



# Quarterly Investment Report July 2022

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Balancing Act

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## Summary

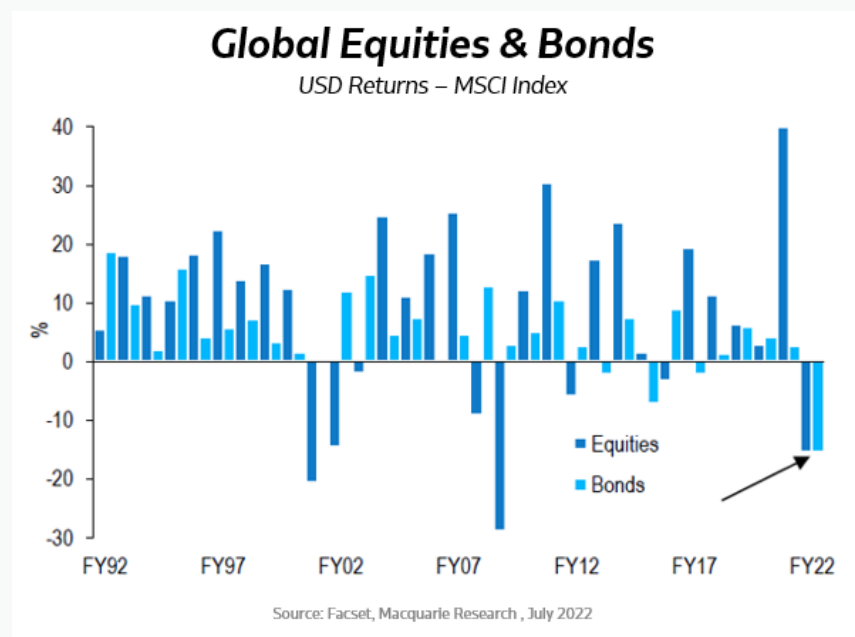
The post-pandemic narrative quickly receded into concern over lingering inflation and higher interest rates. Equities and bonds suffered significant losses in the face of this uncertainty.

In fact, it's the first-time global equity and bond indices have fallen over -10% in the same 6-month period (1H-22); typically the two are less correlated.

It's the first-time global equity and bond indices have fallen over -10% in the same 12-month period (FY22)

If these trends continue, the commitment from central banks to restrain inflation will come at an economic cost

We expect financial market concerns to shift from inflation to growth in 2H-22, focusing on the magnitude of the global slowdown (shallow or deep).



The inflation challenge facing central bankers today is more nuanced than what it was just 12 months ago. The ongoing war in Ukraine has driven up the costs of energy, food, and other key commodities, while recent factory closures in China (COVID-19) have exacerbated supply pressures that might otherwise have eased by this point.

If these trends continue, the commitment from central banks to restrain inflation will come at an economic cost. For now, this cost is somewhat offset by a robust job market and strong corporate spending. Given the significance of the U.S. economy, attention is firmly on them.

While our research partners don't see a global recession this year, they and many other commentators see an increasing probability of a mild one occurring in 2023.

One could argue that the biggest reason to believe a recession is not around the corner is that seemingly everyone in financial markets predicts one. Nevertheless, we expect financial market concerns to shift from inflation to growth in the second half of 2022, focusing on the magnitude of the economic slowdown (shallow or deep).

