INNOVA
ASSET MANAGEMENT

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MARKET OUTLOOK REPORT

INFLATION BRINGS BACK VOLATILITY AFTER STRONG 2021

Most major investment markets ended 2021 positively amid strong global economic growth.

However, the new year has opened with a bout of market volatility as investors grapple with the impact of higher inflation and interest rates, the Omicron coronavirus variant, and geopolitical tensions between Russia and Ukraine.

This has created new uncertainties after decades of falling inflation and central banks pumping easy money into the economy – hence the image that opens this month's quarterly update.

As many of you would know, Nassim Taleb's black swan comment refers to unexpected, unforecastable and catastrophic future events.

Our take on the current environment is a white swan gliding on a black lake: there is a way through these new potential risks and we have been positioning our portfolios to navigate them.

Our portfolios have been able to keep up with and exceed peers while doing so at lower risk and much lower overall valuation (see below).

While the outlook is uncertain, investors can still take away some positives.

Global economic growth remains strong, with the exception of China, which has softened due to weakness in its property and property development market. Consumer spending remains robust despite Omicron with unemployment low and negotiating power returning to the hands of US workers for the first time in about five decades.

Governments and central banks remain supportive despite winding back spending, slowly raising rates and unwinding quantitative tightening. They have little choice given high consumer and corporate debt.

RISING INFLATION: A PORTFOLIO DEFINING SHIFT

But this long period of easy money, combined with supply chain issues following the COVID-19 pandemic, has set inflation on an upward trajectory.

In the US, inflation has hit a 40-year high with CPI now sitting above 7% (compared to the US Fed's 2% target), with a series of rate rises now expected. The Bank of England, Bank of Korea, and Reserve Bank of New Zealand have already lifted rates.

There are some strong arguments on both sides about whether the current inflation spike may be short lived or not, but there's probably more evidence to suggest it may be higher and stickier than expected.

Whether it accelerates or settles down, the sub-2% inflation rate that dominated the previous decade is a low probability in future. The tailwind of falling rates, which allowed cheaper borrowing, ever-increasing liquidity, and positive valuation changes across bonds and equity, will be less likely.

This will have ramifications for interest rate sensitive stocks, bonds, real estate and infrastructure, though to what degree may be dependent on the actions of central banks.

It will ultimately make generating healthy returns much harder and affect portfolio construction.

THE DIFFERENCE BETWEEN 'TRANSFORMATIONAL TECH' AND WELL-RUN BUSINESSES

Parts of the high-flying technology sector – particularly those businesses without real earnings growth – have recently come back down to earth,

The concept of once-in-a-generation "transformational technology" encouraged some investors to ignore the fundamentals of what the underlying investment is likely to do in the future.

However, the internet was transformational (hence the dotcom bubble), and so were railroads and airlines in their time. It doesn't necessarily equate to superior long-term profits.

Each of the above examples represented major shifts in the way the global economy worked, yet all ended up as poor investment because the price investors paid was too high.

For example, if an investor bought Microsoft at its peak before the dotcom bubble, it would have taken 16 years to break even despite the company growing profits.

A great narrative is one thing but a great business is often another. There's only so long that price can be separated from real growth.

The current poster child for this is the US-based firm Ark Invest. The share price of its Ark Innovation ETF (code ARKK on the NYSE) has fallen by about half since its February 2021 peak, following a similar trajectory as the Goldman Sachs non-profitable technology index.

If inflation proves to stay higher for longer (only 4% to 5%) the value of future earnings priced into these type of tech businesses will be worth substantially less.

Meanwhile, tech companies with real and solid earnings growth started 2021 richly priced but continued to grow throughout the year in line with earnings.

This was predominantly concentrated in the mega-caps of Apple, Alphabet, Microsoft, Netflix, Tesla, Nvidia and Facebook (which still had its own share price crash in early February). These companies are generally trading on very high valuations of 40 to 70 times earnings (barring Facebook) but they are real businesses.

THE PANDEMIC CONTINUES – BUT BETTER TIMES AHEAD?

