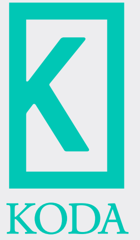

Quarterly Investment Insights and Outlook

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Key Points

The investment landscape is starting to change. The low inflation and low unemployment backdrop has delivered stellar returns for both bonds and stocks in recent decades. This is now being seriously challenged. There is a strong probability that we are moving into higher inflation and then a weaker growth environment than seen in recent decades.

Recent inflation prints across the globe have been elevated, with most countries seeing inflation well above their official targets. Distortions from COVID-19 are playing a part, but cannot be blamed for all of current inflation pressures. COVID-19 has accelerated some long-term trends that were already underway.

A generational spike in inflation is underway. This is opposite of the persistent deflationary pressures seen years after the Global Financial Crisis, and high inflation readings should continue through until at least early 2022.

Current elevated inflation cannot be fully fixed by rate hikes. Although tapering or rate hikes can reduce inflation *via* the channel of inflation expectations (*ie* wages) and property prices, central bankers can hardly do anything on hiring more truck drivers or exploring more oil. Central Banks must remove emergency measures sooner rather than later to retain their credibility.

At present, markets are distorted by a series of noisy events, including the Evergrande default, China slowdown, the broad-based energy shortage and the concerns of persistent inflation. Some assets will significantly underperform when these headwinds materialise.

Key is to make your portfolio resilient to extreme market events, whether it is the black swan like COVID-19 or the grey rhino like the current bond sell-off. *How do we do that?*

We specifically take smaller exposures to a lot more risks. The classic approach to a 70% growth 30% defensive portfolio is about 50% in Australian and US/EU equities plus 10-20% in high duration bonds. We do not build portfolios like that. By way of example, we would rather have a modest exposure to:

- the risk that the People's Bank of China does not inject sufficient liquidity after a major developer goes into liquidation, or a regulatory crackdown on oligarchs impacts its tech leaders
- dozens of frontier economies which are unlikely to crash at the same time
- asset-backed agricultural loans.

Portfolios should not face unrecoverable losses if the RBA miscalculates on its macroprudential tightening and engineers a GFC-like property crash. Such an event is unlikely to affect stocks in Israel, US, Europe *etc*. When something adverse happens, you will likely be worried about 4% of the portfolio, not 30%.

Over the past year, our portfolios have been gradually changed to be able to deal with this evolving investment landscape. These changes are summarised in the table below.

Table 1: Key Portfolio Changes since June 2020

Date	Portfolio Change	Rationale
Q3 2020	Reduced beta exposure in Australian small caps and emerging markets	High valuations & rising economic risks
Early 2021	Confirmed no exposure to developed economies sovereign bonds	Inflation and valuation risks; too dilutive to returns to tolerate in portfolios
Mid 2021	Added two equity strategies with differentiated risk and return drivers	Increase portfolio diversification
Q3 2021	Added two agriculture strategies with differentiated risk and returns drivers	Increase portfolio diversification, capture dislocation & add another inflation buffer
Mid/late 2021	Added two niche commercial property opportunistic strategies	Capitalise on a market dislocation and add another portfolio inflation buffer

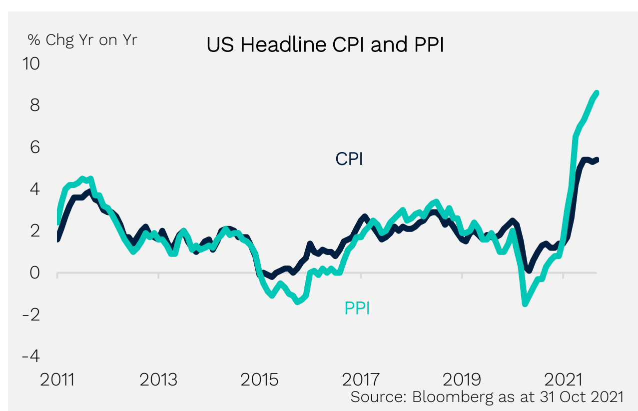
Section 1: The Times They Are A-Changin'

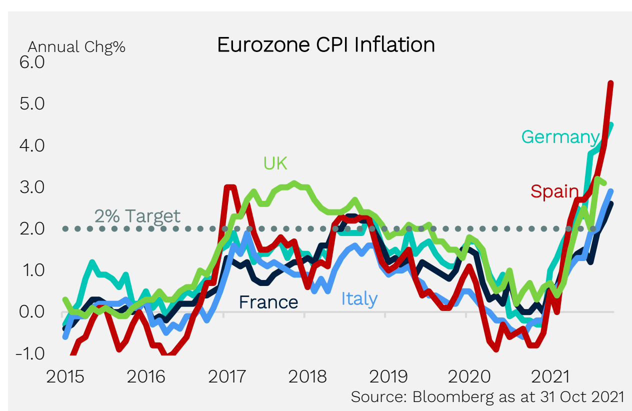
The investment landscape is starting to change. The Goldilocks economy, first coined in the early 1990s, has dominated the investment environment in recent decades. This low inflation and low unemployment backdrop has been great for both bonds and stocks, resulting in stellar investment returns. The Goldilocks economy is now being seriously challenged. There is a strong probability that we are moving into higher inflation and then a weaker growth environment than seen in recent decades. Over the past year, our portfolios have been gradually changed to be able to deal with this evolving investment landscape. These changes were summarised on page 2. In addition to the portfolio changes outlined, we provided access to real assets through closed-end funds, including electricity generation.

Recent inflation prints across the globe have been elevated, with most countries seeing inflation well above their official targets. Distortions from COVID-19 are playing a part, but cannot be blamed for all of current inflation pressures. COVID-19 has accelerated some long-term trends that were already underway. These include:

- **a more fractionalised global trading environment,** resulting in bilateral as opposed to multilateral trade agreements, and move to "nearshoring" and "on-shoring". Collectively this has driven a deglobalisation movement, which started with Brexit and gathered momentum under the Trump Presidency.
- **just-in-time supply management was becoming more difficult** due to trade barriers, particularly conducted by tariffs. The cost of moving away from just-in-time supply management is that firms are unable to optimise the supply chain as efficiently as previously.
- **forthcoming technological change particularly in the services sector is not either sufficiently advanced or scalable enough.** Examples of this include autonomous vehicles, robo-brokers, and traditional white-collar industries. These industries will face heavy disruption in the future but are unfortunately seeing significant inflation pressures now as the technology is coming but has not arrived. Worse still, workers have either exited or are avoiding entering knowing that technological will eliminate these roles.
- **market distortions in the energy sector**. An underinvestment in fossil fuels relative to demand in recent years combined with government emission targets and taxes, are creating supply inconsistencies. On the renewables side, output has yet to successfully to fill the void from fossil fuel energy.
- **changing worker lifestyle preferences and priorities.** Led by the technology sector, working from home became a genuine option and as a result moving to more cost-effective cities with large lifestyle gains. This has resulted in wage inflation due to a reduced labour force participation rate and for those who work a preference for less hours and reduced working schedules.

Causes of inflation are discussed below. **Their result is a generational spike in inflation**, which is the opposite of the persistent deflationary pressures seen years after the Global Financial Crisis, and high inflation readings should plateau through to Q1 2022.

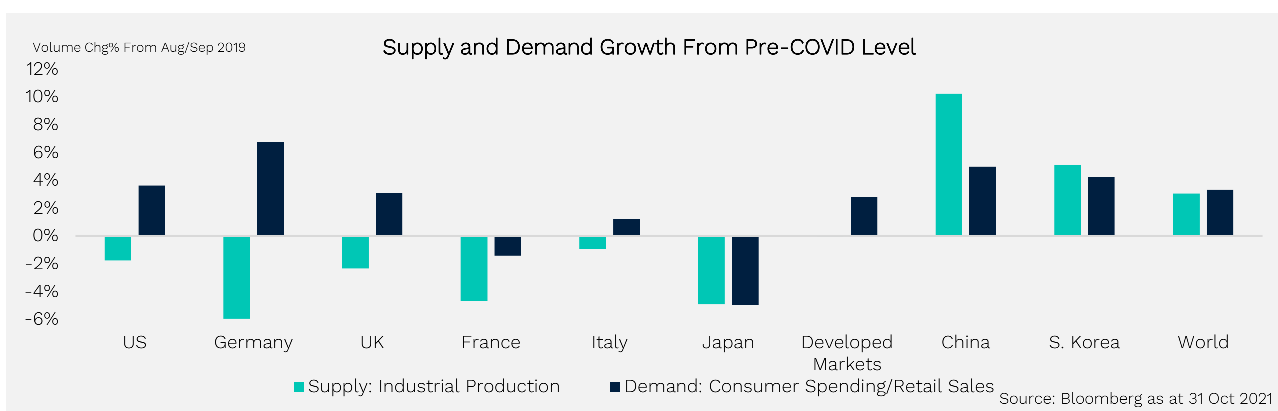




Key is the extent to which current inflation drivers are temporary as opposed to permanent. There are five main drivers of inflation at present. These are supply chain squeezes, energy and labour shortages. Considering each of these in turn.

