Providence
WEALTH ADVISORY GROUP

Disruptive Times

Global Outlook & Strategy

Issue 85: 2nd Quarter 2022

Contents

Co-authors:

Grant Patterson	Chief Investment Officer
Will Porter	Head of Investment Strategy
James Smith	Head of Melbourne

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Disruptive Times

Global Outlook & Strategy Issue 85
2nd Quarter, 2022

1. KEY POINTS

- Markets are vulnerable to a sharp correction
- An inverted yield curve is pointing to a sharp economic slowdown
- Recession risks rising in 2023/24
- Australia looks relatively attractive on the global stage
- Remain diversified and disciplined
- Attractive opportunities will present themselves

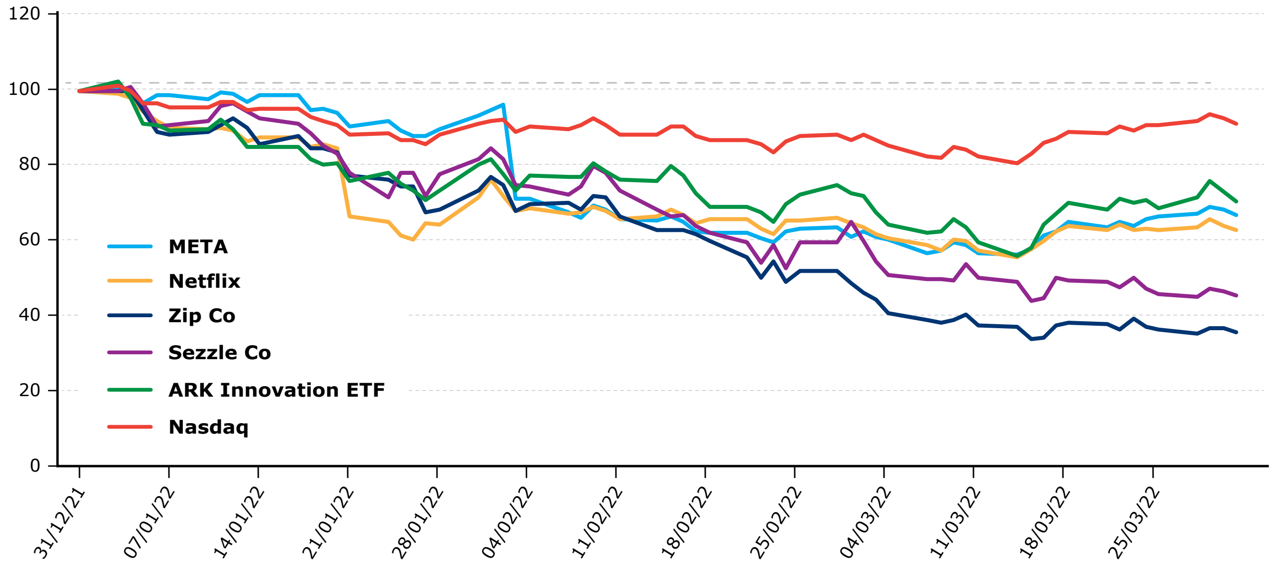
Disruptive Times

The first phase of the correction has started.

A rolling readjustment is underway across various asset classes, with some considerable damage already inflicted below the surface of various market indices (**Figure 1**).

Figure 1: Significant corrections have already occurred with some stocks in various market indices such as those depicted below

Source: Factset



The realisation that inflation is not always transitory and interest rates are on the rise has undermined stretched valuations of assets previously buoyed by surging money supply. Within equities this has been reflected in more recent years in the indiscriminate buying of index funds fuelled by surging retail inflows.

Once renowned for providing a safe haven in a deflationary environment, government bonds did not provide protection (**Figure 2**) as investors recalibrated their thinking (and investment positioning) very rapidly towards the concept of a more aggressive rate tightening cycle across most developed economies. This recalibration was swift and remarkable in its speed, so much so that many observers noted bond price movements were at times statistically breaching the outer-bounds of movements on particularly news-worthy days (such as days when inflation data was released). Such extremes in intra-day price moves have not been witnessed.

Figure 2: Australian 10 Year Government Bond Yield (%)

Source: Factset

As we cautioned in our previously quarterly update, "The tide has turned", conditions are in place for a significant market correction and increased volatility.

Conditions include:

- Significant falls in pre-loved sectors
- Inverted yield curve (longer term bond yields are lower than shorter yields i.e., 10yr – 2yr)
- Elevated inflation
- Higher energy costs
- Increasing interest rates
- Reduced quantitative support
- High level of complacency
- Elevated valuations
- Increased geopolitical risk

The anticipated correction will result in dislocations across some asset classes, possible swift and painful adjustments to valuations and substantially increased volatility.

