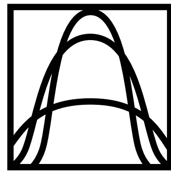


INNOVA
ASSET MANAGEMENT

JUNE QUARTER 2022
MARKET OUTLOOK REPORT

WILL THE MARKET ABSORB RISING INFLATION AND RATES?

The year opened with a fall in many major equity markets as fears about inflation finally hit share prices.

Inflation soared in the US to 7.5% with core inflation (which excludes volatile items such as food and fuel) not much lower at 6%.

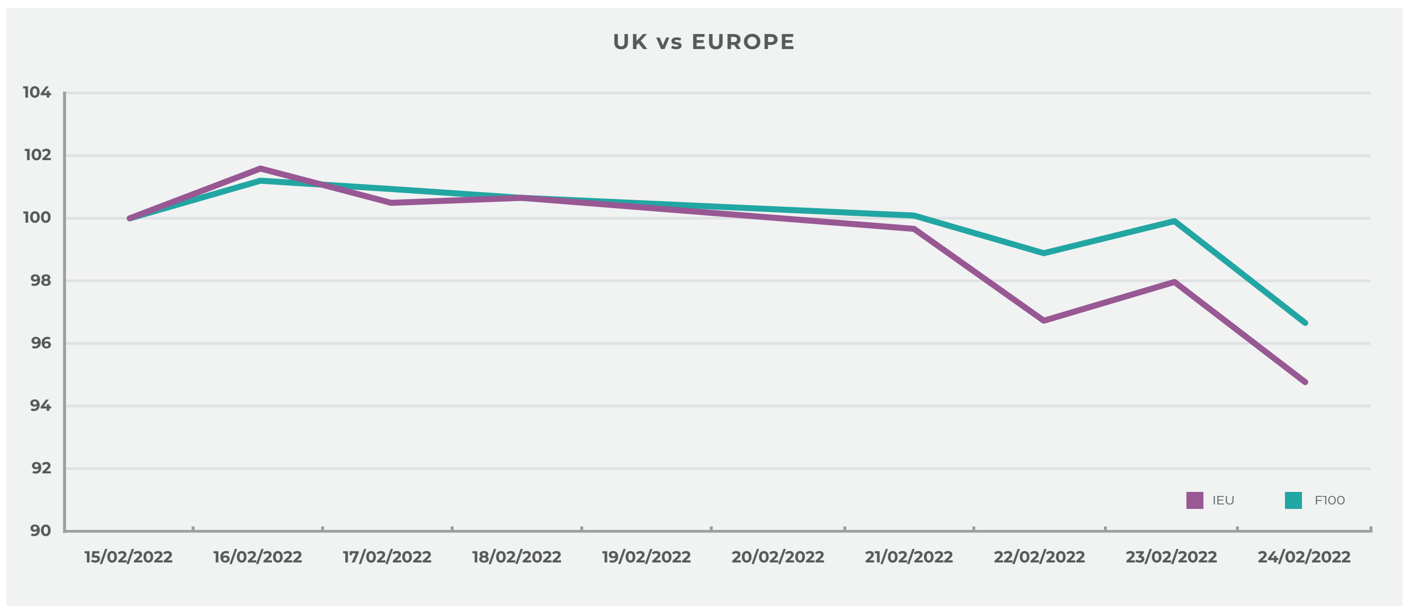
The Australian share market followed the US lower in January, with the highly inflated tech sector and growth stocks falling the most.

However, some equity markets such as the UK bucked the trend and staged a small rally.

In February, Russia invaded Ukraine, which resulted in swift action from the rest of the world, including sanctions on Russia's central bank preventing trade in US dollars and exclusion from the global SWIFT payments system.