The easy transmissibility of the Omicron coronavirus variant presented another challenge to the Australian economy.

It revealed a lack of preparation with not enough ambulances, hospital workers and hospital beds to deal with other emergencies and health related issues.

However, Omicron may in fact be the worlds 'saviour' from COVID.

The transmissibility of this strain could act to crowd out other strains if it becomes the dominant variant and spreads through the population.

If that happens, we may see Omicron become an endemic disease that persists and reduces the likelihood of more crippling future mutations spreading widely.

A NEW GEOPOLITICAL TENSION

Russia has amassed troops near the Ukraine border and there is a real risk the situation escalates, although it's unlikely either side wants to go to war.

Given the high costs already in place for oil and natural gas, as well as Russia's reserves of both commodities combined with the winter timing of discussions, it represents a real risk for much of Europe.

It's not possible to predict the outcome, but it is one we will continue to monitor.

HOW WE'RE INVESTING OUR PORTFOLIOS

ASSET CLASS	FORECAST	CHANGE ON QUARTER
Australian Shares	Neutral to mildly expensive	No Change
Global Shares	Mildly expensive	No Change
US Shares	Expensive	No Change
Asia ex Japan Shares	Neutral	No Change
European Shares	Neutral	No Change
Australian Government Bonds	Expensive long term	No Change
Australian High-Grade Credit	Mildly Expensive	Mild downgrade
Global Sovereign Bonds	Expensive long term	No Change
Global High-Grade Credit	Mildly expensive	No Change
High Yield Bonds	Expensive	No Change
Emerging Market Debt	Expensive	Downgrade
A-REITs	Neutral	No Change
G-REITs	Mildly Expensive	Downgrade
Global Listed Infrastructure	Mildly positive	Downgrade
AUD	Neutral	Mild upgrade
USD	Neutral	No Change
Gold	Positive	Upgrade
Cash and Term Deposits	Mildly Expensive (no real yield)	No Change

We have positioned our portfolios for:

- robust economic growth by increasing our exposure to economically sensitive sectors that will benefit,
- set our largest portfolio tilts away from those with high-interest rate sensitivity,
- Still maintained a defensive stance by avoiding the most expensive sectors in case inflation leads to some ordinary results.

This has helped Innova post attractive risk-adjusted returns across our portfolios.

As an example, we recently calculated the Price-to-Book[1] valuation of our equity exposure and compared that to the MSCI ACWI and the S&P500.

The S&P500 currently trades on a multiple of more than four times, the MSCI more than three times, while our global equities portfolio trades at barely two times.

Yet we have continued to perform by avoiding the sectors decimated in 2021, such as unprofitable tech, and rotated into assets that are more attractive in a relative sense.

[1]Price-to-Book is a well-known measure of value on equity investments. It has come under deserved scrutiny of late, since using the book value of a company doesn't account for intangible assets generally prevalent in highly profitable tech businesses, but whatever measure we used the results were the same.

A TILT TOWARDS VALUE EQUITIES

Our preferred equity allocations are towards cyclical companies, value equities, and emerging markets (ex-China).

We have tilted to equity markets that have more attractive valuations – European equities, emerging markets and Asia (including Japan).

Value equities have rallied recently while emerging markets have suffered from the spill-over effect of China. Nonetheless, their valuations continue to look reasonable, and generally they are beneficiaries of expanding economic growth.

We continue to have concerns around the US market, which is still trading at valuation ranges only ever seen before in the tech bubble, but pockets within the US look fine.

Australian equities recent 8% fall has taken it from expensive to only mildly negative/neutral on valuation grounds.

Our portfolios were positioned for higher inflation, which sparked the downturn, and we now hope to pick up some great long-term assets at depressed prices.

RISING RATES MAKE BOND MARKET CHALLENGING

We maintain a bias to high-grade credit and loans, as well as inflation protection and non-correlated sources of return.

We have not taken on excessive credit or duration risk in the fixed income component of our portfolios, as we don't believe investors are being compensated for the risk. We prefer short duration debt instruments, which are less interest-rate sensitive.

