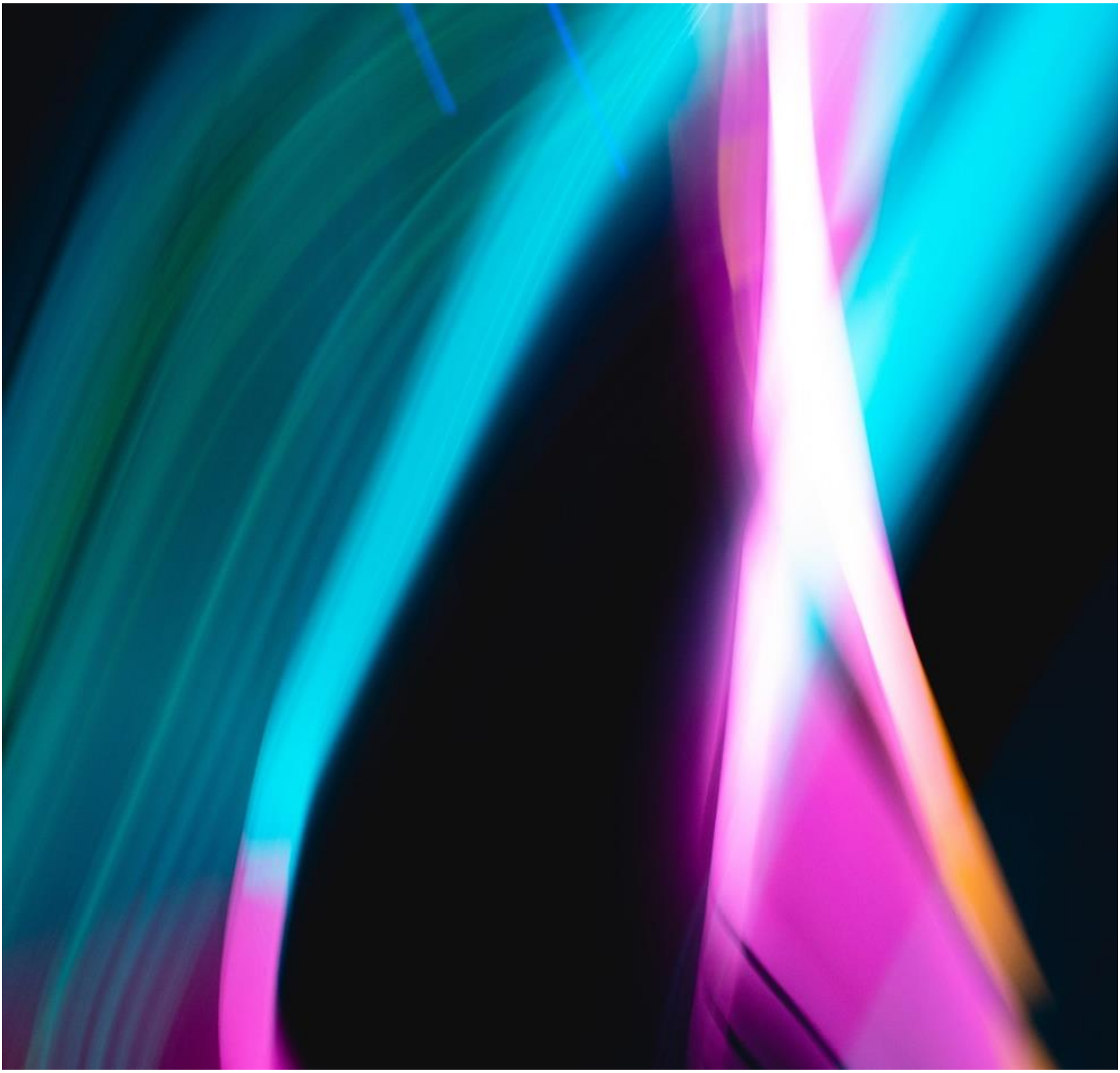
INVESTMENT ENVIRONMENT UPDATE

JANUARY 2023

PATRIZIA ADVISERS



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Prime Super

Investment Environment Update

The 2023 calendar year commenced with a strong rally across both growth and defensive asset classes, with growing optimism about a peak in inflation – and, in turn a less aggressive central bank policy tightening path than previously expected – buoying markets. Nonetheless, the potential for more persistent inflation remains a risk both in Australia and globally, with recent Australian inflation data and US labour market tightness suggesting price pressures may linger for some time.