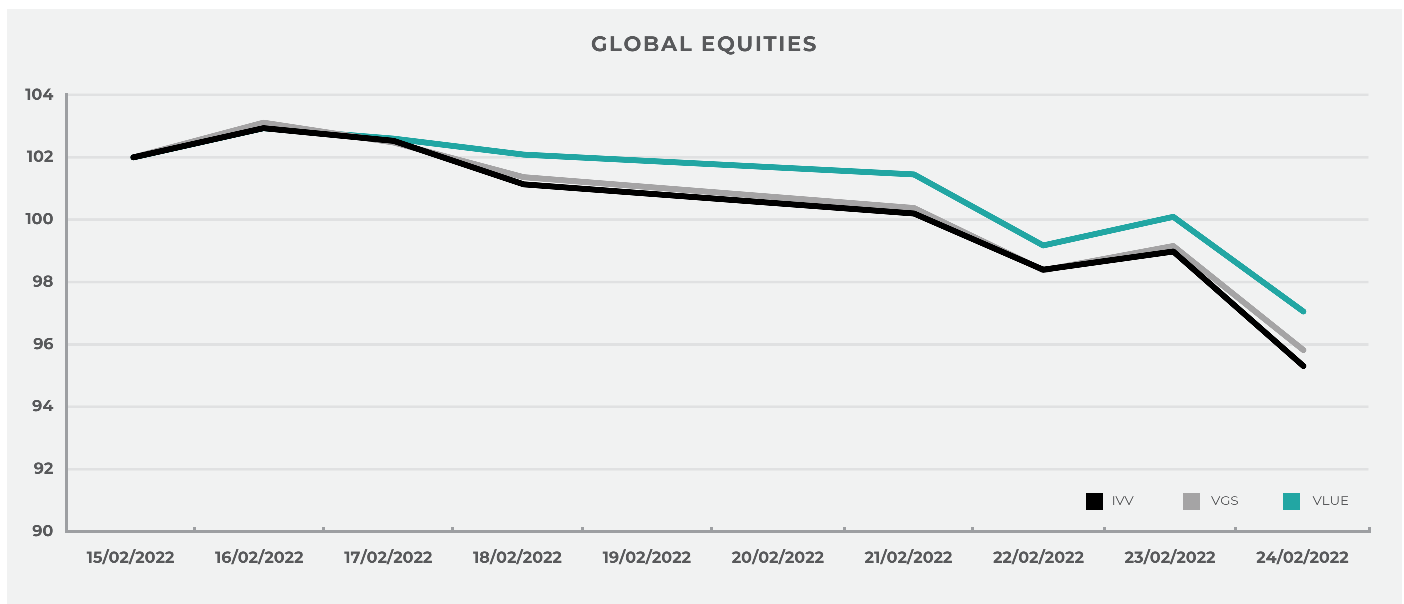
This sharply reversed the UK and European markets strong start to the year, but perversely aided the Australian equity market to rally.

Innova moved out of our European exposure and into the F100 exchange-traded fund (ETF), which tracks the UK's FTSE 100 index. Its relative outperformance is shown in the graph below. (While losing money isn't good, you need to be prepared for it over the short-term and do your best to lose as little as possible).



Our largest portfolio tilt to Value global equities (through the VLUE ETF) also performed relatively well compared to compared to Quality stocks (QUAL ETF), global stocks (VGS ETF) and the US S&P 500 (IVV ETF).