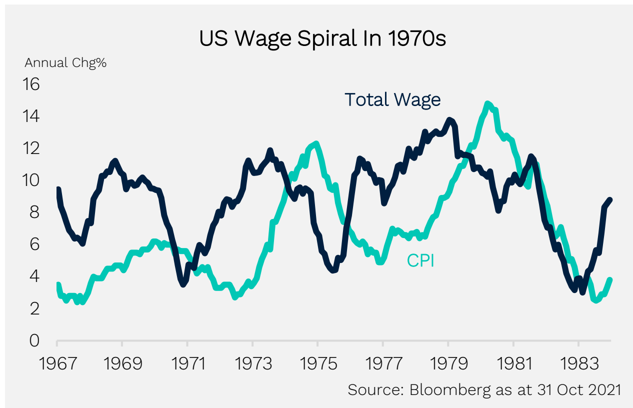
- **Demand side inflation:** Government policy stimulus measures combined with pent-up consumer spending and the release of over-savings, have driven strong demand for goods and services, creating demand driven inflation. This has been particularly pronounced in durables spending, as households have overconsumed on large ticket items due to working from home, sustained incomes due to policy initiatives and lockdown restrictions crimping services spending. This driver of inflation will be largely transitory.
- **Base effects:** as the world went into rolling lockdowns in early 2020, economic activity went into recession and inflation fell. A year on, the base effects from depressed levels of inflation have largely rolled off causing higher inflation prints. This factor was transitory.

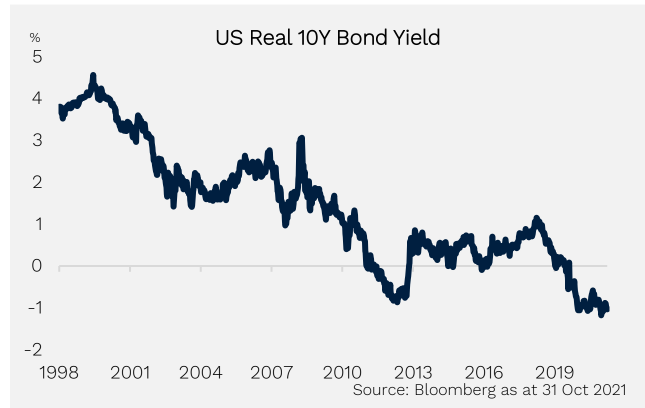
- **Supply chain squeezes:** Problems across the supply chain are both supply and demand driven. The imbalances are shown in the following chart and are most pronounced in the major developed countries. The demand side has been discussed above. On the supply side, the global flow of goods remains in chaos, due to disruptions on top of disruptions which commenced with the closure of many Chinese factories in the initial outbreak of COVID-19. Geographically, the US faces the biggest logistical issues, with congested ports, full warehouses, lack of truck drivers and full trains. Shortages are widespread across the world ranging from computer chips to the metals used in electric car batteries (see Table 2 for a comprehensive list). These shortages are expected to continue for up to two years, albeit in lessening degrees. This inflation driver is therefore more transitory than permanent.
- **Energy shortages:** These are supply driven. The shortage can be attributed to policy decisions to reduce carbon emissions, flooding in China's coal producing areas, underinvestment in fossil fuels and lack of labour - particularly truck drivers and shale oil workers. Some of these influences will recede in 2022, resulting in lower prices. Energy prices are unlikely to drop sharply (to pre-COVID levels) due to production emission targets, carbon taxes and tariffs. "Greenflation" will contribute to inflation for years to come. Energy shortages look likely continue for years to come, at least until there is a global tradeable market in carbon and electrification is scalable to the levels of energy currently derived from oil, coal and gas. This inflation driver is both transitory and permanent.
- **Labour Shortages:** this is supply driven, or increasingly being labelled "The Great Resignation". Across major developed economies, labour demand is outpacing supply. This is because potential workers are leaving the labour markets due to skill mismatches, mobility challenges as COVID-19 continues, and changed life priorities. Two key groups of workforces have exited: females aged between 25-44 and those aged over 55. The former can be largely attributable to home schooling/changed child priorities, and the latter is early retirement. It is unlikely that the labour market participation will revert to pre-pandemic levels. Specifically in the US, there is a pocket of militant resistance to vaccine mandates resulting in loss of difficult to replace staff. The result of "The Great Resignation" is higher wages as labour has more bargaining power. Companies are already offering large sign-on bonuses, higher entry level hourly wage rates, and other onboarding enticements. Labour shortages are the most worrying for future inflation outcomes, as workers will be able to demand higher wages from employers. This will in turn feed into higher inflation expectations, and then into inflation which is the vicious circle that central banks fear the most. This inflation driver is looking to be more permanent than transitionary.



Central Banks will have to remove emergency measures sooner rather than later to retain their credibility. With growth remaining relatively resilient and inflation well above target banks in major developed economies (the exception being Japan), current Central Bank policy settings are no longer appropriate. Some central banks are starting to "correct" policy settings. Russia, South Korea, Norway, and New Zealand are amongst the select few that have already raised interest rates. The European Central Bank is expected to start phasing out its emergency asset purchase program from December, and the Bank of England will act in coming weeks. The all-important US Federal Reserve has become much more concerned about current inflation being more permanent than previously assessed and action is increasingly likely by year end. The US Federal Reserve stance further complicated by current vacancies and whether Chairman Powell will be nominated for a second term. The RBA has just dropped yield curve control rather than fight the market.

The biggest mispricing in markets is negative real interest rates. The US real bond yield remains stubbornly negative. The US 10-yr inflation linked bond yield is holding at -1%. This is largely due to unprecedented central bank liquidity as well as continued "Goldilocks" growth/inflation expectations. As discussed above Goldilocks has gone and the new investment landscape will consist of lower growth and higher inflation – this "porridge" creates multiple investment stresses. For instance, large listed companies face higher cost bases due to inflationary pressures and reduced margins. Select companies – listed or unlisted – will prosper from their monopolistic or niche positioning as they can more than pass on price increases without any loss of market share. Those facing pure competition will face both margin erosion and reduced profitability. **The inevitable correction in negative real interest will flow onto other financial assets. Key is not if, but when.**





Our portfolios have been gradually changed to cope with a shifting investment landscape of higher inflation and lower growth. As outlined in previous reports and reinforced by recent changes as listed earlier, our portfolios have a different growth mix than traditional diversified portfolio. This has been done by accessing less market sensitive investments, in both the growth and defensive spaces. This approach also means that portfolios have exposure to greater number of less correlated risks. A traditional 70% growth and 30% defensive portfolio which is roughly 50% in Australian and US equities would face significant and irrecoverable losses should the RBA miscalculate on their macroprudential tightening and engineer a GFC like property crash. By investing in a greater number of risks, our portfolios will hold up better to such an event. That is not to say they would be immune. Overall, if all goes to plan in portfolios, clients should end up with half to 60% of the mark to market of a standard diversified fund, and with quality assets that have excellent long-term absolute and relative performance.