The key Australian data print released in January was the fourth quarter 2022 consumer price index (CPI), which came in well above forecasts, with a 1.9% quarterly increase taking the year-on-year figure to 7.8% - the highest since 1990. Despite rising rents and utilities, housing as a category contributed less than 0.1% to the headline figure, with recreation the big driver behind the uptick, rising 5.4% as households continued to increase spending on post-pandemic travel and leisure. Domestic holiday and travel accommodation proved particularly strong, with prices rising 13.3% over the quarter. The trimmed mean, which removes more volatile price components, also remained elevated at 1.7% over the quarter and 6.9% over 2022, suggesting inflation is likely to remain broad-based and may become more entrenched, likely providing the Reserve Bank of Australia (RBA) with increased impetus to continue hiking rates in the coming months.

By contrast, employment data for December was slightly weaker than expected, with nearly 15,000 jobs lost compared to a market consensus estimate of a 30,000 gain. That said, an increase in people working fewer hours over the month likely contributed to a slight 0.2% fall in the participation rate from an all-time high to 66.6%, with the unemployment rate remaining at a revised, seasonally-adjusted 3.5%.

Given the above-expected inflation data (in particular the trimmed mean), the RBA's early February meeting met market expectations, with the official cash rate raised 0.25% to 3.35%, its highest level since mid-2012. The statement by Phil Lowe struck a relatively hawkish tone, noting that inflation is not expected to return to around 3% per annum – the upper bound of the bank's target – until around mid-2025; later than previous forecasts.

Asset Class Returns	January (%)	3 Months (%)	12 Months (%)	3 Years (% p.a.)
Cash	0.27	0.77	1.52	0.61
Australian Fixed Interest	2.76	2.20	-6.26	-2.74
Overseas Fixed Interest	2.10	3.15	-8.94	-3.08
Australian Equity *	6.29	9.46	11.61	5.98
Developed Overseas Equity (unhedged) *	2.97	-0.72	-7.90	5.75
Developed Overseas Equity (fully hedged) *	6.23	6.19	-8.30	6.18
Emerging Markets Equity (unhedged) *	3.84	10.85	-12.13	-0.31

** Returns reflect the relevant accumulation indices.*
Source: Bloomberg, Datastream, PATRIZIA Advisers.

The RBA also swiftly removed any notion that rate hikes will pause, flagging that further increases are expected in the coming months to ensure high inflation remains temporary. The RBA also reiterated the increasing difficulties it faces in setting policy, noting that the path to achieving an economic soft landing ‘remains a narrow one’. Accordingly, the market-implied rate curve lifted post-meeting, with the expected terminal rate rising to a peak of around 4.1% by mid-2023.

Retail sales materially surprised to the downside, posting a 3.9% month-on-month decline in December. Non-food retail saw the biggest decline, falling 8.5% for the month, with department store and clothing sub-categories falling by over 13%. While there are nuances around the data given seasonal adjustments and complications around the surge in Black Friday sales in November, it suggests a decline in consumer activity in response to rising interest rates. Despite the deterioration in retail data, consumer confidence improved, with the Westpac-Melbourne Institute survey recording a 5% increase in January, following on from an increase in December. That said, at 84.3, it remains firmly in pessimistic territory (that is, a reading below 100). While households’ economic and personal finance outlook improved, planned expenditure for major items remained poor.

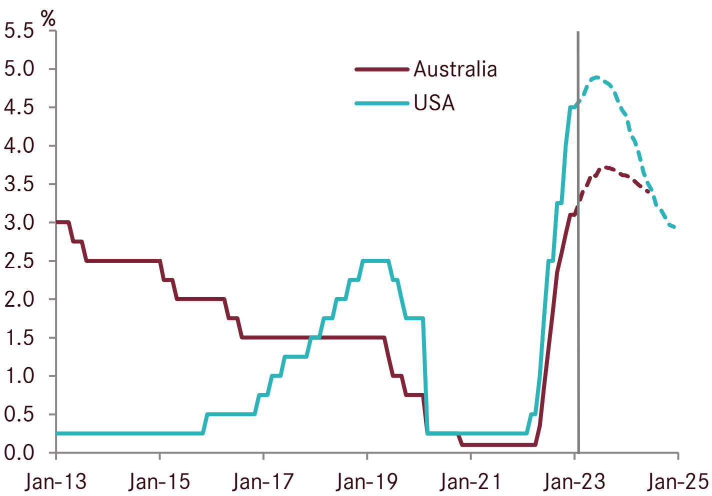
House prices continued to fall at a rapid rate in January, with the annual pace of declines nationally reaching 8.7%, the fastest in at least four decades. Declines have been broad-based, although low transaction volumes over December and January can make this data less reliable. In Sydney, the largest city, house prices are down 14% year-on-year – the sharpest annual drop in 40 years. Housing finance data has also continued to plummet, with the total value of approvals excluding refinancing falling 4.3% in December, and over 25% for 2022.

