years. Similarly, current rates on Term Deposits are much higher than we have seen in years.

The most recent fall has been driven by recession fears

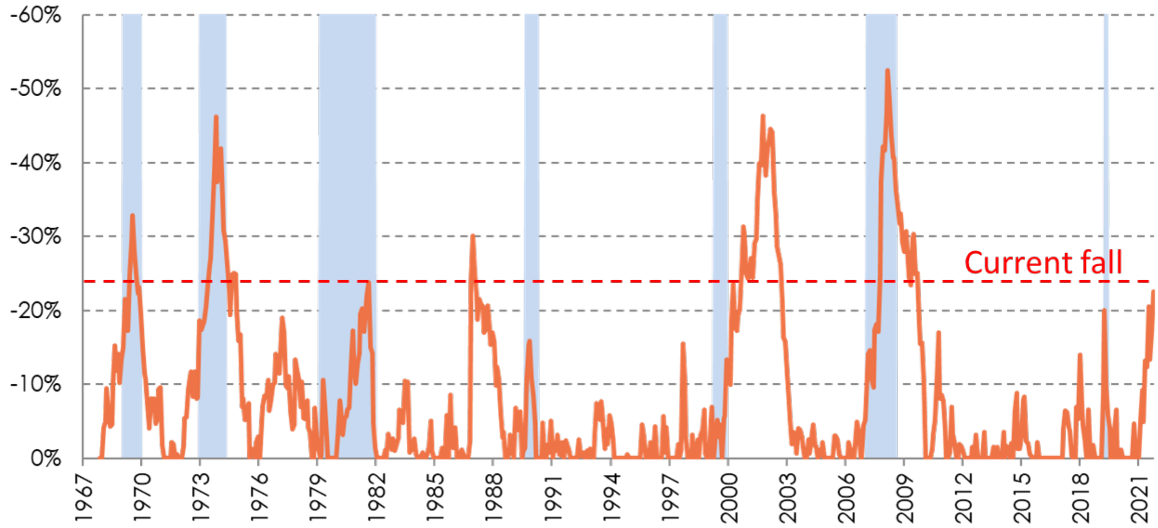
For some time, we have been suggesting that the most likely outcome of the current inflation spike would be that Central Banks would increase cash rates sharply and that those increases would, in time, bring inflation back under control. Cash rates have indeed been sharply increased over the quarter and, now, we must wait to see how long it takes for inflation to subside.

Bringing inflation under control will almost certainly require a substantial economic slowdown, if not a recession. This is because we expect the main driver of inflation to shift from rapidly rising commodity prices to rising wages. We are already seeing falls in the prices of both energy and food which is slowing inflation, but this impact could well prove to be temporary. Shortages in labour world-wide are likely to lead to substantial wage rises before too long which will again increase inflationary pressures.

As equity markets have begun to focus more on the heightened possibility of a recession, they have sold off. In fact, during recessions markets pretty much always fall – but the amount and the timing varies greatly depending upon the severity and nature of the recession.

Figure 2 shows US recessions over the past 60 years and the size and timing of the falls that have accompanied them. Note that the chart has an inverted scale – the peaks on the chart are the worst downturns, sometimes as much as -50% or worse.

Figure 2: US recessions and US sharemarket downturns



Source: S&P, US Federal Reserve

There are a few key lessons here

- In four of the seven recessions the fall was between 15% and 30%. So far, the current fall in the US market is close to 25%; even with a recession we may be close to the bottom
- In the three recessions that featured a close to -50% fall, the early stage of the recovery quickly came back to the current fall of -25%; if this market does fall further, it is likely to quickly recover to its current level
- Even if we knew the exact timing of the start and end of the recession, it may not help us make investment decisions – sometimes the falls continue long after the economy has begun to recover and sometimes the market largely recovers before the economy turns.

While these observations are made concerning the US economy and sharemarket, the observations apply in most other markets as well. The bottom line is that while we may well see continued short-term volatility, if we take a two to three year outlook, there is not too much to fear at present, despite what we will continue to hear in the media.

The Long-Term Outlook for returns

In the much longer term – five to ten years – the outlook is very 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 at the beginning of the year as can be seen in Figure 3. In fact, the outlook for both growth and defensive assets are more attractive than they have been for some time.