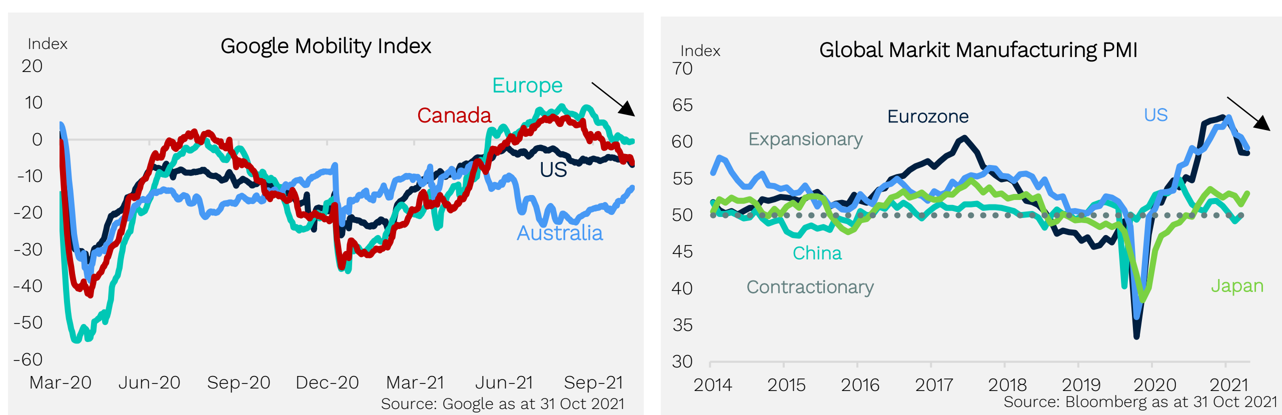
Table 2: Summary of Recent Shortages

Item	Location	Reason
Coal	China, Europe and Southeast Asia	Coal production cut and low wind
Petro	UK	Lack of truck drivers
Natural Gas	Europe and Asia	Low wind and slow production growth
Electricity	China, Europe and Southeast Asia	Low wind in Europe and high coal/gas prices
Steel	US	Slow capacity recovery; production cut in blast furnace mill
Semiconductor Chips	Global	Extreme weather; COVID; frontloading orders; capex cycle
Vehicles	Global	Semiconductor chip shortage
Plastic	Global	Power shortage and production cut on carbon emission limit
Meat/Food	Global	Staff shortage; extreme weather; port congestion
Alcohol/liquid	US	Lack of winery workers and drivers
Diaper/Household Supplies	US	COVID in Southeast Asia; port congestion
Electronics	Global	Semiconductor chip shortage; COVID in Southeast Asia
Labour	Europe, US, Australia	Lack of immigration; home schooling; wealth effect; early retirement, mandate-based firings

Section 2: Economic and Investment Backdrop

Global COVID-19 conditions improved in the past two months. North America, Eurozone, Japan and ASEAN countries are all reporting declining infections. Cases in the UK and Singapore remain elevated whilst the death numbers are low. In Australia, infections are also declining in both VIC and NSW. The fast vaccination rollout compressed the death tolls with the nationwide mortality rate below 0.7%. Across major economies, fully vaccinated rates have exceeded 50% with Eurozone and Japan both over 65%. On policy response, New Zealand, Australia and Vietnam have all abandoned the “elimination” approach and intended to live with the virus. This leaves China the only major economy to keep pursuing zero-case infections.

Despite the improving COVID situation, economic activities in major economies have moderated recently. Mobilities in Europe and North America are rolling over since late August. Even though these countries have fully reopened, mobilities in public transport and offices are still 10-30% below the pre-COVID level. The disruption of the pandemic on consumer behaviour is persisting much longer. Also, on the manufacturing side, business confidence mildly weakened although the underlying demand is still solid. The ongoing supply bottlenecks, labour shortages and surging energy prices are weighing on the margins. Two key leading indicators, South Korea and Taiwan export growth are both rolling over from the peak level of H1 2021, suggesting that the booming stage of global trade may be over.

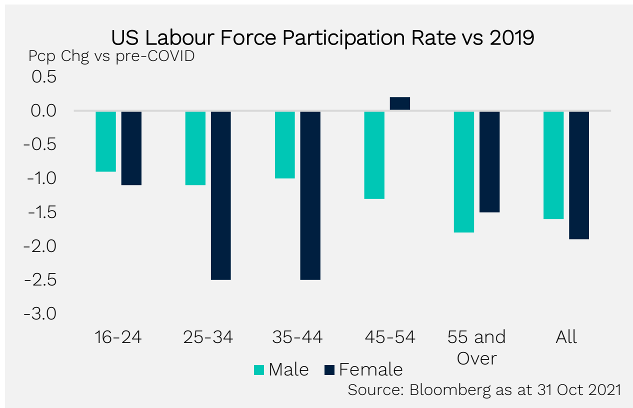


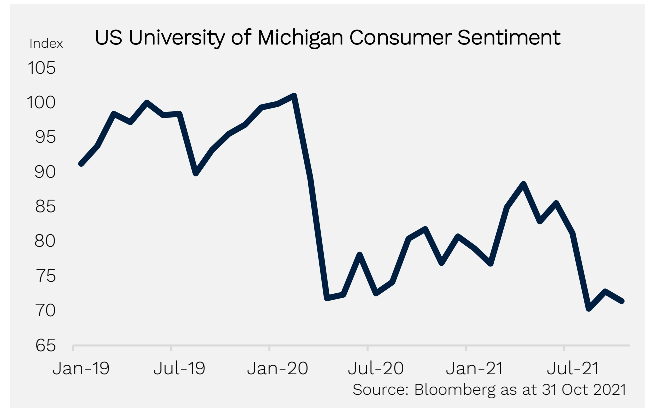
The economic condition across the regions is converging as strong economies (i.e. Europe and US) are moderating following the strong summer holiday season in Q3. By contrast Australis which suffered less than others during the pandemic is now facing a “uniquely” impacted Q3 2021.

The US economy is losing momentum after the strong first half year. Business sentiment proxied by ISM PMI is still strong but has mildly moderated from the peak level in Q2. Businesses are reporting mounting cost pressure and supply shortages. Consumer confidence weakened and the University of Michigan consumer sentiment index even went lower than the level during the pandemic. Households are increasingly concerning the price rises of their daily consumption.

Labour markets are very tight with significant labour shortages. The expiry of jobless subsidies in September did not bolter people’s willingness to “return to work”. Labour force participation rate is still 1.8% below the pre-COVID level and over three million people are reluctant to re-join the work force. Among them, key detractors are female aged 25-44 who have to home-school their children and people aged over 55 who take early retirement. The labour shortage is also pushing wages higher. In Q3 alone, US hourly wage rose 1.3% and the year-on-year growth in September is 4.6%, near a post global financial crisis high. Both job vacancy rate and quit rate are at record highs as people are actively seeking higher-paid jobs.

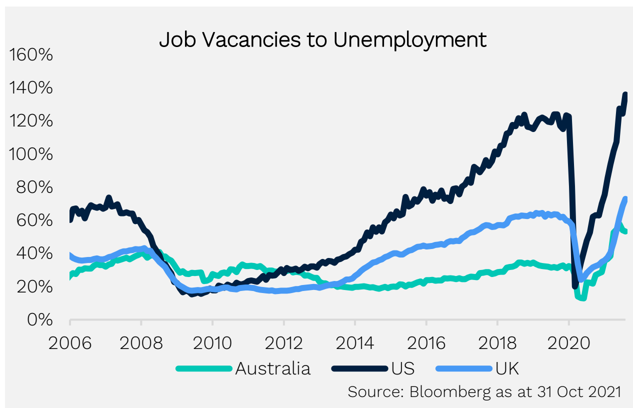
Inflation pressure is building up and persisting much longer than “transitory”. The headline annual CPI is jumping at above 5% and even the core CPI (excluding energy and food) is at 4%, well above the 2% target. From here, some items such as fuel, power or second-hand cars, will normalise early next year when the supply recovers. However, the backbones of the inflation, including sheltering, hospitalities and household product will even go higher due to the strong consumer income growth. As a result, the US Federal Reserve will have to respond ahead of the curve in case of the re-run of untamed inflation in 1970s/1980s. The bond markets have started to price in the potential policy shift. The future markets are now priced in 65 bps official interest rate rise by Feb 2023, up from 20 bps in mid-September. Our portfolio has very small exposure to interest rate sensitive (high duration) assets and section 3 will further discuss that.