We see an increased chance of a recession in late 2023/24 driven by higher interest rates, mortgage stress, higher cost of living and lower corporate earnings.

The protection and preservation of capital will be paramount during this time to take advantage of the attractive opportunities that will emerge.

2. Investment Overview

Encouragingly, global growth currently remains above trend, or at least back to long term trend lines (**Figure 3**) and labour markets are very strong. This scenario, coupled with supply disruptions and surging energy costs has elevated inflation expectations.

Such strong growth is contrary to the signal suggested by the bond market via an inverted yield curve (**Figure 4**). An inverted yield curve is normally a good indicator of a future downturn/ recession although the yield curve did give a false signal in 2018. Nevertheless, it is a signal that needs to be respected. It is very unusual to have an inverted yield curve before an interest rate tightening cycle has begun. However, some leading indicators are starting to turn down and with the threat of 200-250 bp of monetary tightening, bond markets are suggesting the potential for an economic downturn in late 2023.

The recent sell off in bond markets, indicated by higher yields, is reflective of the current surge in inflation numbers, which continue to print strong rises (**Figure 5**), especially regarding headline inflation. That said, we may be at the peak in the rate of change in prices and the market is looking through this to a slowdown and potential recession. All eyes will be on inflation data prints in the coming months as we start to see inflation prints 12mths plus from when prices began to rise post the COVID 19 lockdowns (the base effect).

Increasing input prices, higher wage costs and funding costs are likely to put some pressure on company margins and thus on earnings. In a world of stretched valuations and contracting money supply markets are vulnerable to a downturn. It is difficult for us to see any surprise to the upside.

Figure 3: GDP growth is either back to long-term, pre-Covid trend or indeed tracking above trend

Source: JP Morgan Asset Management

Real GDP levels

Indexed, 1Q06=100

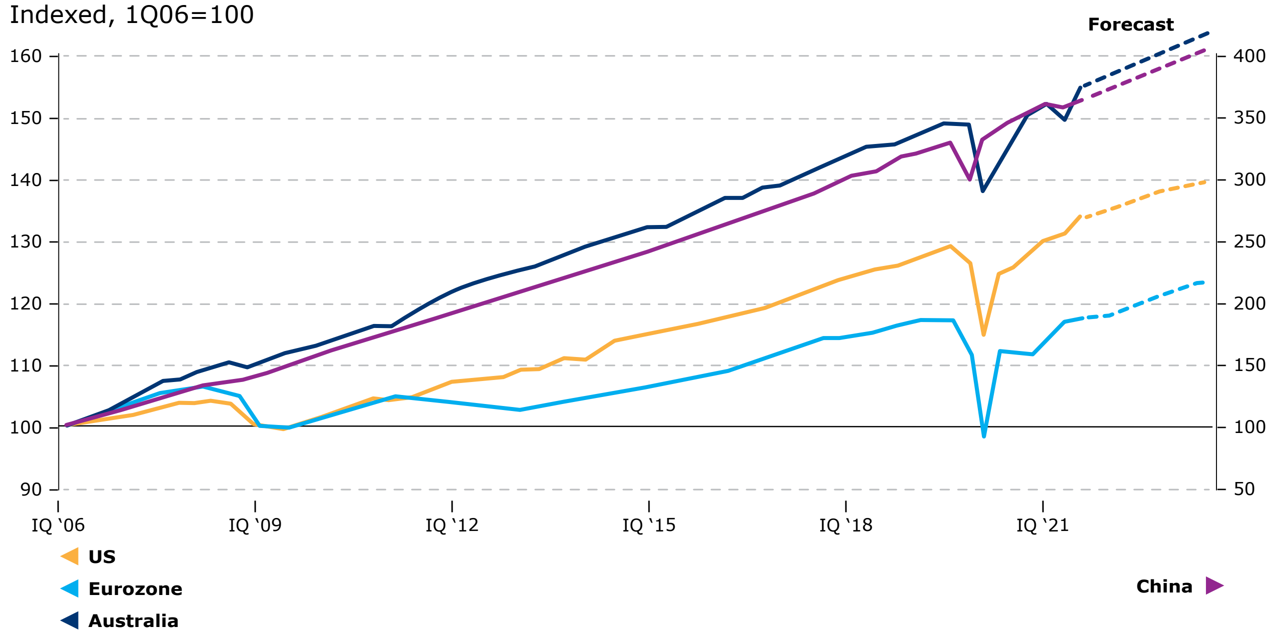
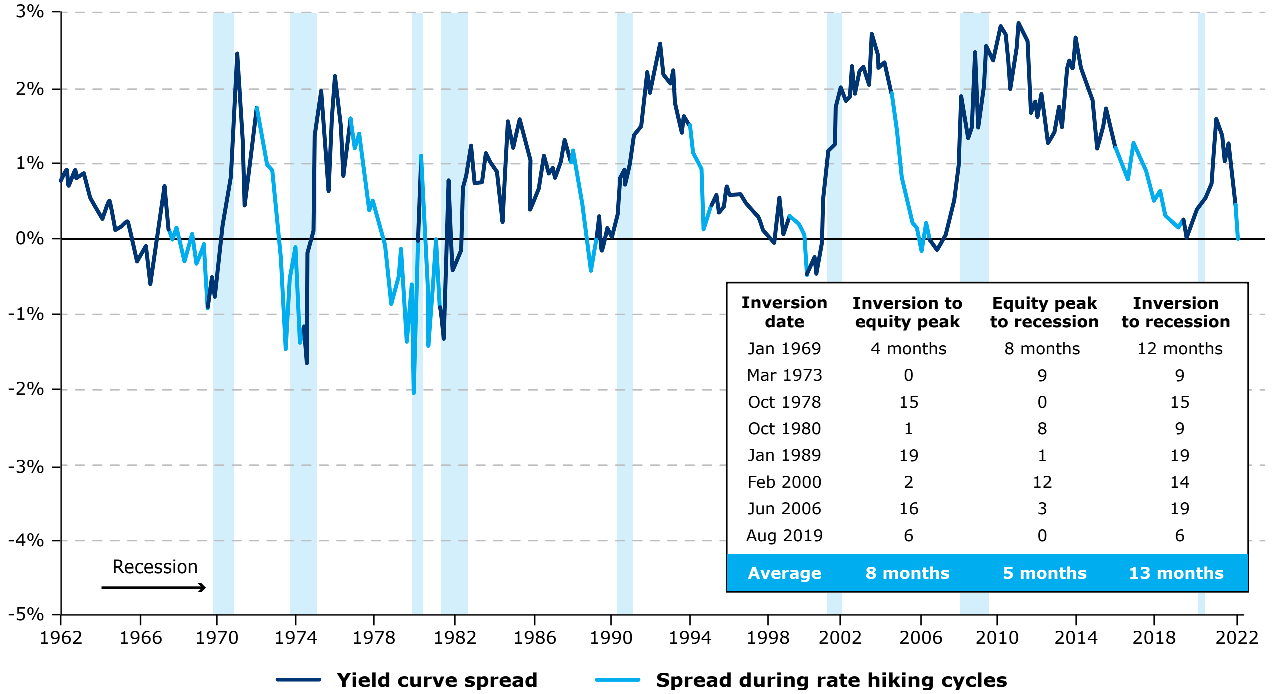


