Q2 2023 – Investment Strategy Outlook

Pitcher Partners Investment Services Pty Ltd

In this document we outline the economic and market views of our Investment Strategy Committee. We discuss the key issues and events occurring both locally and offshore, translating those into appropriate and actionable positioning for your portfolios over the next 6-12 months.

Key Summary

- We expect global activity to trend lower as the cumulative and lagged effects of tighter monetary policy take hold.
- Headline inflationary pressures are unwinding however sticky services based inflation may force central banks to sit on their hands for longer than anticipated.
- We have moved to an underweight stance on global equities, where we expect earnings and profit margins to retrace against a backdrop of fading demand and tighter financial conditions.
- We have increased our positive view on Australian bonds and cash, as we move closer to the peak of the current interest rate cycle.
- We continue to look to bonds, cash and alternatives for sources of uncorrelated and/or defensive returns over what appears to be an increasingly murkier outlook over the next 6-12 months.

	Underweight		Neutral	Overweight	
	--	-		+	++
Australian Equities		■	■		
Global Equities		■			
Domestic Property		■	■		
Global Property		■	■		
Alternatives				■	
Domestic Fixed Interest			■	■	
Global Fixed Interest			■	■	
Cash				■	■

New tilt this quarter Unchanged since last quarter

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Our Outlook for 2H 2023

Recessionary risks building as tightening financial conditions take hold.

Financial markets are continuing to grapple with a darkening, yet complex outlook.

For the US, a number of leading indicators are flashing red for a looming recession, however there are a number of important differences in this economic cycle relative to the past.

We believe this is a key factor why the performance of equity markets has been so seemingly disconnected to that of the bond markets.

Locally, we expect activity to slow through softer consumption and business investment with the risk of stickier services inflation weighing on local markets.

Despite a slightly more resilient platform for corporate earnings over the next couple of months, the risks in our opinion are skewed to the downside and we have moved to an underweight stance on equities, reflecting the increasing probability of a recession in the US and Europe within the next 12 months.

We have shifted to a more positive near term stance on income assets, focussing on liquidity, capital preservation and secure income generation.

Global Macro Outlook

Stresses within parts of the US banking system have now joined sticky services inflation as primary catalysts for a recession over the next 12 months.

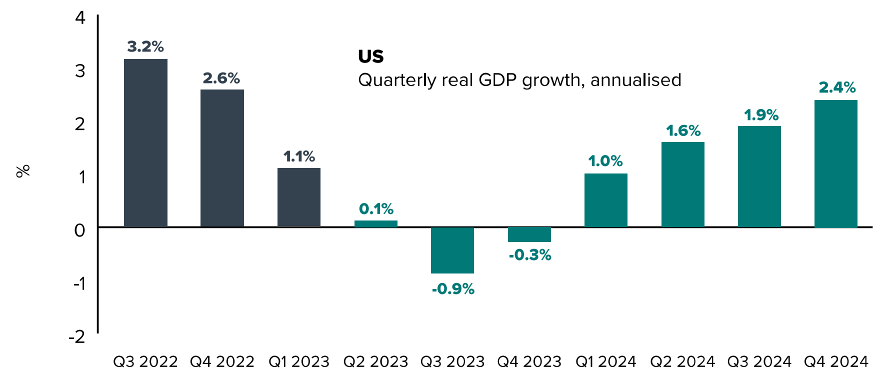
Economic activity was generally more robust in Q1 23 than anticipated, as lower energy prices, ongoing strength in demand and partial easing in some components of inflation raised hopes we were at or close to the peak in interest rates.

However the quarter gave us our first real tangible evidence that the immense tightening in financial conditions is beginning to expose some of the frailties/cracks in the financial system, most notably within the US regional banking sector, but also evidenced by the Swiss National Bank forcing through the acquisition of Credit Suisse by UBS.

Financial crisis driven recessions tend have proven to be far more severe than 'traditional' industrial downturns in the past.