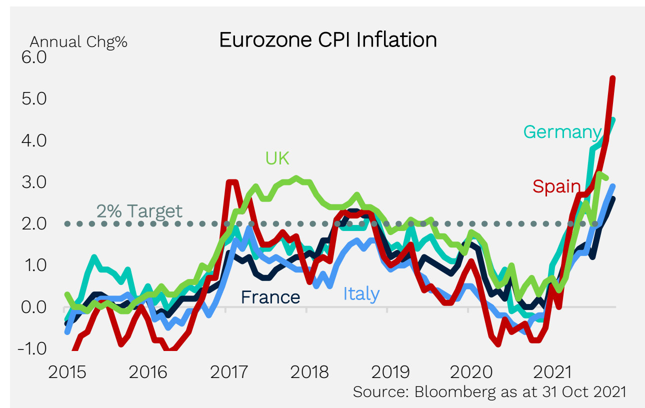




In Europe, the economic recovery is also moderating. Business confidence, as measured by German IFO and French INSEE, has stalled in recent months as companies are reporting ongoing problems in procurement of raw material and intermediate products. Order books are still relatively full, but order intake is levelling off. On the consumer side, household spending and confidence in Eurozone continues to recover despite the recent surging energy prices. By contrast, UK consumers are less optimistic as the country is reporting broad-based shortages from fuel to meat.

The labour market slack in Europe is significant. Although the headline unemployment rates have largely recovered to pre-COVID levels, total employment is 1.2% lower. In particular, countries like UK, Poland and Slovenia are struggling to find workers with record high job vacancies. On the other hand, European inflation is also rising. Headline inflation (HICP) in Eurozone was up 3.4% in September compared to one year ago, with Germany and Spain even above 4%. This is well above 2% target of Bank of England and European Central Bank. The future markets are now priced in four interest rate hikes in UK and half interest rate hike in Europe by Q3 2022.





In Australia, the economy is set to rebound following the ease of lockdowns. Over 280k jobs were lost in the past three months but most will be recovered by the end of this year. The underlying demand for staff remains strong even during the current pandemic, evidenced by the resilient online job advertisements. Once the restrictions on the demand side (*e.g.* consumption) fade, the country will face the issue of work force shortage again due to the lack of immigration, home schooling and early retirement. Evidenced by situation occurred in the US and Europe, wage pressure in Australia will elevate and push the inflation higher. A persisting period for headline CPI (Q3 2021 at 3.0%) over 3% or 4% by mid-2022 cannot be ruled out. The market consensus of CY 2021 CPI has already been revised up to 2.5% from 2% two months ago.

At present, the Reserve Bank of Australia plans to taper its bond purchases from November and keep the cash rate on hold until 2023 or more likely 2024. However, such announced roadmaps significantly deviated from the market expectations due to the looming inflation pressure. As a result, the Aussie 2y government bond yield jumped 70 bps in the past two weeks, suggesting over three rate hikes in 2022. In response, the RBA surrendered its yield curve control, and no longer targets an April 2024 yield.

In China, negative news has occupied the headlines in the past three months, from tech regulations to Evergrande defaults. Regardless the market noises, the key backdrop is that Chinese economy has been always cyclical, needing strong counter-cyclical demand management from the central government. Investment performance is largely unrelated to the macro fundamentals. Chinese equities significantly underperformed in the first seven months in 2021 due to monetary tapering/tightening, deleveraging and tech regulations. Meanwhile, the economy was running very strong in Q1 and Q2. By contrast, when the economy has slowed down since September, the equity markets stabilised and mildly outperformed developed markets.

On the macro side, China is experiencing a painful period of economic reform, from investment to consumption-driven growth. Annual GDP has slowed down to 4.9% in Q3, below 7.9% in Q2 and the long run target of 6%. The reasons of such weakness are threefold.

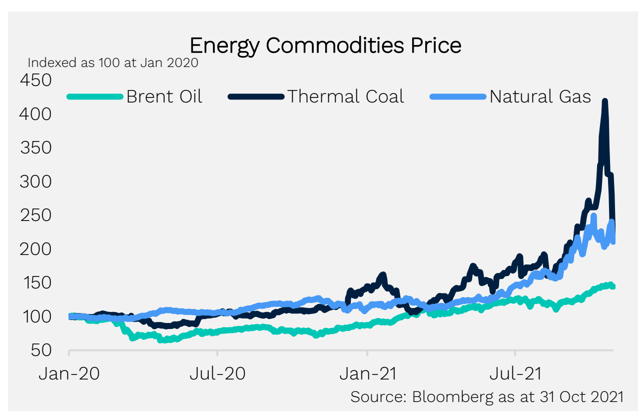
- First, China is experiencing the re-run of policy-induced deleveraging mandate as per 2018. Banking lending to property developers and infrastructure projects has been restricted to reduce the systematic risks in property sectors and local government debt. In the past one month, due to the Evergrande default and related contagion risks, Chinese regulators are starting to ease some restrictions of property lending.
- Second, household consumption is still disrupted by intermittent COVID as China is still adopting the elimination approach with border closures and regional lockdowns. Such headwinds will at least persist into 2022.
- Third, industrial production is curbed due to the carbon emission target, even though the underlying demand remains solid. Add on top, the recent power crunch has enforced energy-intensive industries to further cut production. Such impact will not fade until early next year.

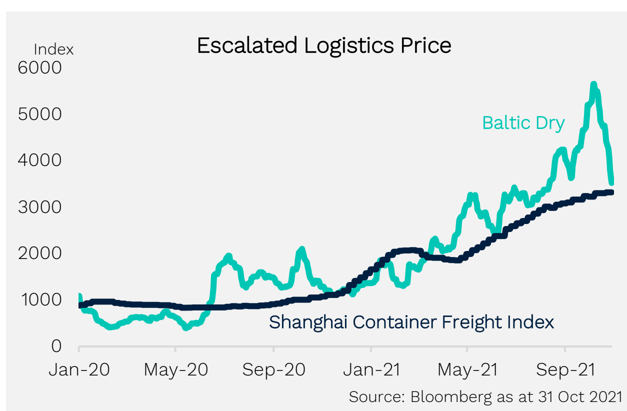
From here, markets now expect the Chinese PBOC to either cut interest rates or reduce required reserve ratio in the next six months to support the economic growth. Also, lending restrictions on developers and local governments will moderately loosen. However, a re-run of flooded stimulus as per 2009 is unlikely.

In financial markets, global equities have lost the momentum as investors concern the stagflation risks. MSCI World experienced a mild sell-off in September but recovered the losses in October due to strong earnings results. In Emerging markets, China stabilised after the wild sell-off in July whilst Russia and Frontier outperformed due to strong commodity prices.

The bond markets experienced a sell-off on the expectations of imminent US tapering and potential rate hikes in 2022. US 10Y bond yields have risen near 40 bps since August and the US inflation expectations, proxied by 5Y breakeven rates, jumped to 2.9%. The futures markets have now priced in two and a half rate hikes by Feb 2023. On the other hand, market liquidities remained intact for now. Both Investment grade and high yield bond spreads are still at very low level although they have mildly widened in recent weeks.

Commodity markets saw large swings in the past three months. The global power crunch pushed natural gas prices to record highs and oil price has topped $85 per barrel. Meanwhile, thermal coal peaked in mid-October at double its previous record and then fell over 40% due to the production recovery and regulatory intervention on speculation. In industrial commodities, copper and aluminium are grinding higher whilst iron ore fell over 50% due to the production cut and economic slowdown in China. On the other hand, global logistics prices are also moderating with Baltic Dry Index down 35% from the peak. Nevertheless, shipping costs are still significantly higher than pre-COVID due to the ongoing issues of truck driver shortage and port congestion.