Figure 4: Yield curve inversion (10yr US treasury yield less 2yr US yield moves into negative territory) is historically a precursor to a future recession

Source: JP Morgan Asset Management

Yield curve spread

10-year less 2-year US Treasury

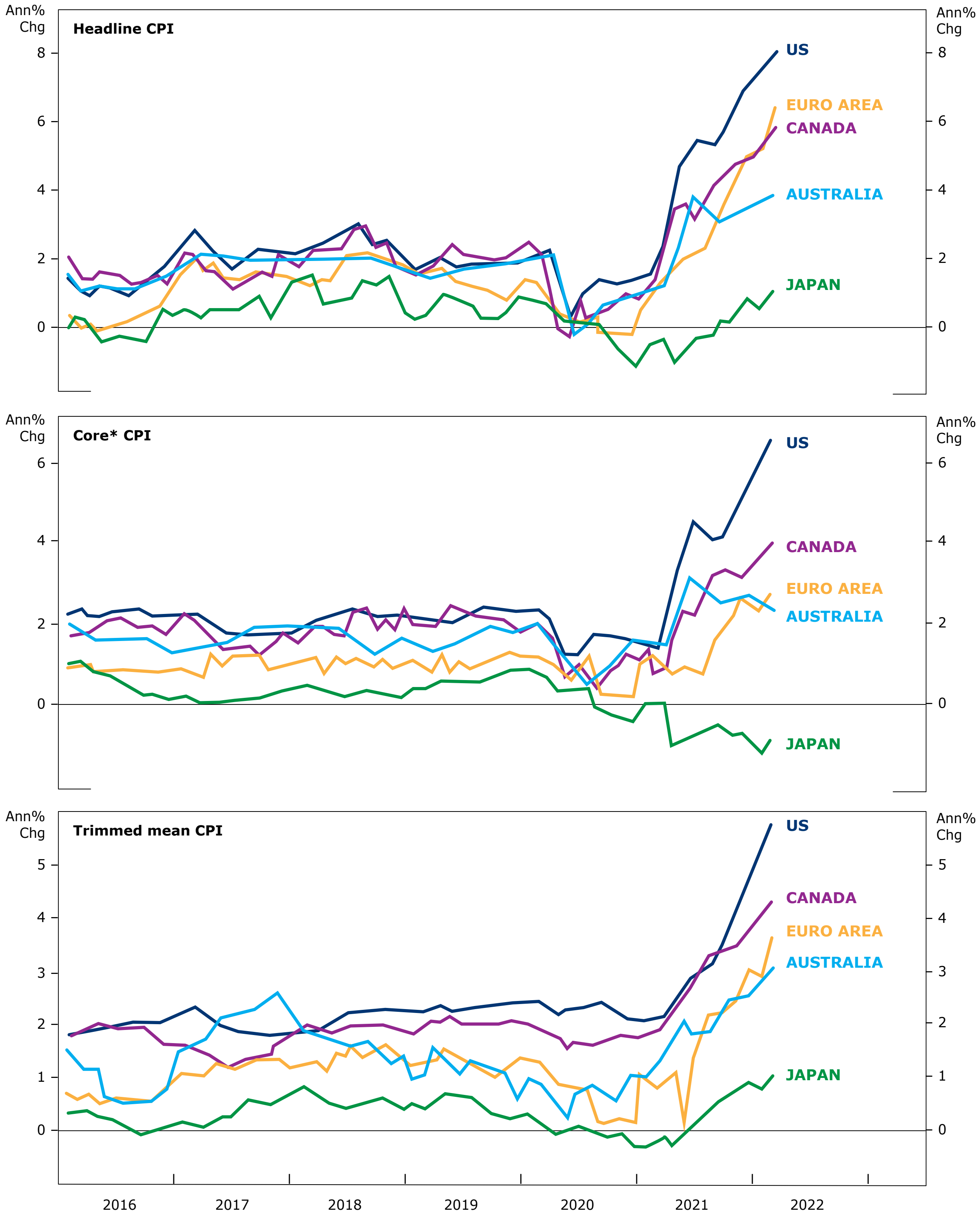


Inversion date	Inversion to equity peak	Equity peak to recession	Inversion to recession
Jan 1969	4 months	8 months	12 months
Mar 1973	0	9	9
Oct 1978	15	0	15
Oct 1980	1	8	9
Jan 1989	19	1	19
Feb 2000	2	12	14
Jun 2006	16	3	19
Aug 2019	6	0	6
Average	**8 months**	**5 months**	**13 months**

Figure 5: Headline inflation prints are very strong at decade highs, core inflation whilst elevated in many jurisdictions is not as profound (especially in Australia)

Source: BCA Research

Inflation is running high, especially in the US



* Excluding food and energy – for Euro area
Excluding food, energy and tobacco – for Australia
Excluding fresh fruit, vegatables and automative food

Australia looks relatively well positioned given the strength of commodities prices and the agricultural sector. Households have a significant excess savings buffer however, rising mortgage costs along with elevated fuel and food prices will put pressure on household budgets. Moreover, we note in the recently released RBA semi-annual review that around three quarters of outstanding fixed rate loans will expire by the end of 2023. The RBA observed that if those loans were rolled into variable loans and those variable loan rates rose by 200bps, the expectation is that >90% of fixed rate loans expiring in the next two years would face an increase in repayments of up to 20%. Further, surging construction costs will put additional pressure on builders and developers with additional failures likely. One risk that doesn't seem to be widely discussed at the time of writing is the potential for a hung parliament, which would be very damaging for ongoing reform and budget repair.

On the international stage, the unfolding event in Ukraine represents a human tragedy hard to fathom in this day and age. We can only hope and pray a resolution is forthcoming without a significant escalation. However, even after any resolution, the issue of elevated energy costs will not dissipate. The globe does not have sufficient renewables in place to offset the closure and lack of development in traditional energy sources. For over a decade the broad energy sector has seen underinvestment (at the operating level not the investor level), leading to the supply and demand imbalances the globe is experiencing now. This may prove to be another boon for resources rich Australia.