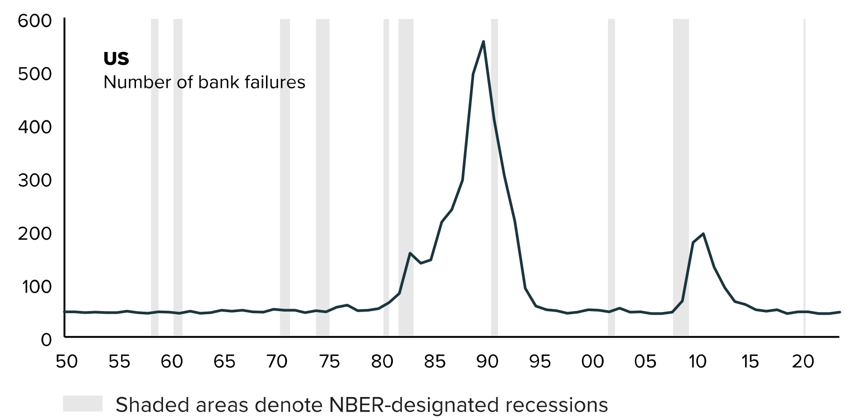
Whilst recent events triggered all too painful memories from the global financial crisis in 2008, we do know that banks are better capitalised than back then, the quality of loan books are generally stronger and policy makers now have a more effective array of tools for mitigating panic.

Consensus expectations call for a US recession in the second half of 2023



Source: Bloomberg Finance L.P.

A repeat of the bank failures of the late 80s and early 90s is unlikely



Source: BCA Research

Where to from here?

Regardless, a squeeze in credit availability is already occurring and concern is growing rapidly around the potential flow on effects to the commercial real estate sector, given 40% of its outstanding loans originate from the US regional banks (vs 13% from the large banks). We would be naive to assume that that the 'cracks' in the financial system rest solely here and it remains a key downside risk for markets.

The long awaited peak in inflation appears to have arrived as goods prices retreat from post-pandemic highs amid supply chain reparation and easing (but still elevated) demand. In direct contrast to Australia, rental costs which comprise ~8% of U.S CPI, are also showing signs of easing.

In contrast, the outlook for services driven inflation, which developed market economies are generally far more sensitive to, appears to be less clear cut as ongoing tightness in labor markets continue to place upward pressure on wages and relevant pricing – this generally takes much longer to unwind than goods inflation and the risk may well be that these types of pricing pressures remain far 'stickier' than originally thought.

In turning attention to growth, in our opinion it still seems improbable (but not impossible) that the US and Europe can escape this cycle without a recession – for us the central debate for the US hovers around whether this is a mild or deep recession.

A financial crisis style event would likely result in a deeper but more immediate recession in the US. We could see inflation retreat drastically as end demand evaporates, with a likely swift reversal of interest rate settings. Bond markets at the time of writing are pricing in ~90bps of rate cuts in 2H23.