Market Indicators at a Glance

As at 3 Nov 2021	LEVEL			PRICE CHANGE %					
Equities	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
ASX 200	7404	7633	5951	3.0	-0.9	5.3	22.1	12.4	1.2
ASX Small	3548	3598	2722	3.7	2.9	8.6	27.7	14.8	4.9
S&P 500	4631	4635	3336	6.3	4.7	10.4	37.4	23.3	7.8
Nasdaq	15650	15657	11005	7.4	6.0	12.6	40.2	21.4	7.9
Russell 2000	2362	2364	1572	5.4	6.2	3.7	46.3	19.6	2.2
MSCI Europe	159	159	116	5.9	3.1	9.1	34.6	20.2	5.8
Japan Nikkei 225	29521	30796	23097	2.6	6.8	2.5	26.7	7.6	2.5
Israel Tel Aviv 125	1963	1968	1387	5.1	11.6	13.3	40.7	25.2	11.3
UK FTSE 100	7275	7303	5655	3.5	2.4	4.4	25.7	12.6	3.4
MSCI China All	3415	4425	3266	1.6	-2.1	-9.8	-3.0	-9.4	-12.1
Russia RTS$	1851	1934	1077	4.5	13.0	24.6	67.0	33.4	11.9
MSCI World	3196	3198	2323	5.7	3.3	8.4	34.9	18.8	5.9
MSCI EM	1264	1449	1114	1.4	-2.3	-5.6	12.8	-2.2	-8.1
MSCI Frontier	687	693	516	3.7	6.3	12.4	31.5	20.2	6.3

	YIELD LEVEL			YIELD CHANGE (BPS)					
Bond	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
3M BBSW Rate	0.1	0.1	0.0	4	4	2	1	5	3
2yr Aus Treasuries	0.7	0.8	0.0	63	64	60	58	57	62
10yr Aus Treasuries	1.8	2.1	0.7	34	67	7	106	82	30
Aus Corporate Spread	1.0	1.1	0.8	1	13	12	-5	19	14
2yr US Treasuries	0.4	0.6	0.1	19	28	29	30	33	20
10yr US Treasuries	1.5	1.8	0.7	9	37	-8	71	64	8
Global Agg Spread	0.9	1.2	0.8	2	-1	-1	-34	-8	4
Global HY Spread	3.9	5.3	3.4	10	11	33	-157	-19	46
EM USD Bond Spread	3.1	3.4	2.6	10	9	35	-34	27	39

	LEVEL			PRICE CHANGE %					
Commodities	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
Baltic Dry Index	3187	5650	1111	-38.7	-2.9	4.4	152.3	133.3	-5.8
Aluminium ($/t)	2693	3229	1855	-5.8	3.0	12.3	44.3	36.0	6.7
Brent Oil ($/bbl)	83	86	44	6.2	18.3	28.6	92.9	64.8	16.2
Coking Coal (CNY/t)	3591	3995	1253	-4.6	75.9	123.0	169.1	139.3	61.1
Copper ($/t)	9496	10748	6670	4.0	-2.1	-3.4	40.4	22.3	1.3
Gold ($/oz)	1781	1966	1677	0.7	-1.6	-0.7	-6.7	-6.2	0.6
Iron Ore ($/t)	96	185	90	-15.7	-42.9	-40.0	6.8	-23.6	-46.6
Silver ($/oz)	23	30	21	3.3	-8.2	-12.9	-3.3	-11.3	-10.3
Thermal Coal (CNY/t)	1100	2360	566	-23.4	7.4	29.2	75.6	38.5	13.1

	LEVEL			PRICE CHANGE %					
Currencies	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
AUD/USD	0.7430	0.8007	0.7049	2.0	0.5	-4.3	3.7	-3.4	-0.9
USD Index	94.1	94.6	89.2	0.1	2.2	3.5	0.6	4.6	1.8
EUR TWI Index	122.0	127.3	121.5	-0.3	-1.0	-2.6	-1.5	-3.3	-1.6
AUD TWI Index	62.8	65.4	59.5	3.5	1.9	-2.5	5.9	-0.9	0.2
JPY TWI Index	108.2	118.9	107.2	-2.7	-3.3	-2.3	-8.4	-7.8	-1.4
GBP TWI Index	75.6	76.5	70.3	0.7	-0.3	0.9	5.5	5.4	0.1
CNY TWI Index	100.2	100.3	94.8	1.1	1.5	3.6	5.0	5.7	2.3

Source: Bloomberg as at 3 Nov 2021

Investment Style Monitor		Four Weeks Return/Index Point				
		Now	4 Weeks Ago	One Year Average	Ten Years Average	Long Term Average
Growth - Value Spread	↑	3.6	-4.6	-0.2	0.5	0.2
Cyclical - Defensive Spread	↑	4.1	2.3	1.0	0.8	0.6
Emerging – Developed Markets Spread	↓	-3.0	-2.4	-1.0	-0.5	0.1
US - Non-US Spread	↓	0.7	2.0	0.4	0.7	0.3
US - Europe Spread	↓	-0.1	0.0	0.1	0.5	0.3
Australia - Developed Markets Spread	↓	-3.3	0.1	-0.6	-0.3	-0.1
Australia - Emerging Markets Spread	↓	-0.3	2.5	0.4	0.2	-0.2
Covid-19 Impacted - Non-Impacted Spread	↓	-0.9	6.2	0.7		
Cyclical - Haven Currency Spread	↑	2.5	0.0	0.8	0.0	0.0
Tech - Non-tech Spread	↑	-0.7	-3.6	0.2	3.4	1.4

Source: Bloomberg as at 3 Nov 2021

vs. prior	
↑	Increasing
↓	Decreasing
→	Steady

vs. history	
(green)	Higher
(red)	Lower
(beige)	In line

Market Volatility Monitor		Now	4 Weeks Ago	One Year Average	Ten Years Average	Long Term Average
Equity Volatility Vix Index	↑	16.0	21.0	20.1	17.1	20.3
Bond Volatility Move Index	↓	71.0	59.4	60.5	63.8	81.9

Source: Bloomberg as at 3 Nov 2021

vs. prior	
↑	Improving
↓	Deteriorating

High Volatility — Low Volatility

		Valuation - Forward Price to Earnings Ratio			Technical Indicators	
		Now	4 Weeks Ago	Long Term Average	Relative Strength Index	Volume
ASX 200	↓	18.2	17.3	14.3	Normal	Flat
ASX Small	↓	21.9	20.3	14.5	Normal	Flat
S&P 500	↓	21.2	20.3	15.1	Normal	Flat
Nasdaq	↓	29.5	27.6	19.5	Normal	Flat
Russell 2000	↑	26.4	27.0	21.6	Normal	Flat
MSCI Europe	↓	15.4	14.9	12.6	Normal	Flat
Japan Nikkei 225	↓	16.8	16.8	16.7	Normal	Flat
Israel Tel Aviv 125	↓	11.7	11.7	11.5	Normal	Flat
UK FTSE 100	↓	12.3	12.0	12.0	Normal	Flat
MSCI China All	↓	14.0	13.8	14.2	Normal	Flat
Russia RTS$	↑	6.4	6.5	5.9	Normal	Up
MSCI World	↓	19.2	18.5	14.3	Normal	Flat
MSCI EM	↓	12.7	12.6	11.1	Normal	Flat
MSCI Frontier	↓	13.1	12.8	9.8	Overbought	Flat

Source: Bloomberg as at 3 Nov 2021

vs. prior	
↑	Improving
↓	Deteriorating

vs. history	
(dark red)	Very Expensive
(light red)	Expensive
	Fair Value
(light green)	Cheap
(green)	Very Cheap

Market Breadth	% of Stocks in Bull Territory[1]		% of Stocks in Bear Territory[2]	
	Now	4 Weeks Ago	Now	4 Weeks Ago
ASX 200	56%	52%	9%	9%
S&P 500	70%	66%	1%	1%
Nasdaq 100	56%	50%	5%	5%
European Stoxx 600	64%	52%	3%	4%
Japan Nikkei 225	62%	59%	1%	0%
UK FTSE 100	60%	47%	3%	5%
China CSI 300	22%	0%	30%	0%

Source: Bloomberg as at 3 Nov 2021

Legend	
(green)	Improving
(blank)	No Change
(red)	Deteriorating

Economic Heatmap - November 2021

	US	Eurozone	Australia	China	Japan
Headline Unemployment Rate %*	↑ 4.8	↓ 6.8	↑ 4.6	-	↑ 2.8
Real Unemployment Rate %*	↑ 6.6	↓ 7.9	↓ 6.0	-	↓ 3.7
Employment Million	↑ 153.7	↑ 41.4	↓ 12.9	-	↓ 66.5
Manufacturing PMI	↑ 60.8	↓ 58.3	↓ 50.4	↓ 49.2	↑ 53.2
Service PMI	↓ 61.9	↓ 54.7	↓ 45.7	↑ 52.4	↑ 50.7
Retail Sales Yr Growth %	↓ 13.9	↓ 0.0	↑ 1.7	↓ 4.4	↓ -0.6
Consumer Confidence	↓ 71.7	↓ -4.8	↓ 104.6	↑ 121.2	↑ 39.2
Business Confidence	↓ 99.1	↓ 1.8	↑ 13.0	↓ 50.8	↑ 56.7
Industrial Production Yr Growth %	↓ 4.6	↓ 2.9	-	↓ 3.1	↓ -2.3
Housing Starts Yr Growth %	↓ 7.4	-	↓ 12.8	↑ -13.5	↓ 4.3
Official Interest Rate %*	→ 0.3	→ 0.0	↑ 0.1	↓ 2.3	↓ -0.1
Producer Prices Yr Growth*	↓ 8.6	↓ 13.4	-	↓ 10.7	↓ 7.2
Inflation CPI Yr Growth*	↓ 5.4	↓ 4.1	↑ 3.0	↑ 0.7	↓ 0.2
Money Supply Trillion	↑ 21.0	↑ 15.2	↑ 2.6	↑ 234.3	↑ 1520.7
Google Mobility Index	↓ -3.8	↓ 3.3	↑ -11.2	-	↑ -3.8

Source: Bloomberg and Google as at 3 Nov 2021

*Reversed

vs. prior	
↑	Improving
↓	Deteriorating
→	Steady

vs. history	
(green)	Better
(pink)	Worse
(beige)	In line

[1] Bull territory refers to year on year price change over 20%.