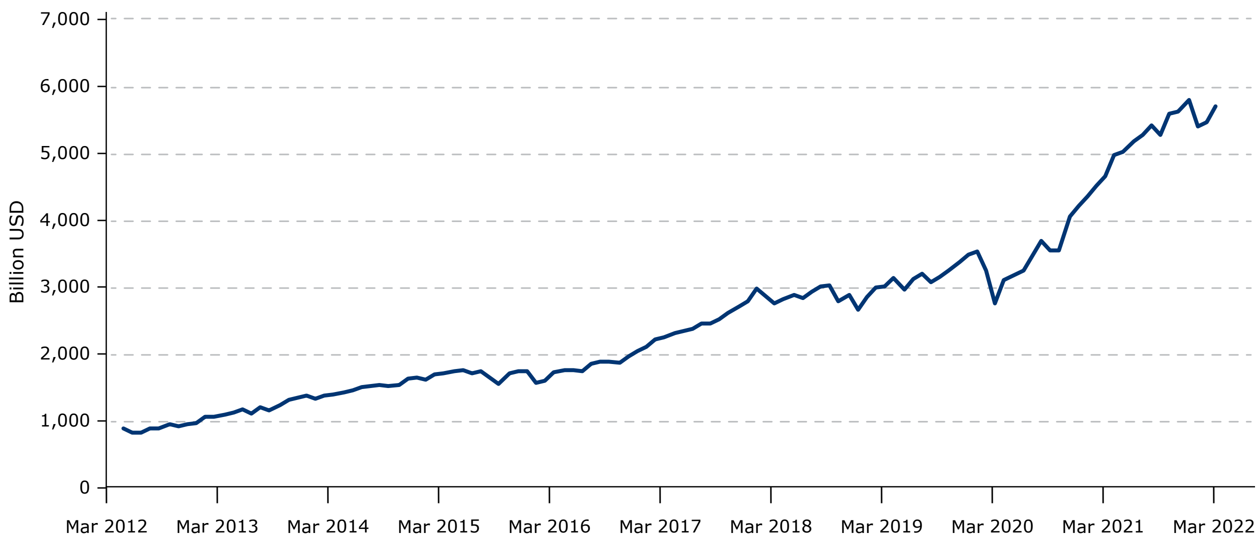
We continue to see sustained cost of living pressures around the globe and the potential for a significant slowdown in global economic growth.

3. Asset Class Review

3.1 Equities

A rolling correction is already underway in global equity markets. The NASDAQ was down 22% during the quarter from its peak in November 2021, and now sits 11.5% below said peak at the end of March. It must be understood that as funds flowed into broad index funds (or ETFs) (**Figure 6**), this led in many instances to the valuation of stocks overshooting to the upside. The largest market capitalisation stocks just kept on getting larger and the reverse will be true as fund outflows necessitate the sale of those same stocks should the tide continue to turn.

Figure 6: Equity ETF Assets under Management
Source: Factset

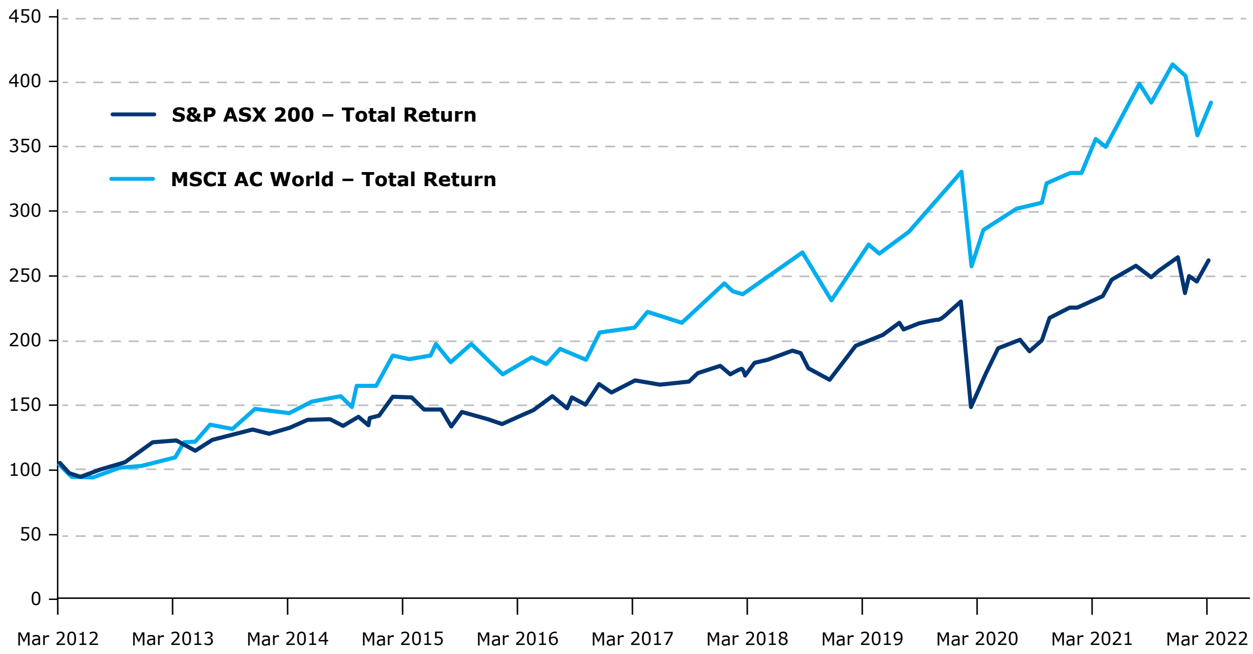


These conditions will provide a fertile ground for active managers (stock pickers) who are truly index unaware, not passive funds. There will be a very high dispersion of returns amongst equity funds.