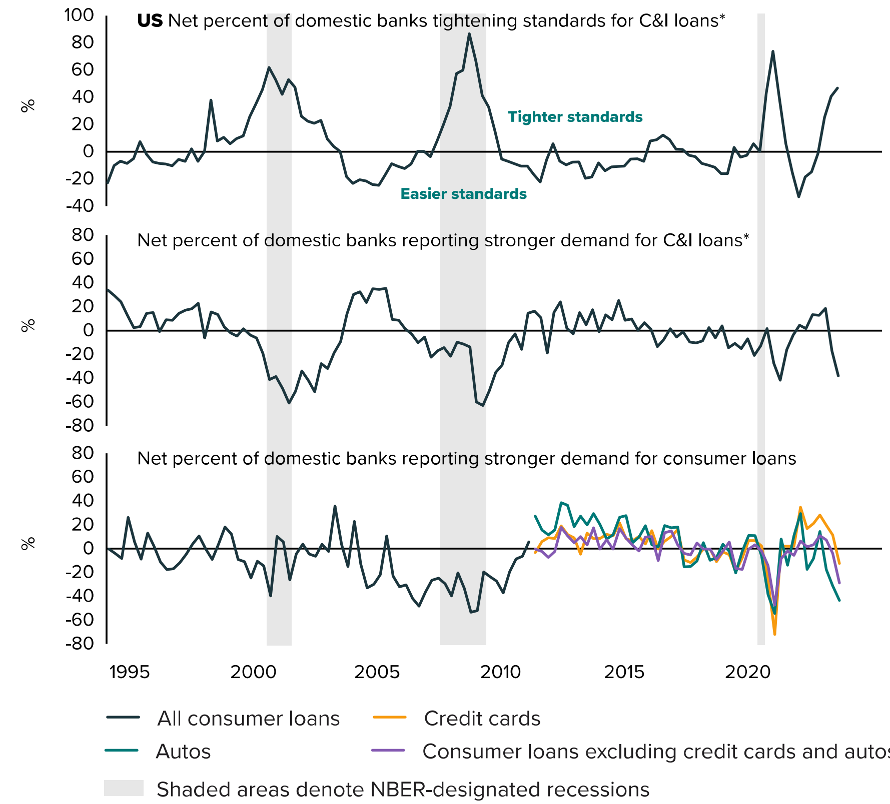
If activity declines at a more gradual pace as we anticipate over the next quarter or two and should core inflation remain well above central bank target ranges as it is now, it's unlikely that the Federal Reserve will entertain interest rate cuts – having only recently flagged a potential 'hawkish pause' at the May FOMC meeting.

The implication for financial markets is that it may take even longer for equity investors to adjust to this reality, while bond prices may very gradually grind lower over time.

In Europe, improved fiscal support and falling natural gas costs supported our 'it's not quite as bad as it seems' last quarter. The region will not be able to escape the tightening in global credit conditions and their outlook remains cloudy at this point, with strong recent equity performance reducing the margin of safety here.

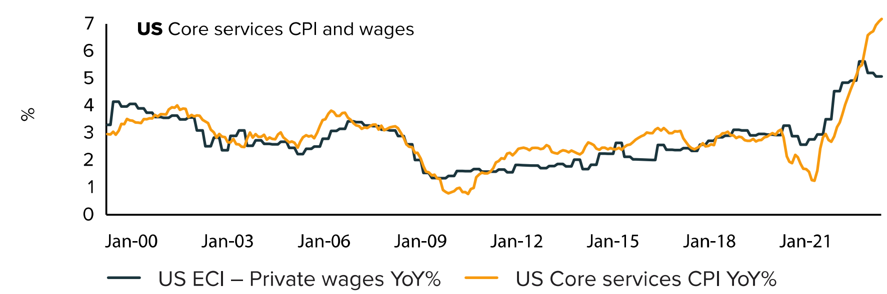
China's reopening boom in Q1 has shown some initial signs of moderation. While we have observed increased mobility data and a surge in tourism spending, fading demand from offshore could dampen some of the potential upside to the consensus 5.6% GDP forecast for 2023. Record levels of household savings as a % of GDP bodes extremely well for domestic consumption and we continue to seek investments tied to this thematic.

Credit squeeze underway



* Average of loans to small and large firms.
Source: Federal Reserve. Senior loan officer survey.

US core services CPI (7.3%YoY) is mainly driven by wages



Source: Datastream, Ord Minnett Research.

Cost of living pressures to finally take effect

Domestic Macro Outlook

Over the coming quarters we expect to see greater evidence of the impact from higher interest rates on the economy.

After pausing in April, the RBA surprised most market economists and forecasters by raising interest rates again to 3.85% at its meeting in early May.

Governor Philip Lowe highlighted that risks around rising services inflation remains too high – underpinned by rising wage and rental pressures. Concerns also remain over ongoing tightness in labour markets, rising house prices and inflationary pressures offshore.

