AUGUST INVESTMENTS UPDATE

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Executive Summary

- **Major global share markets are up +100% from March 2020 lows and +45% from pre-COVID highs.**
- **These gains are supported by strong corporate earnings and highly supportive Government and Central Bank policies.**
- **Future policy direction is key and at this stage is likely to remain loose (positive for markets) into year end.**
- **Corporates keep banging the cost pressure drum whilst the Fed remains steadfast that inflation will be transitory.**
- **All eyes are now on employment growth. "Maximum" employment being the goal before higher interest rates come into play.**
- **Private businesses in China are reminded Beijing is most powerful as they step up regulation.**

The March 2020 bear market low for the US S&P 500 Index was 2,237. Fast forward 17 months and the Index is at 4,522. **Yes, up over +100%. Even if we ignore the crash, the US S&P 500 index is still +45% higher** than the 3,130 seen before the start of the COVID-19 crash.

Can we go higher? Anyone who said No over the past 17 months have hoof marks all over their backs as they got trampled by the bulls. **To us the strong gains are justified** as earnings have recovered swiftly and more importantly Central Banks have been highly supportive.

The latest US reporting season delivered record earnings for the US S&P500 Index. **Analysts expect robust earnings growth for the next 18 months and continue to upgrade these expectations**. We do think these forecasts are achievable but share the view that much of this growth may already be priced into markets. This is no reason to be bearish, just a moderation in share market return expectations over the next 18-months.

Crucial to the future direction of the share market are the actions of the US Central Bank (US Fed). At this stage they are still printing $120B a month and have interest rates set at 0-0.25%. Whilst good for markets, concerns are growing around the longer-term implications of these policies as asset prices continue to surge higher.

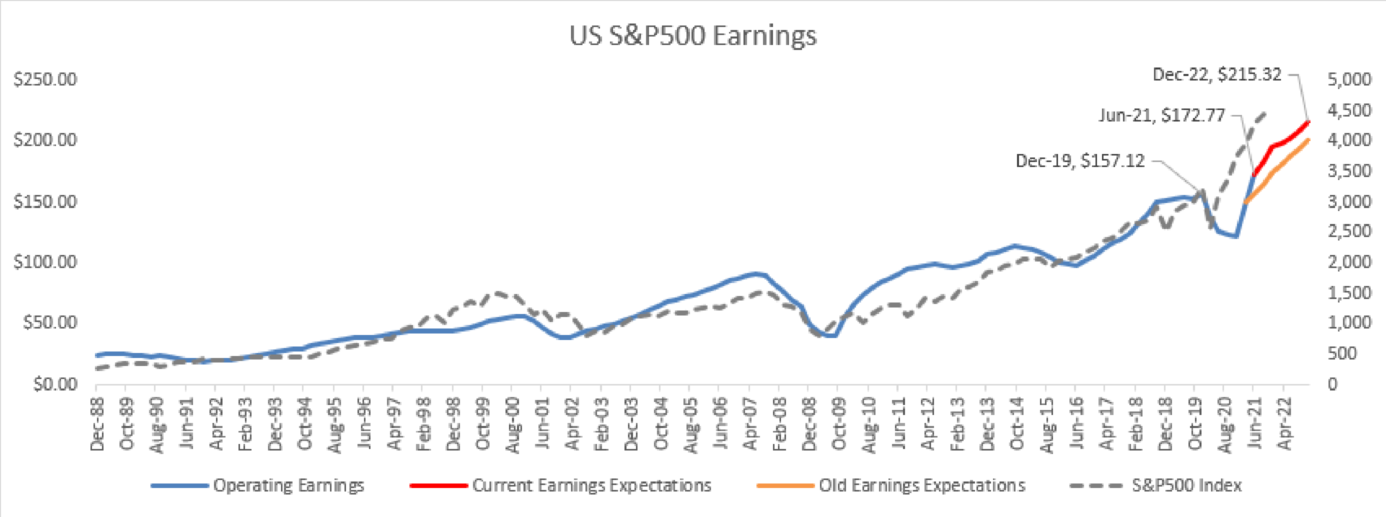
The market is focussed on what the US Fed has to say. Inflation will be "transitory". Corporate CEO's are telling a different story as they see cost pressures in many parts of their businesses. Who wins this tug of war? **The market's focus may shift to what CEO's have to say as we edge to the Fed's goal of "maximum" employment**.