After a decade of underperformance of 4% p.a against international equities (which equates to a total underperformance of 30% over 10 years) (**Figure 7**), Australian equities now look like a better home for investors. We believe the low interest rate environment that was a key contributor to this offshore outperformance may have run its course, raising the prospect that cash flow generative domestic businesses are now well placed to outperform their global peers.

Figure 7: Offshore equities have significantly outperformed Australian equities over the last decade. This could be changing

Source: Factset



Additionally, the sector weightings in the ASX, towards financials and resources, make for a more attractive investment prospect than some of the tech-heavy offshore indices. Financials should also benefit from a rising interest rate environment, assuming bad and doubtful debts do not increase putting additional stress on loan books via higher mortgage payments. Resources are a beneficiary of supply chain bottlenecks, geopolitical tensions and surging demand for materials to help facilitate a transition to cleaner energy. Valuations although still above long-term averages have improved sharply with the Australian equity market PE derating from 23.6x to 17.4x largely due the resource sector strength. Consequently, for the first time in a decade, we are aiming to hold more Australian equities than international shares.

Domestically, some sectors have been sold down aggressively: healthcare and tech may provide some selective opportunities. We currently hedge 50% of our international equities back to AUD.

3.2 Property

Funding costs (and building costs) in commercial property have risen substantially in a short period of time. Rising building costs will benefit existing property values given increasing replacement costs. However, the substantial increase in funding costs will put pressure on the very tight cap rates currently experienced in the market. The cost of 3-year debt has risen from 65 bps to 276 bps and the 5-year rate from 90 bps to 310 bps. Add to this the bank margin of 200bps and the cost of funds is now around 5%. These revised funding costs are yet to be reflected in valuers' reports. That said, the weight of funds are still chasing assets at previous values. A perfect storm appears to be brewing that may break at a time when growth is slowing. Private wealthy property developers are raising cash levels and selling to the institutional market. Who do you want to follow? We are cautious in committing new capital in the traditional sectors.

Given the likely elevated inflation level, it will be important to ensure that property assets have a CPI linked component to rental increases. We are very cautious regarding the A REIT index given its high exposure to corporate earnings. Our preference remains for an active funds management exposure to the A REIT sector. For direct property, we prefer retail shopping centres, specialist sectors like Social Disability Housing, Regional Hospitality and Community Living.

There remains a lack of transparency as to how the office environment will change for us to be totally confident in the office space. Industrial property valuations/cap rates are incredibly tight and potentially vulnerable to a higher discount rate.

The Build to Rent space is gaining a lot of attention and attracting large pools of capital. The high cost of construction may put pressure on IRR assumptions however very low vacancies and deferred construction will put upward pressure on rents and perhaps valuations.

3.3 Fixed Income

The recent savage selloff in government bonds is a 2 standard deviation move which would imply, at the very least, a pause from the current selloff and if the inverted yield curve is correct in forecasting a slowdown, bonds should rally from here. The rate of change in inflation should moderate which would also provide some support.

In our view, credit remains vulnerable to a slowdown and to rising defaults especially given how narrow spreads have become. Rising bad debts and fund outflows will put pressure on these spreads.

We favour government bonds and asset backed loans to provide some income and protection to portfolios.

3.4 Alternatives

In the most recent quarter, our alternatives exposure broadly achieved its objective, that is to smooth out some of the potential volatility from risk markets via non-correlated exposures. We divide our allocation in alternatives between growth and defensive.

Our growth alternatives allocation has provided strong returns irrespective of the direction of equity markets. This provides another differing source of return for client's portfolios outside of traditional markets. We continue to look for other forms of alternative growth exposure for client portfolios that broadens the return stream and reduces reliance on equity markets to drive overall portfolio performance.

4. Conclusion

Overall, we expect to see higher volatility and some market dislocation given the potential for a significant slowdown in global growth. Now is a time to exercise extreme caution to protect and preserve capital. Nevertheless, we look forward to the opportunities this season of disruption will present for the patient long term capital investor.