The clear message through all of this is that its unlikely we are completely through this cycle of monetary tightening, which current market pricing indicates may not finally occur until one more hike is made in the next 2-3 months. The RBA has repeatedly stated it will be highly 'data dependant' and that the costs of inflation remaining too high for too long far outweigh an early end to this cycle.

Consumption remains an integral component of our economy and with a tight labour market and ongoing drawdown of household savings, has proven to be relatively resilient despite the sharp increase in cost of living pressures, despite consumer sentiment now close to record lows.

2023 will witness the reset of many fixed rate mortgages that were set at record low settings in 2020. Energy bills are set to rise higher and rental price growth is ~10% at the time of writing.

The Federal budget has attempted to assist in managing some of these cost of living pressures for vulnerable households, but this support is not broad based.

We see a more mixed backdrop for the other components of our economy.

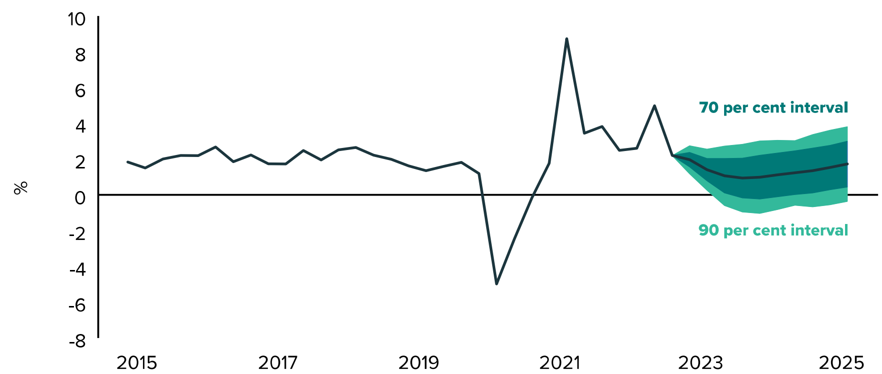
Government spending will likely be constrained in future years as those factors supporting our strong budget position will potentially reverse – namely a weaker economy and lower commodity prices.

The contribution from investments is mixed. Business expenditure has continued to underwhelm despite the post pandemic surge of demand. With a general tightening in the availability and cost of credit, in the face of a slowing economy, we are unlikely to witness a sudden surge in counter-cyclical capex spending.

The residential construction industry continues to face cost pressures amid declining approvals for both homes and apartments. Surging migration levels should be supportive over the medium to longer term, but this dynamic is only contributing further to the current tightness in rental markets.

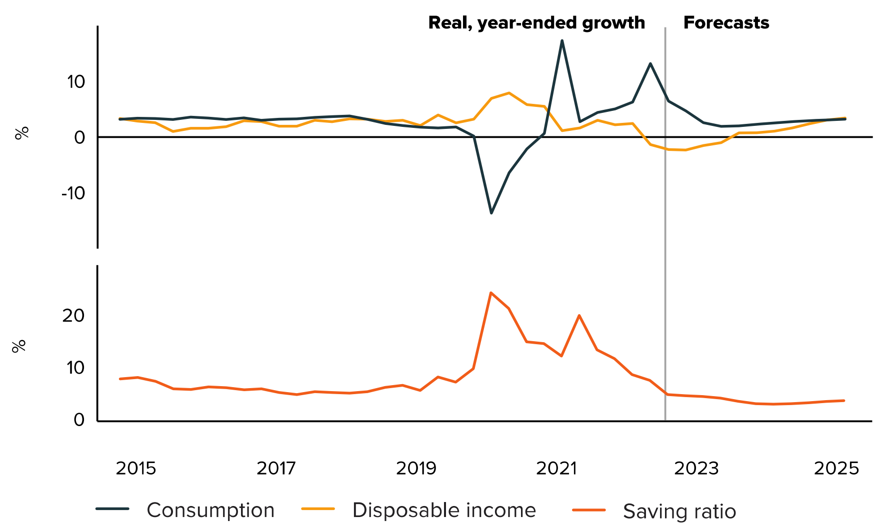
We expect the $A to remain captive to sentiment around global growth.