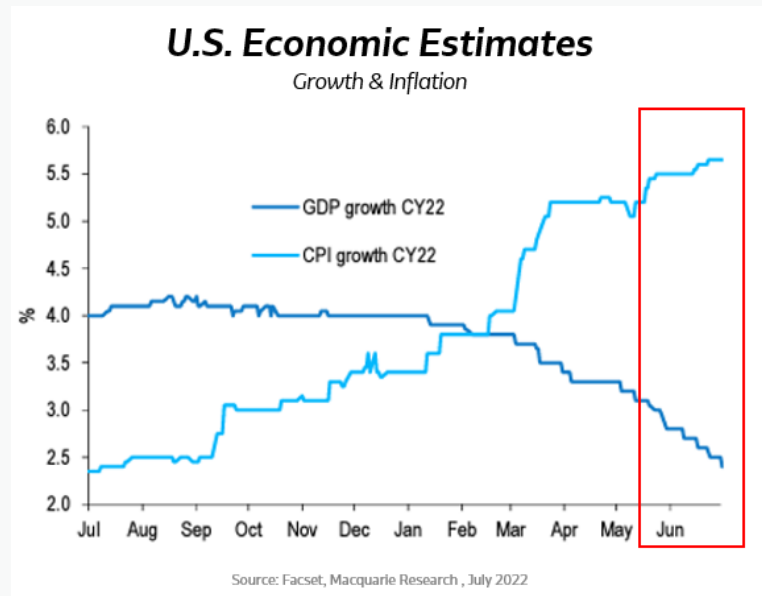


Front loading rate hikes to cool demand is considered essential in ensuring the next recession is mild, as opposed to a further deteriorating outlook (stagflation).

Dealing with uncertainty is part of investing and an ample reason why fear and greed habitually exaggerate market cycles.

Fixed interest managers have built valuable yield buffers into their portfolios, which should provide some positive real returns over the medium term.

Ironically, due to the unconditional focus on inflation, bad economic news will likely be considered good news over the coming months, as it should mean less pressure on prices. Front-loading rate hikes to cool demand is considered essential in ensuring the next recession is mild, as opposed to a further deteriorating outlook (stagflation).



At this point, investors need to keep in mind that the economy does move in cycles, and the outlook, although challenging, is not permanent. Dealing with uncertainty is part of investing and an ample reason why fear and greed habitually exaggerate market cycles.

Renowned investor Howard Marks highlighted the predictability of investor behaviour in a recent memo by stating, "the events of investment history don't repeat, but familiar themes do recur, especially behavioural themes (fear & greed)."

There are a lot of potential outcomes for financial markets over the near term, and the only certainty is that the path will be volatile. Investors face new challenges in the year's second half, given both the slowing momentum in the global economy and persistent inflation.

Periods of weak performance are never comfortable, but if we take a longer-term view, the recent volatility has some positives.

With the recent spike in bond yields, fixed interest managers have built valuable yield buffers into their portfolios, which should provide some positive real returns over the medium term and, once again, play an important role in balanced portfolios.

The Advisory Board have updated their asset allocation preferences this quarter, closing their three-year underweight to fixed interest, favouring a more balanced allocation between fixed interest and equities post a swift price adjustment.



We are approaching a turning point for asset allocation decisions, a balancing act between growth and defensive assets due to slowing momentum in the global economy and fixed.

The environment for equities over the next 3-6 months will remain challenging.

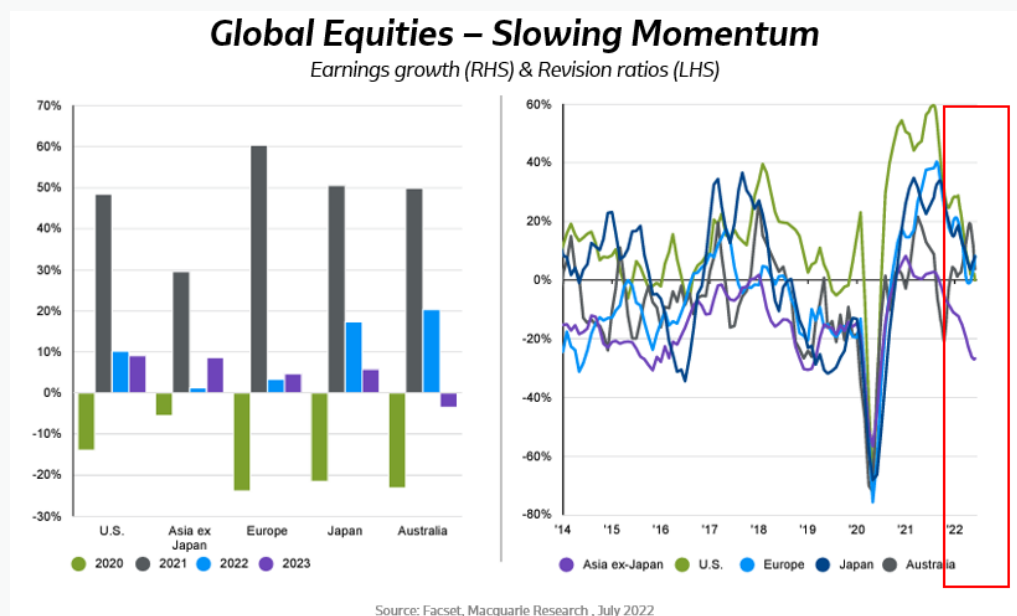
Our neutral allocation to equities reflects equal downside and upside risks to the outlook, both from an inflation and growth perspective, which are month-to-month assessments.