4.1 Opportunities

- Australian government bonds
- Niche/boutique direct property
- Asset backed loans
- Australian equities on a relative basis

4.2 Risks

- Rising defaults in credit
- A renewed surge in inflation and significantly higher interest rates
- Collapsing corporate earnings
- A hung parliament in Australia
- A housing collapse

4.3 Implications

- Remain very diversified having non correlated assets
- Prefer value and quality in equities
- Be patient and disciplined
- Attractive opportunities will present themselves

Asset Class	Strategic*	Range	Tactical	Overweight/ Underweight
Australian Shares	35%	20% – 50%	23%	Underweight
International Shares	25%	10% – 40%	24%	Neutral
Property	10%	0% – 25%	13%	Neutral
Infrastructure	n/a	0% – 20%	0%	n/a
Government Bonds	25%	0% – 50%	10%	Underweight
Corporate Bonds/Credit	0%	0% – 50%	2.5%	Overweight
Cash (term deposits)	5%	2% – 50%	14.5%	Overweight
Alternatives/Hedge Funds	n/a	n/a	13%	n/a

* Strategic Benchmark is the Lonsec Balanced Strategic Asset Allocation, updated in August 2020

The Contrarian

It took a while, but everyone has finally realised that inflation is here and it's out of control. At least we don't have to listen to talk about 'transitory' inflation anymore. This discussion was initially annoying and amusing in equal measure but eventually just became annoying. Listening to the boffins running central banks with their pseudo-scientific pretensions using such an imprecise term and triggering profound discussion and widespread agreement rather than open ridicule was simply too much for this contrarian to bear. As mentioned previously it seems printing trillions of dollars and taking rates to zero has caused rampant inflation. Is anyone surprised?

Don't fear however, help is at hand in the form of central bankers aggressively raising interest rates. Good luck with that. The general public don't have much experience with inflation (except those who were at Woodstock) and are only just starting to realise what's ahead. Many families' largest expense is servicing debt on artificially inflated assets purchased with debt at artificially low rates. When they figure out that the central banker's solution to their increased living costs is to increase them even further there will be hell to pay. The argument that this particular cost of living isn't included in CPI calculations probably won't cut it.

The idea that central banks can get ahead of the curve is even more absurd than the belief that the inflation problem was transitory. To kill off inflation you have to get rates not just ahead of inflation but ahead of inflationary expectations. Just about everyone from the US government down will be bankrupt before you get there. If you're someone who's a tad sceptical that the CPI represents an accurate picture, and you include things like the cost of where you live in the cost of living then you've probably worked out that inflation has been running wild for years. Catching up with inflation when you've given it a head start of over 10 years may prove difficult.

Granted, the type of inflation we've had until recently didn't seem all that bad. Nobody who owns assets was exactly begging the central planners to save us from the horrors of getting richer. Now, it seems the fun part is over and it's time for the not so fun part where asset prices fall and the cost-of-living increases. As rates rise trends that have lasted decades will kick into reverse. An end to booms in growth stocks and residential property will come as an even bigger shock because they've lasted so long most assumed they were permanent. In reality, they lasted about as long as the cycle of falling interest rates.

Raising rates will cause a heap of pain but is unlikely to fix the problem. Inflation has been fed by our self-imposed energy crisis. This is likely to get worse before it gets better. At root it's a problem with supply of reliable energy. Raising rates will make it harder to increase supply not easier. This crisis has been a decade, at least, in the making and will take that long to fix once we've acknowledged the problem. We're not even at that point yet. An increased price of energy feeds the price of just about everything else, most concerningly food. At some point an energy crisis becomes a food crisis and that point would be about now. Hopefully we come to our senses soon but unfortunately, we seem intent on doing it the hard way, In the interim the inly inflation the central banks are going to kill off is the asset price inflation they never acknowledged in the first place.

Providence Investment Committee

Steven Crane

Steven has over 40 years of investment experience having started in financial markets in the early 1970s. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. His current directorships include APA Group, Bank of Queensland and Shopping Centres Australia (SCP).

David Croll

David has over 20 years' experience in stock broking and funds management. He has held such positions as a dealer on the options trading floor and manager of the branch office network for stockbroker Rivkin Croll Smith in Melbourne. Since 1998, he has managed several private companies involved in options trading and investment in listed and unlisted equities. He is currently the Managing Director of Noontide Investments Ltd. He has a Bachelor of Arts majoring in Politics from Macquarie University.

Chris Grubb

Chris has held senior fund management and broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was also a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian-focused investment funds. He also chairs Boardroom Australia.

Peter Hooker

Peter has over 30 years' experience in investment markets including Industrial Analyst at BZW Australia, and Director reporting to Head of Research. He was on the Equities Executive Committee and Director and Head of Industrial Research. Peter has served as Treasurer of Médecins sans Frontières Australia and as a member of the Psychology Board of Australia. Peter also consults as a business mentor. He has a B.Sc. in Chemistry, B.E. (Honours) in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment.

Justine Morton

Justine has 25 years of investment and finance experience both in Australia and internationally. Prior to joining Providence, she was a Relationship Manager at Credit Suisse Private Banking. Justine started her career in Perth at First State Fund Managers (Colonial) then Hartley Poynton before moving to London. At Lehman Brothers and then Cargill Investor Services she focused on event arbitrage and special situations before returning to Australia, to start and run Finsbury Capital Advisors. She has a Bachelor of Commerce from UWA.