[2] Bear territory refers to year on year price change below -20%

Region	Data	Now	4 Weeks Ago	8 Weeks Ago	1 Year High	1 Year Low	3 Year Average
Global	Baltic Dry Index	4577	4496	3959	5057	1172	1674
	Global M&A Value Rolling 8 Weeks Mln$	755	701	777	912	528	569
	Global Flight Numbers	94988	94195	90417	95411	60948	67721
	Global Oil Floating Storage kbbl	102625	90072	92127	130616	79706	90782
US	Financial Stress Index	-0.6	-0.7	-0.6	0.5	-0.8	0.0
	FRA to OIS Spread Bp	10	8	4	17	4	21
	Capital Expenditures Intention Index	32	34	23	34	16	19
	Total Unemployment Benefit Recipients 000	2831	5028	12186	21531	2831	10972
	US Oil and Gas Operating Rig Count	543	527	496	543	300	643
Europe	Passenger Car Sales	-24.1	-21.8	-23.6	265.0	-24.5	1.2
	Core CPI Yr Growth %	2.1	1.9	1.6	2.1	0.2	1.0
	Inflation Expectation Yr Growth %	1.9	1.8	1.7	2.0	1.1	1.3
	ECB Total Assets Bln€	8366	8289	8208	8368	6797	5927
Australia	Job Advertisements	203428	191564	197058	203486	147313	155376
	Auction Clearance	79	84	67	86	55	66
	Total Credit Yr Growth%	5.3	4.7	4.1	5.3	1.0	3.0
	Trade Balance Mln$	15077	12650	11680	15077	5440	6617
Asia	South Korea Preliminary Exports Yr Growth %	36.1	22.8	40.8	53.2	1.2	3.2
	Taiwan Exports Yr Growth %	29.2	26.9	34.7	38.6	9.7	8.9
	China Iron Ores Port Inventory Million Tonnes*	142820	130780	122550	142820	114260	118210
	China GDP Growth Proxy - Li Keqiang Index	6.8	5.9	7.5	17.6	5.9	8.0
	China Passenger Car Sales Yr Growth %	-16.2	-11.1	-6.8	408.9	-16.2	6.3
	China Loan Growth Yr Growth %	11.9	12.1	12.3	12.9	11.9	12.8
	China Passenger Traffic Yr Growth%	-19.4	-41.7	35.9	154.6	-52.6	-1.3
	Japan Machine Tool Orders Yr Growth%	71.9	85.2	93.4	141.9	-6.0	0.0

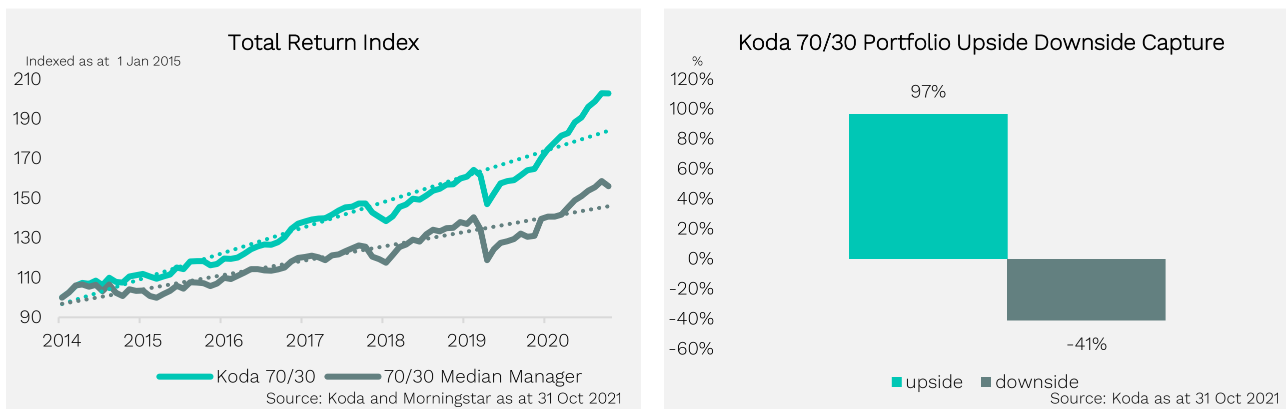
Source: Bloomberg as at 3 Nov 2021

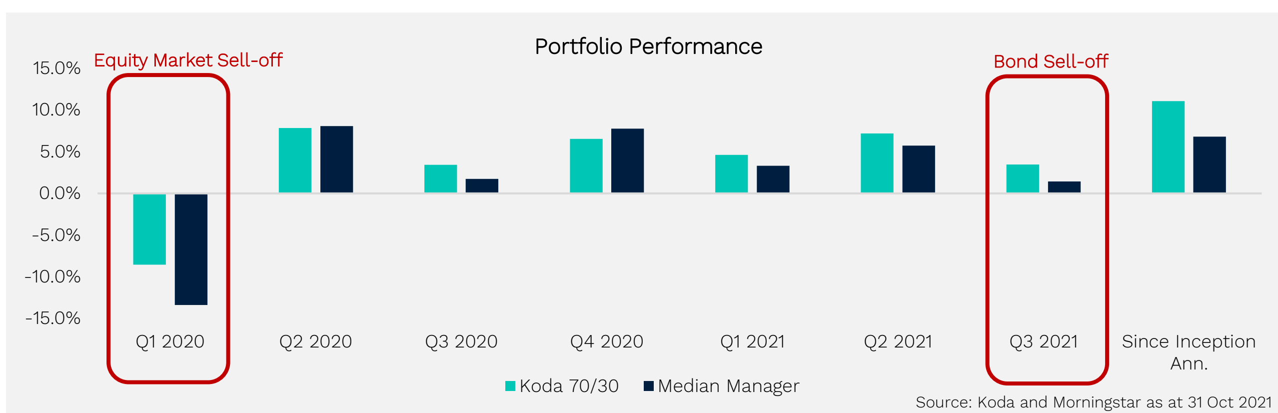
*Colour reversed

Colour	Meaning
Green	Improving
Beige	Steady/fluctuating
Red	Deteriorating

Section 3: Asset Allocation

Our reference portfolios continued to deliver very strong returns in Q3 2021. More importantly, portfolios are largely immune to recent sell-offs in bond markets due to near-zero exposure to developed markets sovereign bonds. Our investment philosophy of investing across the cycle is proved to help portfolios to navigate through the market gyrations. Since inception, the flagship portfolio since has captured 43% of down markets (defined by the diversified peer group), and 97% of upside.





In Q3 2021, investment market sentiment started to moderate as markets are increasingly concerning the stagflation outlook. In the current environment, we are neither adding risk to portfolios nor seeing to outright de-risk – see our portfolio construction framework below. However, for portfolios significantly deviate from our models, ensure that such portfolios have near-zero exposure to government bonds in developed markets have no more than modest exposure to S&P 500/ASX 200 risk.