RBA latest GDP Growth forecast* – year ended



* Confidence intervals reflect RBA forecast errors since 1993.
Source: RBA SOMP forecasts May 2023.
Shaded areas indicate potential forecast errors/breadth of outcomes

RBA latest household consumption and income



Source: RBA SOMP forecasts May 2023.

Outlook Summary - Scenario analysis

We summarise our outlook via a high-level scenario view, sharing our broader thoughts with respect to the key issues around growth, inflation and interest rates.

	Downside scenario	Central case	Upside scenario
	Steep slide into recession, persistent inflation prevents Central Banks (CB) from loosening policy, prolonging the downturn	Slowing growth through 2H23 with an increasing probability of US and European recession, CB's on pause by end of Q3, sticky services inflation	Sharp reversal in inflation, growth recovery
Growth	• We see three potential catalysts for an accelerated or deeper recession; 1) Persistent or renewed outbreak of inflation prompts further unexpected tightening in financial conditions, collapsing aggregate demand 2) Further failure or collapse of parts of the financial system 3) Severe escalation in Ukraine/Russia war or escalation in China/Taiwan conflict • China's re-opening is hampered by a renewed COVID outbreak/mutation or a collapse in global demand.	• Divergence globally – multi-paced. High risk of recession in EZ, UK and US, sub-trend outlook for Australia. • China the big swing factor – potential for a significant rebound by mid-23 although this may lose some steam should global demand falls. Chinese consumers to boost consumption through a drawdown in record savings levels. • Outside of EM, consumption and investment set to slow considerably as cost of living pressures begin to bite and consumers and businesses on masse adjust spending patterns.	• Major G7 economies experience below trend growth but no recession, with activity measures building from the start of this year, aided from a stronger than expected recovery from China. • Weaker $US spurs a recovery in emerging markets. • Consumption and investment revert back toward trend like levels and macro volatility eases.
Inflation	• Inflation becomes entrenched, fuelled by rising wages forcing disorderly CB policy action, driving recession and financial risk even higher.	• Headline levels receding in the developed world, Australia still to grapple with wage and rental pressures. • Stubborn services inflation to prevent headline inflation from reverting back to CB target ranges. • Record household savings in China to create local inflationary pressures?	• Inflation retreats quickly as it rolls off base effects, amid ongoing weaker energy and commodity prices. • Labour markets remain full but don't lead to higher wages, allowing inflation to rapidly retrace back to CB target levels.
Fiscal & Monetary Policy Impulse	• Financial conditions tighten further to try and contain inflation. Rebasing of terminal rate expectations, forcing further interest rate hikes in 2H23. Probability of policy error increases significantly. • Indebted Governments unlikely/unable to provide fiscal support in isolation.	• Federal Reserve and RBA to hit the pause button by the end of Q3. Current US rate cut projections in 2H23 are optimistic – risk is that persistent services inflation prevents any swift reversal of policy settings. • Monetary and fiscal policy settings may diverge further between countries and regions, could result in higher fx and bond volatility.	• CB's regain control of the inflation narrative and move to pause/dovish mode in 2H23. • Greater alignment between fiscal and monetary policy. • Fiscal discipline gradually restored, debt loads are manageable due to lower rate settings.

Q2 23 Recommended investment tilts

We share our thoughts and suggested positioning below with regards to the outlook for each of the equity asset classes.