So, it is fair to assume US Fed policy is to remain loose until the remaining 6M jobs lost due to the pandemic are recovered. **The next few job reports are therefore critical as we will learn the impact of the COVID-19 Delta** strain on the US labour market. For now, expectations are for more stimulus and some tapering into year end and throughout 2022.

We remain optimistic about the long-term outlook for markets. Corporate earnings are likely to remain strong and central banks accommodative. A well-diversified approach is likely to deliver the best outcome in the coming months.

US Earnings Boom!

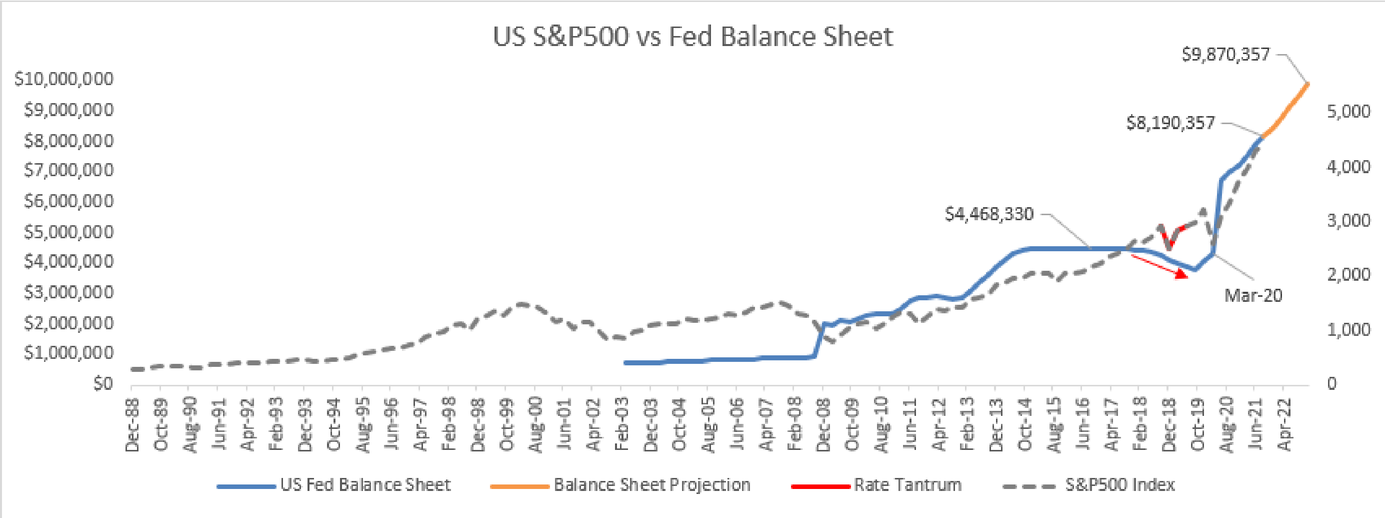
- **The stimulus induced economic reopening set expectations for a strong Q2 reporting season in the US**. **The results did not disappoint**.
- Highlights include:
  - The S&P500 has now **surpassed the pre-pandemic earnings peak** ($172.77 in Jun-21 vs $157.12 in Dec-19).
  - **More companies beat estimates** compared to previous reporting seasons.
  - Companies were **beating estimates by a wider margin** than previous reporting seasons.
- **The strength is encouraging for us as long-term investors**, especially considering the high level of earnings.
- Current expectations are for **earnings to grow by another +24%** ($215.32) over the next 18-months (red line). This is much higher than the $200.95 expected after the Mar-21 reporting season (orange line).



- **We do think this is achievable** as economic policies remain highly supportive of economic growth. Demand continues to outstrip supply and corporates are likely to respond and meet this growing demand.
- **How much of this growth is already priced into share markets?** We think a fair bit as the grey dashed line (S&P500 Index) outlines in the above chart.
- The **risk to markets is slowing or declining earnings** as seen in 2001, 2008, and 2015. We think this is the lowest probable outcome at this stage. We are now focussed on how fast the labour market recovers enabling interest rates to rise.
- **We remain broadly diversified in highly liquid ETFs** such as iShares Core S&P/ASX 200 ETF (ASX:IOZ) and Vanguard MSCI Index International Shares ETF (ASX:VGS).