We are approaching a turning point for asset allocation decisions, a balancing act between growth and defensive assets as fixed income becomes more appealing and growth momentum slows.

High-quality bonds can provide a vital downside hedge to portfolios, improving the resilience of portfolios in the face of slower economic growth and moderating inflation, historically a suitable environment for these assets.

We think the environment for equities over the next 3-6 months will remain challenging. Corporate earnings that have held up so far this year look to be slowing.

Notably, equity markets tend to front-run the economy on the decline and the rebound. We believe the uncomfortable price adjustment since the start of the year has likely factored in *some* of the expected slowdown to company earnings, but not all scenarios.



Our neutral allocation to equities reflects equal downside and upside risks to the outlook, both from an inflation and growth perspective, which are month-to-month assessments.

An easing of monetary policy settings could kick the cycle down the road, providing a sugar hit to risk assets.

We believe investors should be disciplined in keeping portfolios on a level footing, maintaining an allocation to risk assets (equities) if the outlook is better than expected, whilst building up fixed interest (bonds) if the outlook is worse than expected.

Our Alternative asset exposure has added meaningful value to clients over the past six months, and we continue to favour this as an essential diversifier.



Overweight

Neutral

Underweight

# Cash

## Themes

- Interest rates are slowly increasing, in line with unwinding of policy settings. It is important to find a balance between liquidity and interest rates.
- Cash offers liquidity for short-term opportunities in a volatile market.

## Strategy

- We have downgraded our Cash allocation to **neutral**.
- An increase in bond yields supports as move from Cash into Fixed Interest given the higher relative returns on offer.
- Cash rates are increasing and maintaining neutral allocation for future buying opportunities.

## Positioning

- **Neutral** – cash remains a reliable means of capital preservation



# Fixed Interest

## Themes

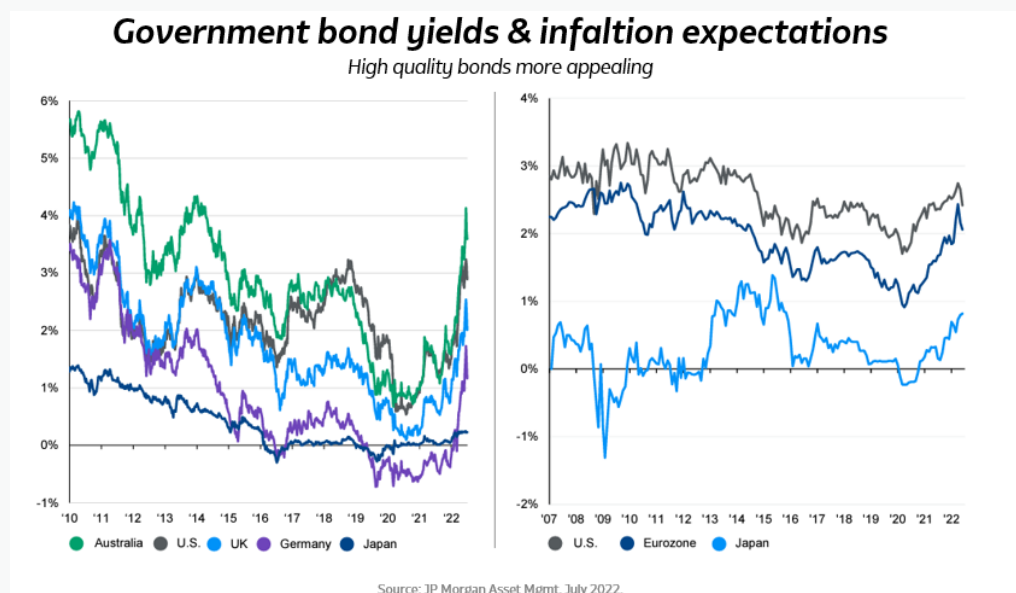
- Global central banks, led by the U.S. have delivered consecutive interest rate rises during Q2022, with global bond yields moving to multi-year highs.
- At the time of writing, 10-year Australian government bonds are now yielding 3.7% and US treasuries yielding +3.0%.
- Short-term rates are likely to continue to increase as the RBA further tightens monetary policy to help bring inflation back to a more acceptable level.
- If there is an economic slowdown or moderation to inflation, longer dated bonds should perform well. Some forecasters believe we are already at peak yields.
- While bond yields have risen dramatically, numerous uncertainties could still push them higher (persistent inflation), albeit we expect a slower pace.