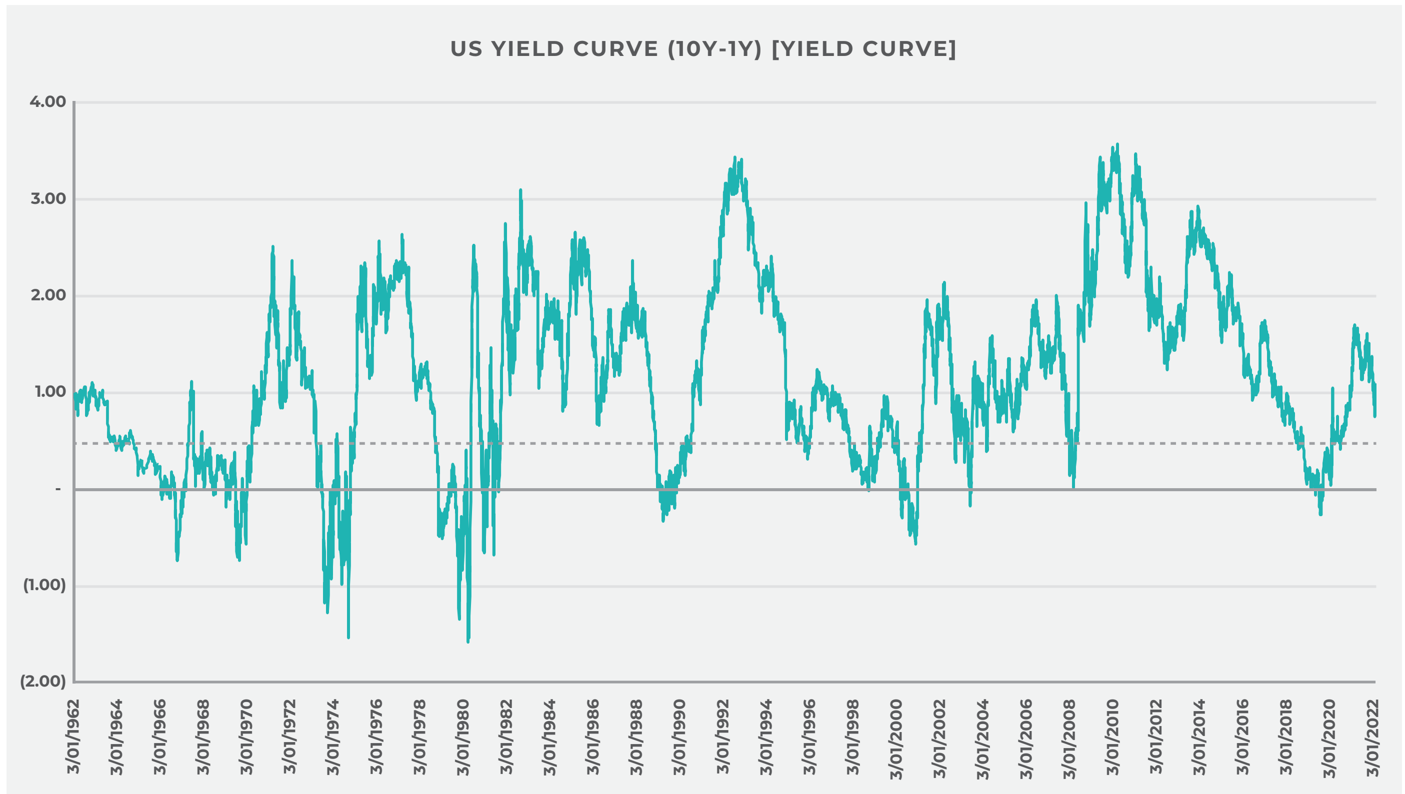
Higher inflation erodes the worth of a company's future earnings, reducing its value today. The future earnings of Value stocks are, by definition, priced more fairly than Growth stocks – one reason for its recent relative outperformance.



Another key moment was the US yield curve temporarily turning negative (for two days) in the quarter, sparking questions about the potential for a recession.

However, the yield curve is not a perfect indicator, and a negative yield curve prior to recession has historically needed at least 10 days in negative territory before a recession.

Nonetheless, rising rates during an economic slowdown could be a meaningful drag on future growth.



WILL HIGHER INFLATION PERSIST?

Our biggest area of focus now is on whether inflation will stay persistent.

Is the US Federal Reserve now raising rates too late, forcing it to bludgeon markets and the economy to control inflation? Or is economic growth robust enough to allow for real economic growth and higher inflation even during a rate hiking cycle?

A range of economic data suggests that the US economy is still expanding, albeit with a slowing services sector.

The US, and by extension, the global economy is fragile but not broken. The market seems to be suggesting a slowdown – not necessarily a recession – and higher inflation in the short term.

There's a reasonable probability that this environment is positive for Value equities, short-dated and floating rate bonds with a high credit rating, and supportive of materials and commodities, as well as gold.

But much will depend on the actions of the Fed.

We see three different scenarios:

1. The Fed makes inflation their primary concern and raises rates even in the face of a slowing economy. This could lead to a market fall. This would be the worst outcome for investors but best for the economy long term. In that environment we believe the positions we hold are the right ones, but we may want more fixed rate sovereign bonds and less equities in general (maintaining our current Value style bias).
2. The Fed may raise rates as above, but at the first signs of market weakness, follow their playbook of the last decade and rush to the rescue by stopping rate rises and re-starting Quantitative Easing (QE). This would likely be inflationary. Cyclical exposures that are not overly expensive should benefit the most, and equity exposure should be rewarded.
3. The economy could absorb rate rises, setting the scene for a soft landing and return to more 'normal' economic conditions fuelled by higher, yet reasonable, inflation. This would be the best outcome for investors. It would help cyclical businesses as Growth stocks get re-rated by the acceptance of higher inflation. Sovereign bonds would slowly increase in yield until they return to a more normal upward sloping yield curve.