Richard Nicholas

Richard has over 30 years of experience in private client portfolio management in London, Hong Kong and Australia. Richard started his career with Deloittes in London before cutting his investment teeth with the Rothschild family. He was the founding Research Director at S&P Fund Research UK and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia and ANZ Private Bank. He is currently Director at Peak Investment Partners.

Michael Ogg

Michael has over 30 years of experience in investments, starting his career at JPMorgan Investment Management in London in the early nineties. In Australia, Michael worked for AMP Asset Management holding senior roles in Institutional Equities and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA (Honours) Economics from Aberdeen University.

Jonathan Pain

Jonathan has 30 years of international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University and a Master's degree in the Economics of Finance and Investment from Exeter University.

Providence Investment Committee

Grant Patterson

Grant has over 30 years of experience in equity markets. Prior to forming Providence, he was a Director of ABN Amro and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk and Head of Corporate Liaison.

Will Porter

After joining Providence in 2012, Will spent two years in London to gain insight into global developments in Asset Allocation and to review alternative investment opportunities, primarily hedge funds and structured products. During this time, he met with six hundred different investments managers and reviewed approximately 1500 strategies. As Head of Investment Strategy, he is responsible for asset allocation, portfolio construction research and development and investment performance monitoring. Will completed a Bachelor of Commerce in 2007 and a Master's degree in Applied Finance in 2019.

Stephen Roberts

Stephen has over 50 years of experience as an economist and financial markets strategist in banking, broking, and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

James Smith

James has over 20 years of investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand. James also sits on the Benetas Investment Committee as an external adviser.

Marc Wait

Marc has over 25 years of investment experience. He began his career in Sydney with HSBC and Citigroup Global Asset Management (CGAM) managing Fixed Income and Money Market portfolios. Marc has also held positions in London with CGAM as a Fixed Income Portfolio Manager and Fidelity International where he was the Group Leader, Short Dated Bonds and chaired the Fixed Income Asset Allocation meetings for the firm. Marc was subsequently the Head of Treasury at the sovereign wealth fund, Abu Dhabi Investment Authority. Marc has a B.Agr.Ec (Honours) from the University of Sydney, is a Chartered Financial Analyst and a Chartered Alternative Investment Analyst.

Ian Wenham

Ian has over 30 years of experience in equity research, investment strategy and portfolio management. He has held such positions as Equity Analyst with Meares and Philips and Research Director of BZW Australia covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia and Director of Asian Research at Lehman Brothers Asia where he chaired the Investment Policy Committee and was the firm's supervisory Analyst for the Asia-Pacific Region. He has also managed strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Glossary of Terms

Alpha	The level of outperformance relative to a benchmark
Credit Spread	The margin paid over the risk-free rate (government bonds)
Cyclically Adjusted Price Earnings Ratio (CAPE)	The price of a security or index divided by the moving average of ten years of earnings, adjusted for inflation
Economy-agnostic	Unlikely to be impacted by the fluctuations in the economic cycle
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
GDP	Gross Domestic Product - a measure of an economy's total output
Gearing	A measure of how much debt a company has relative to equity
GFC	Global Financial Crisis
High-Yield corporate debt	Debt issued by a corporation that has a credit rating that is below investment grade
Inflation	When the inflation rate is above 0 and the general price level of goods and services increases
Leverage	An alternative term for gearing i.e. a measure of how much debt a company has relative to equity
Monetary Policy	The process by which a country's monetary authority (usually a central bank) controls the supply of money. Traditionally by setting short-term interest rates
Net Asset Value (NAV)	The value of an entity's assets less the value of its liabilities
Non-Correlated	An asset class that does not move in a similar direction to another asset class
PE Ratio	Price Earnings Ratio - the share price divided by the earnings per share of the company
Populism	A belief that the majority of a population is being mistreated by a small circle of elites
Sovereign Bond	A bond issued by a government
Volatility	The degree of variation of a price over time
Alpha	The level of outperformance relative to a benchmark
Credit Spread	The margin paid over the risk-free rate (government bonds)

Providence
WEALTH ADVISORY GROUP

Purpose Legacy Peace of Mind

SYDNEY
Level 9, 20 Martin Place, Sydney NSW 2000
PO Box R536 Royal Exchange NSW 1225
T +61 2 9239 9333

MELBOURNE
Level 23, 101 Collins Street
Melbourne VIC 3000
T +61 3 8793 8383

ADELAIDE
Level 4, 2 Ebenezer Place
Adelaide SA 5000
T +61 8 8318 7900

www.providencewealth.com.au

info@providencewealth.com.au