Portfolio Construction Framework

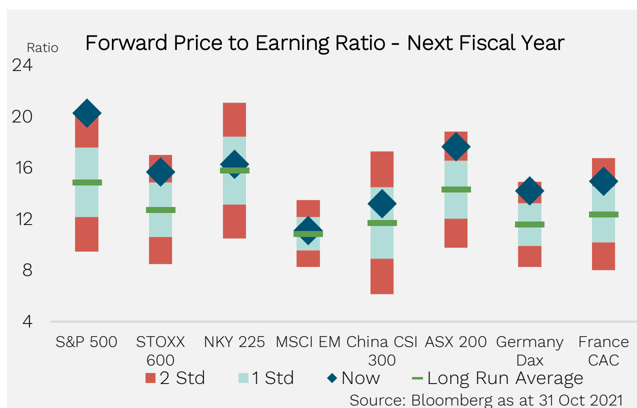
	Three Months Ago	**Now**	**Next Six Months**
Earnings/economic Growth	Very Strong	Strong	Moderate
Liquidity	Strong	Strong	Moderate
Valuation	Very Stretched	Stretched	-
Portfolio Positioning		**Unchanged**	

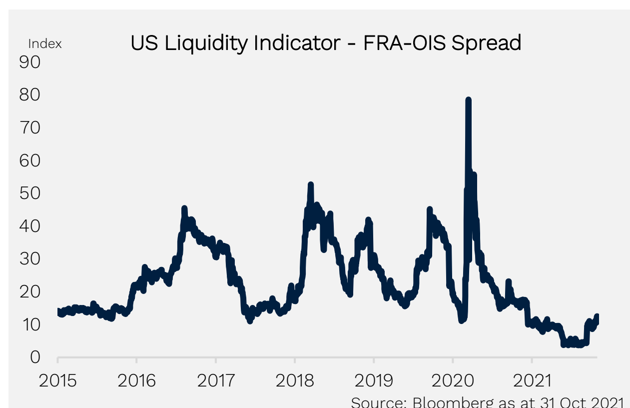
The underlying economic and earnings growth has been very strong in the past six months due to the fast vaccine rollout, strong government stimulus and solid consumer demand coming off a low base from 2020. However, growth figures in the US and Europe are expected to have peaked in Q2 and Q3 respectively, and should normalise to pre-COVID levels. Add on top, a range of growth headwinds, including labour shortages, wage pressure, logistics costs and elevated raw material and energy prices, are weighing on the corporate margins and profit outlook. At present, the markets expect the US S&P 500 to deliver 30% earnings growth in the current Q3 reporting season. And the growth is estimated to moderate to 20% in Q4 and near 5% in Q1 2022.

Liquidity is going to moderate. The US Federal Reserve is expected to start tapering its asset purchases since November and possibly hike interest rates in late 2022. Globally 11 out of 27 major central banks have already hiked interest rates in the past four months due to the inflation and overleverage issue. However, we do not expect the upcoming tapering or tightening to significantly disrupt the investment fundamentals. *Why?*

1. US Fed tapering and rate hikes do not necessarily lead to equity market sell-off. US S&P 500 actually performed very well during the taper-tantrum in H2 2013 and rate hikes in 2017. The negative impact from tapering or tightening can be fully offset by improving economic fundamentals. Some stocks, such as banks, can even outperform when interest rates rise. By contrast, interest-sensitive government bonds significantly underperform when liquidity moderates.
2. The current elevated inflation cannot be fully fixed by rate hikes. Although tapering or rate hikes can reduce inflation *via* the channel of inflation expectations (*ie* wages) and property prices, central bankers can hardly do anything on hiring more truck drivers or exploring more oil. Therefore, a re-run of Volcker's aggressive rate hikes (*ie* Fed official rate at 10%) is unlikely. A mere monetary policy normalisation (as seen as 2017-2018) will create more volatilities but will not end the bull market.

Valuation-wise, equities have mildly moderated on the solid earnings growth. However, most equity markets, including US, Europe and Australia, are still over one standard deviation more expensive than long run average. By contrast, China and Japan have largely pulled back to fair value after the recent sell-off. By contrast, bonds are still very expensive at the current level. Real yields are still negative at -1% and IG bond spreads are very tight.





In defensive assets, portfolios remain overweight private debt and underweight traditional bonds, in particular sovereign bonds. We started to overweight private debt in late 2017/early 2018 and this has been our key deviation from the market consensus. Our private debt strategies utilise the market dislocations as banks retreat from SME and property developer lending due to regulatory capital cost. Despite the recent yield compression from the general credit markets, our selected strategies continue to deliver equity-like returns with low risk and volatilities, plus being floating rate will handle higher rates of inflation. By contrast, our portfolio has near zero exposure to sovereign bonds in the developed markets. We intentionally reduced our duration exposure and as a result, our defensive strategies are largely immune from the volatilities seen in the general US treasury market since the beginning of the year.

For equities, portfolios have moderate exposure to beta (*i.e.* market risk) and continue to focus on alpha generation. We remain neutral on overall developed market equities and mildly underweight US as the valuations are stretched. We continue to overweight China and more broadly selected emerging markets which benefit from commodity prices and moderate valuations. Domestically, we still prefer highly active and concentrated strategies.

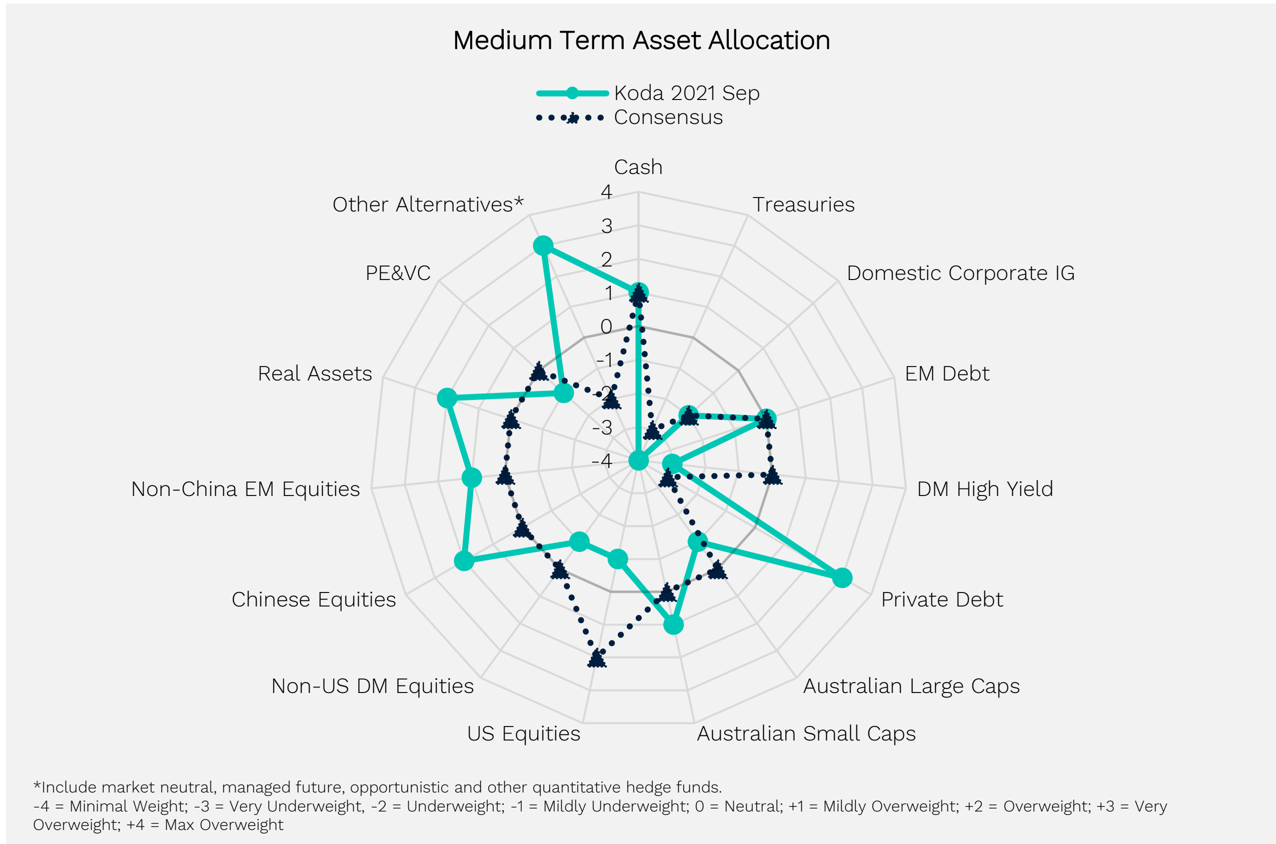
At present, markets are distorted by a series of noisy events, including the Evergrande default, China slowdown, the broad-based energy shortage and the concerns of persistent inflation. Some assets will significantly underperform when these headwinds materialise. However, as your financial advisor, our job is to make sure that your portfolio, as a whole, is resilient to any extreme market events, whether it is the black swan like COVID-19 or the grey rhino like the current bond sell-off.