We are positioned for the second scenario but have plans in place for the other two as more information becomes available. The next few meetings of major central banks will provide us with more information.

HOW WE'RE INVESTING OUR PORTFOLIOS

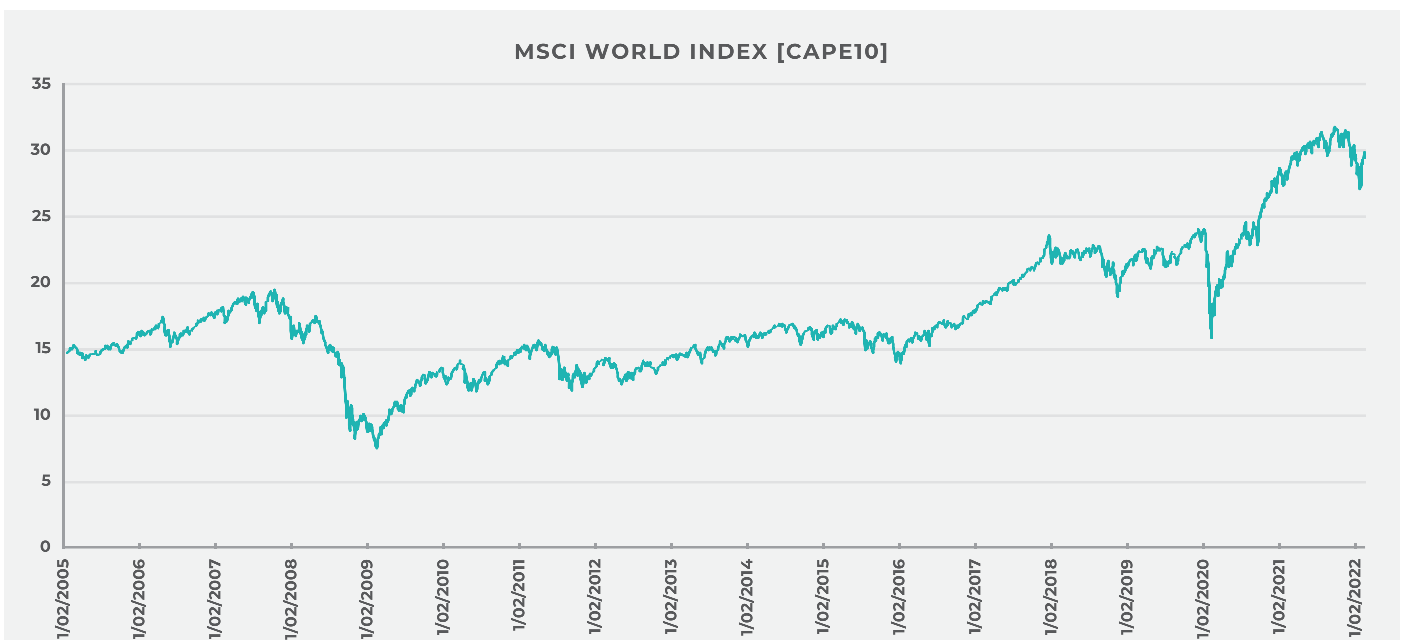
ASSET CLASS	FORECAST	CHANGE ON QUARTER
Australian Shares	Neutral to mildly expensive	No Change
Global Shares	Mildly expensive	No Change
US Shares	Expensive	No Change
Asia ex Japan Shares	Neutral	No Change
European Shares	Neutral	No Change
Australian Government Bonds	Expensive long term	No Change
Australian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

We have tilted our portfolios towards equity markets that have more attractive valuations, such as UK equities (via the F100 ETF), which was one of the few equity markets apart from Australia posting positive returns for the quarter in local currency terms.

We have little exposure to Growth style equities given their stretched valuations, however we maintain an allocation in Australian equities to hedge our exposure. True Quality exposure is hard to come by in the Australian market, which has large sector biases towards banks and mining.

Australian shares have held up well in the current period of market volatility, primarily due to its large materials exposure, but remains neutral to mildly expensive. Rising inflation and interest rates may put this under pressure during the year.

Global shares have fallen over the quarter, making valuations more attractive, however, compared to history the fall has been minor.



Our preference for robust and sustainable earnings growth may be difficult to come by as economies re-open and then shut borders due to waves of COVID, compounded by supply-chain bottlenecks and, importantly, energy input costs in the form of oil and gas.