The Fed, Peak Stimulus.

- **Are the emergency policy measures set in place in Mar-20 still needed today**? If not, the current actions of the Central Banks are likely to contribute to the next economic and financial crisis.
- **What are the policies which are still in place today?** In the US, the US Federal Reserve Bank (the Fed) still has interest rates at 0-0.25% and continues to buy $80B worth of Treasury Securities and $40B worth of mortgages per month.
- The below chart shows the massive growth in the Fed's Balance Sheet. The Fed's portfolio of **assets has expanded from $1T in 2003 to $8T today**.

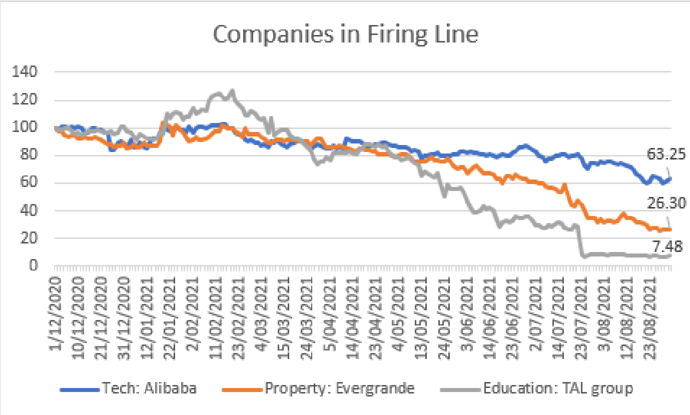


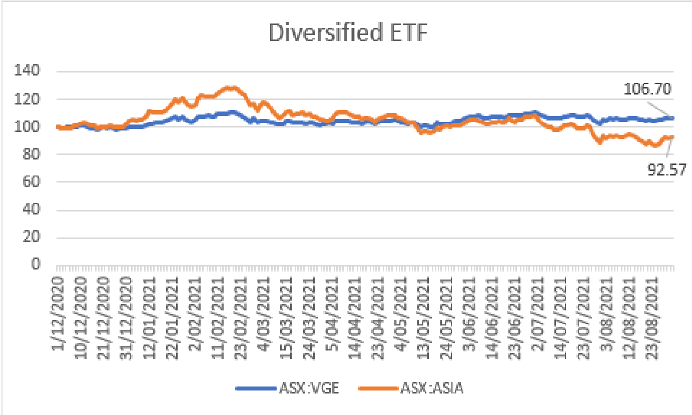
- If they continue to **purchase $80B worth of Treasury Securities and $40B worth of mortgages per month** till Dec22 (hopefully not), the Fed's Balance Sheet is likely to reach $10T (orange line).
- All of **this has been good for share markets** as funding supports the economy (earnings), keeps interest rates low, and drives asset prices higher.
- Some critics are now saying the Fed's mandate is to support asset prices. The Fed disagrees with their official mandate being "**two goals of price stability and maximum sustainable employment**".
- Let us take a closer look on how these two areas of the economy is faring.
    - **<u>Price Stability (Inflation):</u>** Consumer inflation is running hot with the last 4 core inflation prints being 3.0%, 3.8%, 4.5%, **4.2% (July) vs the Fed's goal of average core inflation of +2.0%**. Was June the peak in consumer inflation?
    - **<u>Employment:</u>** The official **US unemployment rate is +5.4% which is higher than the pre-pandemic low of +3.5%**.
- Most recently US Fed Chair Jerome Powell has said that **for inflation they have met the test of "substantial further progress"**. He also said there has "**been clear progress toward maximum employment**".
- This progress has seen the US Fed take the view that "**it could be appropriate to start reducing the pace of asset purchases this year**."
- **The hard work starts now. Removing the punchbowl which is still being filled with $120B of liquidity each month.**

Beijing Flexes its Regulatory Muscles.