Within credit, we believe the highest-grade credit exposures are not offering sufficient return or yield, however, the investment grade space below the A rating level seems reasonable.

Government bonds remain unattractive (apart from real yielding bonds), but the recent sell-off has them back on our radar although higher inflation remains likely.

We have a tactical allocation to cash to take advantage of price anomalies when they present themselves, though we would prefer not to hold such large cash allocations since cash isn't offering a real yield.

We also believe gold is attractive given the unprecedented stimulus from governments and central banks.

TRADITIONAL PERFORMANCE AT DECEMBER 2021								
	3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	7 YEAR	9 YEAR	INCEPTION
Conservative	1.64%	2.29%	5.29%	5.50%	4.39%	3.94%	4.60%	4.89%
Morningstar benchmark	0.23%	0.54%	1.97%	3.87%	3.32%	3.14%	3.69%	3.90%
Difference	1.41%	1.75%	3.32%	1.63%	1.07%	0.80%	0.91%	0.99%
Moderately Conservative	2.29%	3.47%	9.03%	7.76%	5.82%	5.12%	6.08%	6.38%
Morningstar benchmark	1.03%	1.90%	5.66%	5.86%	4.51%	4.09%	4.83%	5.07%
Difference	1.27%	1.56%	3.37%	1.90%	1.31%	1.03%	1.25%	1.31%
Balanced	2.93%	4.67%	12.57%	10.34%	7.22%	6.30%	7.60%	7.89%
Morningstar benchmark	1.89%	3.18%	10.29%	8.58%	6.27%	5.73%	6.75%	6.91%
Difference	1.04%	1.49%	2.28%	1.76%	0.95%	0.57%	0.85%	0.98%
Growth	3.47%	5.83%	16.93%	12.74%	8.73%	7.64%	9.35%	9.61%
Morningstar benchmark	2.56%	4.20%	14.19%	10.94%	7.89%	7.05%	8.24%	8.41%
Difference	0.91%	1.64%	2.74%	1.80%	0.84%	0.59%	1.11%	1.20%
High Growth	3.80%	6.51%	19.31%	14.30%	9.71%	8.71%	10.74%	10.98%
Morningstar benchmark	3.56%	5.57%	19.00%	13.35%	9.59%	8.75%	10.24%	10.28%
Difference	0.24%	0.94%	0.31%	0.96%	0.12%	-0.04%	0.50%	0.70%

RISK DEFINED PERFORMANCE AT DECEMBER 2021						
	1 MONTH	3 MONTH	6 MONTH	1 YEAR	3 YEAR	INCEPTION
Lifestyle Preservation Flagship	0.73%	0.86%	1.48%	3.98%	3.38%	2.80%
Lifestyle Preservation Fundamental	0.75%	0.65%	0.95%	2.87%	3.12%	3.09%
Target Cash Rate +1.5%	0.13%	0.40%	0.80%	1.60%	2.03%	2.34%
Difference Flagship	0.60%	0.46%	0.68%	2.38%	1.35%	0.46%
Difference Fundamental	0.62%	0.25%	0.14%	1.27%	1.09%	0.76%
Wealth Creation Flagship	1.57%	2.19%	4.27%	12.59%	9.47%	6.57%
Wealth Creation Fundamental	1.64%	2.47%	3.76%	10.93%	8.09%	6.65%
Target Cash Rate +3%	0.26%	0.77%	1.55%	3.10%	3.54%	3.85%
Difference Flagship	1.31%	1.42%	2.72%	9.49%	5.93%	2.72%
Difference Fundamental	1.38%	1.70%	2.21%	7.83%	4.54%	2.80%
Aspiration Flagship	1.91%	3.00%	5.72%	17.06%	12.92%	8.76%
Aspiration Fundamental	2.11%	3.44%	5.17%	15.52%	11.25%	8.98%
Target Cash Rate +5%	0.42%	1.26%	2.54%	5.10%	5.55%	5.86%
Difference Flagship	1.49%	1.74%	3.18%	11.96%	7.37%	2.89%
Difference Fundamental	1.69%	2.18%	2.63%	10.41%	5.70%	3.11%