We remain tilted away from US equities based on valuation, and Growth style equities in particular, though maintain some exposure through our Quality equity exposure. If the economy and/or markets slow, we would consider increasing allocations at the right price.

Emerging markets and Asia are still in our portfolios but on watch, while recent weakness in Japan provides a potential opportunity.

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

In the sub-investment grade and private credit markets (excluding domestic loans) we don't believe investors are being compensated for the risk they are taking.

We are reducing our tactical allocation to cash to take advantage when attractive assets fall in price. We continue to look to alternative forms of cash to enhance returns where possible without taking undue risk, which can be seen in our short-term fixed income allocations.

TRADITIONAL PERFORMANCE AT MARCH 2022

	3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	7 YEAR	9 YEAR	INCEPTION
Conservative	-1.62%	0.01%	2.89%	3.71%	3.88%	3.22%	4.51%	4.60%
Morningstar benchmark	-3.07%	-2.85%	-0.29%	1.76%	2.46%	2.30%	3.56%	3.56%
Difference	1.45%	2.86%	3.18%	1.95%	1.42%	0.92%	0.95%	1.04%
Moderately Conservative	-1.87%	0.40%	4.89%	5.45%	5.19%	4.25%	5.86%	6.02%
Morningstar benchmark	-2.99%	-2.00%	1.97%	3.32%	3.59%	3.12%	4.63%	4.63%
Difference	1.12%	2.40%	2.92%	2.13%	1.60%	1.13%	1.23%	1.39%
Balanced	-2.31%	0.57%	6.88%	7.17%	6.42%	5.13%	7.25%	7.44%
Morningstar benchmark	-2.55%	-0.77%	5.06%	5.49%	5.32%	4.57%	6.42%	6.42%
Difference	0.24%	1.34%	1.82%	1.68%	1.10%	0.56%	0.83%	1.02%
Growth	-2.76%	0.64%	8.80%	8.89%	7.75%	6.23%	8.81%	9.06%
Morningstar benchmark	-3.23%	-0.80%	6.87%	7.04%	6.69%	5.60%	7.73%	7.73%
Difference	0.47%	1.44%	1.93%	1.85%	1.06%	0.63%	1.08%	1.33%
High Growth	-3.09%	0.61%	9.89%	10.03%	8.60%	7.10%	10.06%	10.36%
Morningstar benchmark	-3.51%	-0.08%	9.25%	8.68%	8.19%	7.02%	9.43%	9.43%
Difference	0.42%	0.69%	0.64%	1.35%	0.41%	0.08%	0.63%	0.93%

RISK DEFINED PERFORMANCE AT MARCH 2022

	1 MONTH	3 MONTH	6 MONTH	1 YEAR	3 YEAR	INCEPTION
Lifestyle Preservation Flagship	0.09%	-1.56%	-0.71%	1.71%	2.03%	2.29%
Lifestyle Preservation Fundamental	0.26%	-1.53%	-0.76%	1.61%	2.04%	2.60%
Target Cash Rate +1.5%	0.13%	0.39%	0.79%	1.60%	1.91%	2.29%
Difference Flagship	-0.04%	-1.95%	-1.50%	0.11%	0.12%	0.00%
Difference Fundamental	0.13%	-1.92%	-1.56%	0.01%	0.12%	0.31%
Wealth Creation Flagship	0.62%	-2.62%	-0.47%	6.25%	6.22%	5.59%
Wealth Creation Fundamental	1.21%	-2.19%	0.38%	6.71%	6.11%	5.94%
Target Cash Rate +3%	0.26%	0.76%	1.53%	3.10%	3.42%	3.81%
Difference Flagship	0.36%	-3.38%	-2.00%	3.15%	2.80%	1.78%
Difference Fundamental	0.95%	-2.94%	-1.16%	3.61%	2.69%	2.13%
Aspiration Flagship	0.81%	-3.25%	-0.33%	8.44%	8.73%	7.49%
Aspiration Fundamental	1.77%	-2.42%	1.00%	9.45%	8.47%	8.10%
Target Cash Rate +5%	0.42%	1.23%	2.51%	5.10%	5.43%	5.82%
Difference Flagship	0.39%	-4.48%	-2.84%	3.34%	3.30%	1.67%
Difference Fundamental	1.35%	-3.65%	-1.51%	4.35%	3.04%	2.29%

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