In the US, inflation appears to have peaked, with the CPI print for December revealing a sharp decline in energy prices and falls in some food items, with prices falling 0.1% for the month overall, and taking the year-on-year figure down to 6.5% over the 2022 calendar year. While this may be interpreted as a sign that the Federal Reserve may well be successfully engineering a ‘soft landing’, there remain signs that price deflation is yet to broaden out, with other categories – such as clothing – continuing to rise at a brisk pace.

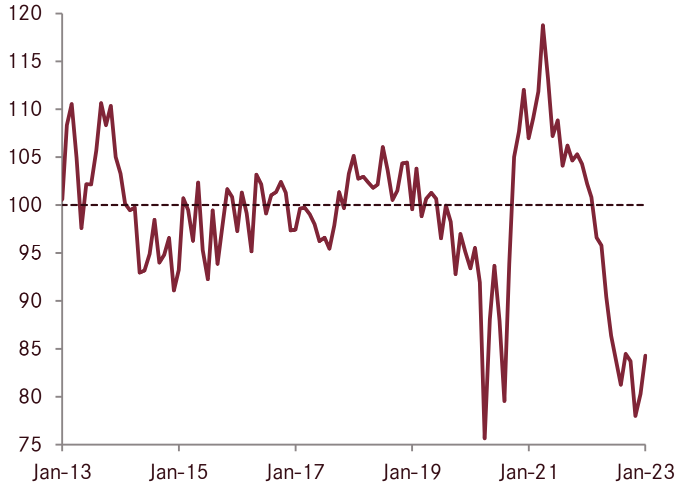
US fourth quarter GDP data was also released in January, with the world’s largest economy growing at a healthy annual rate of 2.9%, albeit with consumption growth relatively more modest, including a slowing in services growth and minimal change in goods consumption over the second half of the year. The slowdown in fourth quarter GDP growth suggests a likely further easing in the growth of the US economy over the first half of 2023.

Following its dovish tilt in late 2022, the US Federal Reserve’s Open Market Committee (FOMC) lifted its target rate by 25 basis points at its 1 February meeting, lifting the range to 4.50% to 4.75%, the highest since late 2007. While Chair Powell noted that inflation was showing signs of easing, he reiterated that it remains elevated, and accordingly there was no suggestion that a cut in rates was likely in the coming months. Two days after the FOMC’s meeting, US employment data smashed forecasts, with non-farm payrolls recording over half a million jobs added compared to forecasts of 185,000. The unemployment rate fell to 3.4% - a level last seen in May 1969. While Powell’s comments on inflation were considered dovish overall, the jobs data suggests rate hikes will continue in the coming months, with at least two further 25 basis point hikes priced in for March and May.

Australia and US Cash Rates



Westpac-Melbourne Institute Consumer Sentiment



Source: Bloomberg

While the war in Ukraine remains a battle of attrition over the northern winter, with limited change in territory and the widely-publicised delivery of tanks by other European countries to Ukrainian forces, the European economy continues to grapple with high inflation and weak growth – although a warmer than typical winter has at least offered some reprieve from soaring heating costs, as did a one-off German government subsidy that covered the entire gas bills of most German households for the month of December. The European Central Bank (ECB) raised interest rates by an as-expected 50 basis points at its early February meeting, lifting the main refinancing rate to 3.0% - its highest level since 2008. The ECB also noted that it will hike rates by the same margin in March, reiterating its desire to steadily raise rates to drive inflation down to its target of around 2% per annum. The asset purchase programme portfolio was also to be reduced by €15 billion per month from March through to June 2023, with a further review thereafter. In the UK, the Bank of England raised its target rate by the same level as the ECB, lifting it 0.5% to 4.0%.

While headline inflation in the Eurozone fell for a third consecutive month in January, it remains elevated at 8.5% per annum, while core inflation remained unchanged at 5.2% per annum. That said, due to delays in German inflation data, the figures are expected to be slightly adjusted following the release of German data on 9 February. While GDP growth for the region continues to weaken, fourth quarter GDP beat forecasts, with the economy growing 0.1%, staving off any chance of a technical recession until mid-2023 at the earliest.