Australian Equities

Negative to neutral

Rationale

- **We have retained our modest underweight tilt on Australian equities,** reflecting a deteriorating outlook for earnings but less downside risk, in our view, than global equities at this point in time.
- Consensus earnings forecasts for FY24 are 2.7%, dragged below trend by banks and resources. Margins are still forecast to expand modestly into next year, however we believe this will be difficult to achieve against a backdrop of falling demand and tighter financial conditions.
- The ASX200 is trading modestly below its 20yr average P/E on a multiple of 14.2x, although we see increasing valuation dispersion at the industry level.
- Exuberance around any China re-opening driven rebound in commodity prices may be short lived should global growth surprise to the downside. Businesses exposed to the Chinese consumer could benefit from the drawdown in record levels of pent up household savings.
- We seek resilient businesses with balance sheet strength, defensive earnings and yields in what could be a strong environment for active management for the year ahead.
- We do acknowledge though that currently we are seeing some signs of overcrowding (low dispersion in stock returns) in these defensive areas. Therefore we strongly advocate a more nimble approach to portfolio management over the coming months if valuations do become too stretched.

Global Equities

Negative

Rationale / Shift

- **We have downgraded our tilt to underweight, reflecting increased risks to earnings and profit margins.**
- US equities comprise ~60% of our benchmark index and whilst many US listed companies could be characterised as 'high quality' businesses which we believe will weather volatility better than most, with the S&P500 TRADING at 18x next years earnings we believe there is very little in the way of a margin of safety with respect to valuations and recommend trimming this part of your global equity portfolios.
- We retain our preference for Non-US equities. Reflecting on the strong performance of European equities CYTD, we close our tactical tilt in favour of Asia/EM, where we see greater top down support and cheaper relative valuations, with the MSCI Asia Pac x Japan and MSCI EM Index trading on low teen P/E multiples, whilst forecast to generate superior sales and earnings growth over the next 12-18 months.
- From a factor perspective, we favour quality above growth and value in a declining growth environment due to the resiliency of strong balance sheets, durable earning streams and superior free cash flow generation. We anticipate to uncover oversold pockets of the market in coming quarters, which we expect our approved active managers to exploit within the scope of their mandates.
- With the growth outlook moderating, we recommend an unhedged bias with respect to offshore currency exposures, reflecting the $A propensity to provide some downside protection in falling market conditions. Given the relative strength of the $US to date, we would advise against making any extreme deviation away from long term target allocation levels.

Q2 23 Recommended investment tilts

We share our thoughts and suggested positioning below with regard to the outlook for each of the property asset classes.

Australian Property

Negative to neutral

Rationale

- **We continue to seek mis-priced opportunities in the listed REIT markets, as valuation risks loom large over unlisted assets.**
- The end of the June financial year valuation process for unlisted funds will likely trigger further cap rate expansion for many unlisted assets, although transaction activity, an important reference point for valuers, still remains fairly muted at this point.
- We anticipate a couple of landmark local transactions to occur later this year which may present further price risk across certain sectors and assets, including the office sector.
- Residential exposed investments are likely to continue to struggle in the near term due to ongoing cost pressures and falling demand. Strong migration flows will likely provide more tangible support for the sector from next year.
- We continue to emphasise a focus on asset quality, margin of safety around valuation, cash backed earnings streams, lower leverage, low refinancing risk and strong balance sheets.
- New unlisted investments should be skewed toward more opportunistic and/or value add strategies, or where the Fund managers have demonstrated prudence in the valuation of existing assets.

Global Property

Negative to neutral

Rationale

- G-REITS have underperformed A-REITS in recent months reflecting growing macro risks amid tightening credit markets, which have escalated concerns particularly around the commercial real estate sector.
- We expect to see further downgrades to valuations of unlisted assets in coming quarters. Whilst many listed sectors are trading at a material discount to NTA, even taking into account some modest cap rate appreciation, we expect absolute performance may continue to struggle if economic conditions deteriorate from here.
- We continue to expect a wide dispersion of returns in sub-sectors and regions within this asset class reflecting divergent growth and inflation backdrops - active management is therefore key in our view.
- Like A-REITS, we recommend continuing to focus on quality biased metrics, low refinancing risks and inflation linked or high free cash flows where practical.
- We favour specialist unconstrained strategies that can take advantage of any price dislocation, but who can also play defence in periods of market stress.
- Consideration around hedged and unhedged fund managers should be made with reference to your overall portfolio objectives.