How do we do that? **We specifically take smaller exposures to a <u>lot</u> more risks.** The classic approach to a 70% growth 30% defensive portfolio is about 50% in Australian and US/EU equities plus 10-20% in high duration bonds. We do not build portfolios like that. By way of example, we would rather have a <u>modest</u> exposure to:

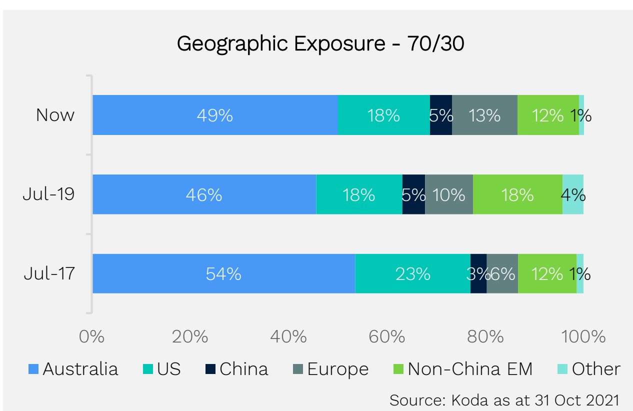
- the risk that the People's Bank of China does not inject sufficient liquidity after a major developer goes into liquidation, or a regulatory crackdown on oligarchs impacts its tech leaders.
- dozens of frontier economies which are unlikely to crash at the same time.
- asset-backed agricultural loans.

Importantly portfolios should not face unrecoverable losses if the RBA miscalculates on its macroprudential tightening and engineers a GFC-like property crash. Such an event is unlikely to affect stocks in Israel, US, Europe *etc*. When something adverse happens, you will likely be worried about 4% of the portfolio, not 30%.

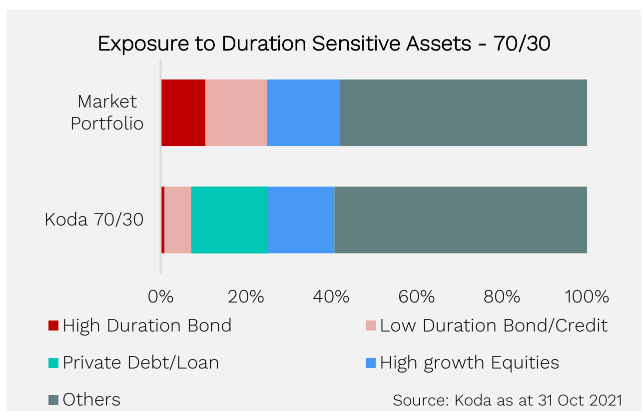
Our investment approach has worked very well in the past two years. During the global crunch in February and March 2020, our portfolios fell around 50%-60% as much as the peer group and captured ~100% of the subsequent rebound. In Q3 2021, when our overweighted position, China, declined as much as 20%, our models still outperformed the peers by 2% due to our positions in energy exporters such as Russia and Frontier markets.



*Include market neutral, managed future, opportunistic and other quantitative hedge funds.
-4 = Minimal Weight; -3 = Very Underweight, -2 = Underweight; -1 = Mildly Underweight; 0 = Neutral; +1 = Mildly Overweight; +2 = Overweight; +3 = Very Overweight; +4 = Max Overweight



Source: Koda as at 31 Oct 2021



Source: Koda as at 31 Oct 2021

From here, we will stick to our philosophy of "*investing across the cycle*." Both bond and equity markets will go through large bumps due to a range of headwinds such as higher inflation, rising bond yields and energy crunch. A 20% sell-off of the US S&P 500 in the next six months is not inconceivable as per Dec 2018. During such a market decline, some assets will underperform, just like China did in Q3. However, the overall portfolio will be resilient to these market noises, due to both solid alpha generation and genuine diversification.

US Bear Market Checklist

	Mar 2000	Oct 2007	Sep 2018	Feb 2020	Now
Valuations					
Trailing P/E	**28.9**	**17.1**	**20.6**	**21.2**	**25.8**
Forward P/E	**24.5**	**15.0**	**16.8**	**18.1**	**21.3**
Dividend Yield	**1.1**	**1.8**	**1.8**	**1.8**	**1.3**
Shiller P/E	**37.0**	**22.7**	**28.4**	**27.4**	**36.8**
Equity Risk Premium (%)	**-3.3**	**-0.2**	**0.7**	**2.1**	**1.2**
Sentiment					
US Yield Curve (%)	**-0.5**	**0.0**	**0.2**	**0.0**	**1.0**
Investor Sentiment	**29.6**	**5.5**	**9.6**	**6.3**	**1.5**
ETF Flows (%)	**11.7%**	**3.9%**	**0.7%**	**0.6%**	**1.1%**
Margin Borrowing (Chg% Rolling 3M)	**34.1%**	**28.5%**	**3.9%**	**4.2%**	**7.2%**
Corporate Behaviour					
Capex Growth (%)	**8.8%**	**21.8%**	**14.0%**	**4.6%**	**-2.1%**
M&A Growth (%)	**18%**	**7%**	**10%**	**4%**	**46%**
IPO Growth (%)	**99%**	**98%**	**73%**	**48%**	**236%**
Profitability					
ROE (%)	**17.9**	**16.4**	**15.0**	**15.8**	**18.6**
EPS Chg% *vs* prior peak	**60%**	**37%**	**31%**	**39%**	**54%**
Balance Sheets and Liquidity					
Asset/Equity (Financials)	**6.0**	**5.7**	**1.5**	**1.4**	**1.5**
Household Debt to GDP (%)	**67.0**	**96.5**	**75.1**	**74.2**	**76.2**
IG Bond Spread (%)	**1.5**	**1.5**	**1.1**	**1.0**	**0.9**
Total Red Flags	**13/17**	**7.5/17**	**2.5/17**	**1.5/17**	**6.5/17**

As at Nov 2021 | **Alarming is 0.5 Flag** | **Alerting is 1 Flag**

● Current Koda
● Current Consensus

	Large Underweight	Mild Underweight	Neutral	Mild Overweight	Large Overweight
Cash					
Cash and cash-like securities				Current Consensus, Current Koda	
Fixed Income					
Treasuries	Current Consensus, Current Koda				
Domestic Corporate IG		Current Consensus, Current Koda			
Emerging Markets Debt			Current Consensus, Current Koda		
Developed Markets High Yield	Current Koda		Current Consensus		
Private Debt	Current Consensus				Current Koda
Equities					
Australian Large Caps		Current Koda	Current Consensus		
Australian Small Caps			Current Consensus	Current Koda	
Developed Markets			Current Koda	Current Consensus	
US		Current Koda		Current Consensus	
Non-US		Current Koda	Current Consensus		
Emerging Markets			Current Consensus	Current Koda	
China			Current Consensus	Current Koda	
Non-China			Current Consensus, Current Koda		
Alternatives					
Real Assets – add agriculture			Current Consensus	Current Koda	
PE and VC			Current Consensus, Current Koda		
Others*	Current Consensus				Current Koda
Currency: AUD/USD			Current Consensus, Current Koda		
Overall Allocation		Current Koda	Current Consensus		

*Others include managed future, market neutral and opportunistic strategies.

As at Nov 2021

Brigette Leckie
Chief Investment Officer | Partner

Brigette Leckie has worked in financial markets since the early 1990s. Previous roles have included Chief Strategist, Chief Economist and Head of Research at Australian, New Zealand and multinational firms including BNY Mellon, Alliance Bernstein, Perpetual and BNP. She has also worked in New Zealand Treasury and served on numerous public and private sector committees.

Bi Zhou, CFA
Research Analyst

Bi Zhou is responsible for undertaking macro-economy and multi-asset research at Koda Capital. Prior to joining Koda, Bi gained experience in analysis and consulting at Aon Hewitt and LVMH Fashion Group. Bi is a Chartered Financial Analyst (CFA) and holds a Master of Professional Accounting from the University of Sydney and a Bachelor of Commerce from Shanghai University of Finance. Bi is a Paraprofessional Interpreter (Mandarin and English) of NAATI in Australia.

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