Figure 3: Ten-Year Forecast Returns 30 September 2022

	Australian Equities[1]	Developed Markets[2]	Listed Property[3]	Infrastructure	HY Debt[4]	TDs[5]
Income	5.8%	2.3%	5.3%	4.2%	9.8%	3.9%
Currency gain/loss		0.0%		0.5%		
Earnings growth	-1.3%	1.5%	2.3%	4.0%	0.0%	0.0%
Valuation change	4.2%	2.1%	1.8%	1.2%	-1.2%	0.0%
Forecast 10 yr return	**8.7%**	**5.9%**	**9.3%**	**9.9%**	**8.6%**	**3.9%**
PE Now	11.3	15.2	0.0%	4.5%		
PE 2032 (f)	17.0	18.7	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 they are obviously based on estimates and are far from perfect, they generally come out within a few percent of the original estimate. Figure 4 shows the forecasts that were made ten years ago using this process, also at a time when economic uncertainty abounded just as it does today.

While the results were not perfect, the take-out from the forecasts was spot on: stay fully invested in growth assets despite the uncertainty. The message is the same today.

Figure 4 : Forecast 10-year returns in September 2012 vs Actual

Market	Australian equities	International equities	A-REITS	Term Deposits	Cash
Sep 2012 forecast	11.0%pa	8.0%pa	6.2%pa	5.2%pa	4.3%pa
Sep 2012-22 actual	10.1%pa	13.7%pa	7.7%pa	3.1%pa	1.6%pa

Source; farrelly's; All Ords Index, MSCI World, ASX A-REITs, RBA TD rates, RBA cash rates

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. This is why we 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 5: The Tipping Point Tables

Australian Equities		
All Ords 6,678.7	10 yr F'cast return	Status
10000	2.7%	Overpriced
9750	3.0%	Overpriced
9500	3.4%	Overpriced
9250	3.7%	Overpriced
9000	4.1%	Fully priced
8750	4.5%	Fully priced
8500	5.0%	Fully priced
8250	5.4%	Fully priced
8000	5.9%	Fully priced
7750	6.4%	Fully priced
7500	6.9%	Fair value
7250	7.4%	Fair value
7000	7.9%	Fair value
6750	8.5%	Fair value
6500	9.1%	Cheap
6250	9.8%	Cheap
6000	10.5%	Cheap

US equities		
S&P500 3,585.62	10 yr F'cast return	Status
4700	0.5%	Overpriced
4500	1.0%	Overpriced
4300	1.5%	Overpriced
4100	2.1%	Overpriced
3900	2.7%	Overpriced
3700	3.3%	Overpriced
3500	3.9%	Fully priced
3300	4.6%	Fully priced
3100	5.4%	Fully priced
2900	6.2%	Fully priced
2700	7.1%	Fair value
2500	8.1%	Fair value
2300	9.2%	Cheap
2100	10.4%	Cheap
1900	11.7%	Cheap
1700	13.3%	Cheap
1500	15.2%	Cheap

World Ex US		
FTSE World Ex US 272.4	10 yr F'cast return	Status
550	0.9%	Overpriced
525	1.4%	Overpriced
500	2.0%	Overpriced
475	2.6%	Overpriced
450	3.3%	Overpriced
425	3.9%	Fully priced
400	4.7%	Fully priced
375	5.5%	Fully priced
350	6.4%	Fully priced
340	6.7%	Fair value
330	7.1%	Fair value
320	7.5%	Fair value
310	7.9%	Fair value
300	8.4%	Fair value
290	8.8%	Fair value
280	9.3%	Cheap
270	9.8%	Cheap

A REITs		
ASX REIT 1215.1	10 yr F'cast return	Status
2300	0.6%	Overpriced
2200	1.1%	Overpriced
2100	1.7%	Overpriced
2000	2.3%	Overpriced
1900	3.0%	Overpriced
1800	3.7%	Overpriced
1700	4.5%	Fully priced
1600	5.3%	Fully priced
1500	6.2%	Fully priced
1450	6.7%	Fair value
1400	7.2%	Fair value
1350	7.7%	Fair value
1300	8.3%	Fair value
1250	8.9%	Cheap
1200	9.5%	Cheap
1150	10.2%	Cheap
1100	10.9%	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 Fully Priced after the recent sharp falls. Other markets are Fair Value or Cheap.

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