Q2 23 Recommended investment tilts

We share our thoughts and suggested positioning below with regard to the outlook for the Alternatives and Cash asset classes.

Alternatives

Positive

Rationale

- **Reflecting the uncertain economic and market outlook, we continue to recommend adopting an overweight stance in this asset class.**
- Alternatives remain an attractive source of capital and income generation and portfolio risk reduction.
- Concerns and pressures are building around private market valuations, however prudent manager selection and product design will help moderate this impact on your portfolio.
- We do recommend broadening exposure into strategies that offer greater directionality and liquidity, including equity long short, trend and macro which will help buttress portfolios against expected market and macro uncertainty.
- Private debt products are also providing some attractive (and increasing) sources of carry due to widening margins and their floating rate structures, but we expect greater stress to emerge in this area with the next 12-24 months – we seek managers that can exploit this opportunity in the coming year(s).
- We recommend balance across the portfolio and avoid overconcentrating into specific sub-sectors where possible – should a market regime change suddenly, the 'sum of the parts' across a diversified Alternatives portfolio will likely provide a smoother and hopefully more profitable ride.

Cash

Positive

Rationale / shift

- **We have increased our overweight toward cash.**
- It remains an attractive source of capital preservation (on a nominal basis) and source of liquidity.
- We are conscious of the opportunity cost associated with more persistent levels of inflation, However our cautious macro outlook overall warrants a greater allocation here as we wait patiently for more appealing deployment opportunities.
- We recommend considering a blend of at-call and special fixed term rates, given opportunities to deploy capital may occur rapidly/suddenly over the year.

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Q2 23 Recommended investment tilts

We share our thoughts and suggested positioning below with regard to the outlook for each of the fixed income asset classes.

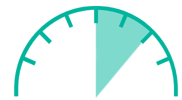
Australian Fixed Income

Neutral to positive

Rationale / Shift

- **We have moved to an overweight tilt on Australian bonds as we approach the peak of the current interest rate cycle.**
- Inflationary pressures are unwinding however we do expect services inflation to stay above trend and weigh on RBA decision making for the time being.
- Current market pricing indicates 1 more hike over the next 3 months with the RBA to remain on hold for the rest of 2023. We see scope for capital gains should economic activity slow faster than consensus expectations in 2H23.
- We recommend local credit portfolios be skewed toward higher quality and liquid securities to broaden the defensive attributes of your portfolio, focussing on securities with maturities up to the ~5yr part of the curve.
- The rates of return are improving for private credit, but a selective approach is required to identify those that adequately reward you for the illiquidity and security in the underlying issuer. Managers with proven track records should be prioritised.
- Sentiment toward hybrids has stabilised post recent volatility, but we are wary of concentration and liquidity risks.

Global Fixed Income



Neutral to positive

Rationale / Shift

- **We have maintained our positive tilt on global bonds.**
- We acknowledge the market is pricing in an aggressive level of rate cuts in the US for the second half of the year, however we still believe the asset class provides an attractive array of investment opportunities for active managers.
- We recommend increasing exposures to issuers that rank high up in quality and seniority, in anticipation of a flight to quality effect as credit fundamentals deteriorate over 2H23.
- A more cautious and selective outlook is advised for lower quality credits, particular with respect to the commercial real estate sector. Private credit and restructuring strategies are seeing improved pricing opportunities, however prudent fund manager selection and justifiable illiquidity premiums will be critical here.
- We expect that policy settings amongst countries and regions may potentially diverge further over the coming 12 months, reinforcing the appeal of active, unconstrained strategies.

We look forward to discussing these views with you and the potential implications for your investments in the coming months, however in the meantime please don't hesitate to contact your Pitcher Partners investment adviser for further information.

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