- "*It is normal for innovation to be ahead of regulation, but when innovation is too far ahead of regulation …far beyond regulator's imagination, it is no longer normal…"* Jack Ma, Oct-20.
- Is this perhaps the phrase that served as a catalyst to **re-balance the relationship between the Chinese Government and Private business**? We think so.
- Beijing continues to flex its regulatory muscles impacting several listed companies:
    - Initially the **shelving of the Jack Ma founded Ant Group IPO** in Nov-20.
    - **Alibaba was fined US$2.8B** after an investigation found it abused its market dominance in April-21.
    - US listed **Didi Global placed under cyber security review** in Jul-21.
    - Food delivery platforms ordered to **pay drivers minimum wages** in Jul-21.
    - **Barring "tutoring for profit"** in core school subjects and restriction of foreign investment in Jul-21.
    - Local governments to **keep home prices at reasonable levels** and make it an urgent task in Jul-21.

- These moves have had a **damaging outcome for shareholders in education and property** related stocks, but not as much in the technology sector (left chart). This is likely because investors know the **importance of the technology sector for Beijing** as they seek to compete with the US.





- We see two key themes playing out in China:
  - Government knows **the power of technology companies** and that is a risk. Even more so in an autocratic political system.
  - **Inequality is bad and needs to be avoided**. Even if it comes at an economic cost to shareholders as seen in the above chart.
- At this stage we remain invested in Emerging Markets as a long-term theme. The middle class is likely to continue to grow as a proportion of the population. We do however prefer a diversified approach, and **this is another example why diversification is important**.
- Despite the actions in Beijing, the Asia Technology Tigers ETF (ASX:ASIA) is down -7.43% since December 2020 and the broad Emerging Market Index (ASX:VGE) is up +6.70% (excl. dividends).

ASSET CLASS PERFORMANCE

	August Return	12-Month Return
Australian Equities	+2.50%	+28.15%
International Equities	+2.49%	+29.76%
Australian Property	+6.26%	+30.75%
International Property	+1.86%	+36.08%
International Infrastructure	+2.17%	+21.35%
Australian Fixed Interest	+0.09%	+1.05%
Commodities	-2.30%	+43.86%
AUD / USD	-0.39%	-0.81%

Sources
Australian Equities: S&P/ASX 200 Accumulation Index. International Equities: MSCI World Index(USD). Australian Property: S&P/ASX 200 A-REIT Index. International Property: S&P Global REIT (USD). International Infrastructure: S&P Global Infrastructure Index (USD). Australian Fixed Interest: Bloomberg AusBond Composite 0+Yr Index. Commodities: S&P GSCI Index(USD).

- **Australian Equities**
  - The S&P/ASX200 Index posted a +2.50% return for the month of August resulting in a still healthy 12-month return of +28.15%.
  - Top-performing sector was the Technology sector gaining +16.81% in August. The sector strength driven by the +39.2% gain in the Afterpay share price. This came on the back of a takeover offer from US listed digital payments company Square.
  - More broadly defensive sectors remained in favour with the Healthcare sector posting +6.79% and Consumer Staples sector posting +6.53%.

  - The more economically sensitive sectors underperformed with the Materials sector and Energy sector posting -7.93% and -5.13% for the month. Commodity prices took a breather impacting the share prices of BHP Billiton (-14.7%), Rio Tinto (-16.0%), and Fortescue Metals (-15.7%).
- **International Equities**
  - The MSCI All World Index gained +2.49% for the month of August and +29.76% over the year. The strength of the last month largely driven by US and Japanese stocks.
  - The US S&P500 Index gained +3.04% over the month with the S&P Japan500 Index also posting a strong +3.03%. The S&P Europe350 Index was weaker but still posted a respectable +1.52% for the month.
  - Emerging Markets also managed to post a healthy +2.77% despite some negative sentiment toward the regulatory push out of Beijing. It did however result in a more muted +0.27% for the S&P China500 Index.
- **Property and Infrastructure**
  - Australian Property Index was the best performing asset class over the month posting +6.26% despite ongoing lockdowns across Australia.
  - Global Listed Property (Hedged) gained a more modest +1.86% over the month but remains one of the best performing asset classes over a 12-month period.
  - Hedged Global Listed Infrastructure gained +2.17% over the month and is set to benefit as the global economic reopening gains momentum.
- **Fixed Income**
  - The Bloomberg Australian Bond Index gained +0.09% over the month and +1.05% over the past 12-months.
  - These low returns are likely to continue for some time with the 10-year Australian government bond yield paying investors a mediocre +1.20% per annum.

If you have questions regarding investments, please don't hesitate to contact us to speak to one of our experts.