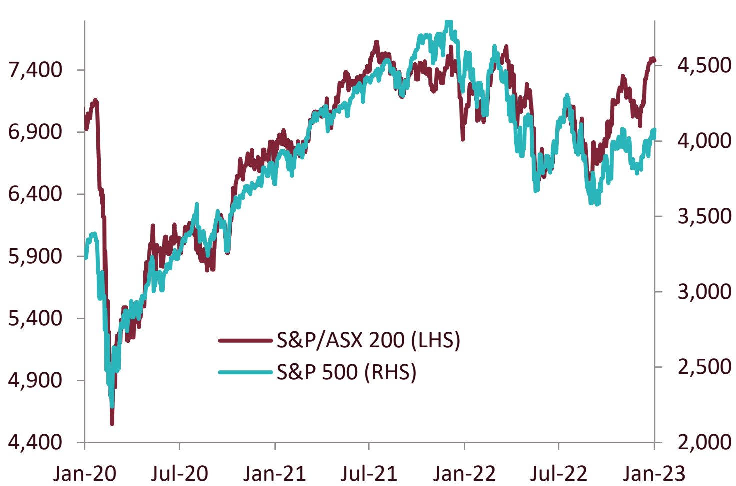
China reopened its borders to international visitors on 8 January, with foreign visitors no longer required to quarantine. The move comes as part of a broader relaxation of authorities' prior strict "zero COVID" following mass protests, although the move has led to a surge in cases, overburdening the health sector. The Chinese economy's Q4 GDP print was released in January, coming in at just 3.0% for the year. Other than 2020, it was the weakest print since 1976. Extensive, ongoing lockdowns impacted both consumer expenditure and manufacturing, with exports falling 10% year-on-year in US dollar terms, the sharpest rate since the start of the pandemic in early 2020.

Following its surprise decision to raise its yield curve control target bounds in December, the Bank of Japan made no changes to its policy settings at its January meeting, reflecting its scepticism about the sustainability of inflation remaining at target levels. Attention is now likely to turn to any pivots in policy when the central bank's current governor, Kuroda, steps down in April 2023.

Signs of easing inflation and a looming peak in cash rates across a number of major economies bolstered equity markets locally and overseas over January, both soaring over 6% (the latter on a fully currency hedged basis). Fixed interest returns also benefitted from a decline in long-dated yields, with local and overseas fixed interest returning 2.8% and 2.1% for the month, respectively. A key benchmark US bond rate, the 10-year Treasury bond yield, fell almost 0.5% over January to the start of February, reaching around 3.5%. However, the front end of the Treasury curve increased further given the FOMC's rate hikes, raising the level of inversion on the 3 month versus 10 year spread to over 1% - the highest level in over four decades. An inverted curve is considered a harbinger of recession; by contrast, economist consensus currently suggests that the US will avoid an outright contraction in growth.

US Treasury Yield Differential – 3 Month vs 10 Year

S&P/ASX 200 (Aus.) and S&P 500 (US) Equity Indices



Source: Bloomberg

Index Returns to 31 January 2023

	MONTH (%)	3 MONTHS (%)	FYTD (%)	12 MONTHS (%)
Australian Equities				
S&P/ASX 300 Accumulation Index	6.3	9.5	16.5	11.6
S&P/ASX Small Ordinaries Accumulation Index	6.6	7.6	14.0	-4.4
International Equities				
MSCI World (ex Australia) Index (hedged A$)	6.2	6.2	8.0	-8.3
MSCI World (ex Australia) Index (unhedged A$)	3.0	-0.7	7.4	-7.9
MSCI Emerging Markets Index (unhedged A$)	3.8	10.9	2.1	-12.1
Property				
S&P/ASX 200 A-REIT Accumulation Index	8.1	9.7	12.5	-5.0
FTSE EPRA Nareit Developed ex Aus Rental hedged AUD	8.6	9.5	0.7	-14.9
FTSE EPRA Nareit Developed ex Aus Rental unhedged AUD	5.3	2.4	0.5	-14.6
Australian Fixed Interest				
Bloomberg AusBond Composite Index	2.8	2.2	2.5	-6.3
Global Fixed Interest				
FTSE WGBI ex-Aust (hedged A$)	2.0	1.8	-3.0	-10.7
Barclay's Global Capital Aggregate Bond Index (hedged A$)	2.1	3.2	-1.1	-8.9
Cash				
Bloomberg AusBond Bank Bill Index	0.3	0.8	1.4	1.5
Commodities				
Gold (US$ per ounce)	6.1	17.4	5.9	7.2
Copper (US$ per metric tonne)	10.2	23.8	11.7	-3.0
WTI Crude Oil (US$ per barrel)	-1.7	-8.9	-25.4	-10.5
RBA Index of Commodity Prices (A$)	1.8	-9.4	-9.9	9.6

Australian Dollar versus Foreign Currencies to 31 January 2023

AUSTRALIAN DOLLAR VERSUS	AS AT 31 JANUARY 2023	MONTH (%)	THREE MONTHS (%)	FYTD (%)	12 MONTHS (%)
US Dollar	0.70	3.9	10.2	2.5	0.0
British Pound Sterling	0.57	1.5	3.1	1.1	9.0
Euro	0.65	2.1	0.3	-1.4	3.2
Japanese Yen	91.64	2.4	-3.6	-1.9	12.9

Source: Bloomberg

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