## Strategy

- We upgrade Fixed Interest to **neutral** for the first time in 3 years.
- Long duration bonds now offer attractive income returns, with the potential for capital gains if yields soften.
- We maintain a healthy exposure to floating rate notes and private debt/credit which have provided a hedge against rising rates.

## Positioning

- **Neutral** – adding to long duration bond and floating rate strategies.







# Australian Equities

## Themes

- The S&P/ASX 200 Index lost -11.9% over the quarter. Australian shares lost ground but not to the same extent as major markets overseas.
- The resource sector was the worst hit (-23.8%) as recession fears leave cyclical sectors vulnerable. This rhetoric is a headwind for consumer discretionary stocks.
- Despite a recent fall in commodity prices, Australia continues to be well placed to outperform global equities through 2022 with stronger economic indicators.
- Company outlook comments will be closely watched this reporting season.

## Strategy

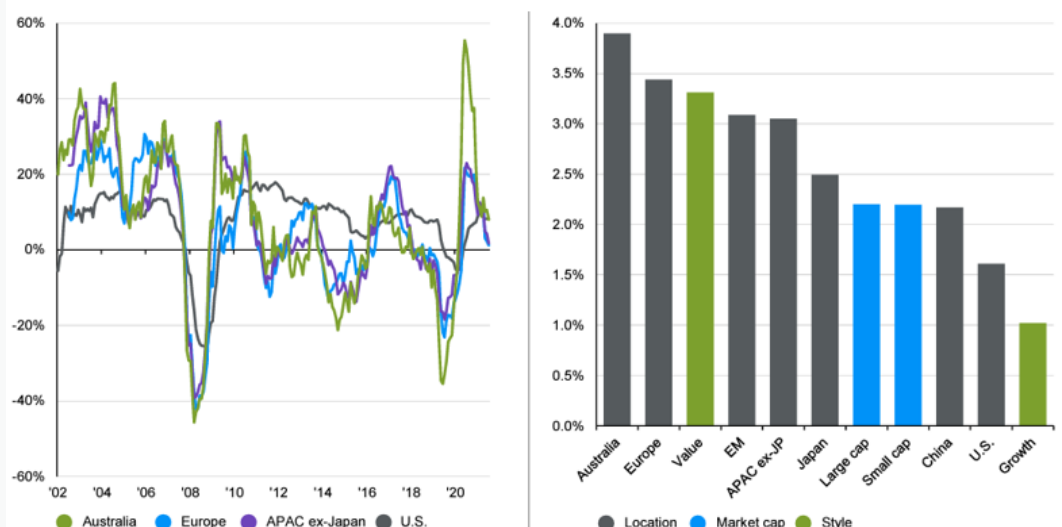
- We maintain our **neutral** position to Australian Equities.
- Australia is insulated from overseas risks (Ukraine) and supported by fundamentally stronger sectors (Resources, Financials).
- Higher dividend yields compared to global peers provides valuation support.
- We are inclined to move overweight into any future market correction until we get clarity on future earnings. Valuations can improve if we see earnings begin to fall.

## Positioning

- **Neutral** – use correction in market prices to add to Australian Equities.

### Dividend Yields – Global Equity Markets

Australia remains attractive



Source: JP Morgan Asset Mgmt, July 2022.





# Global Equities

## Themes

- The MSCI World Index returned -15.66% over the first quarter of 2022, whilst the MSCI Emerging Markets index down -11.45% over the same period.
- Over the short-term, there are many uncertainties that continue to overhang the macroeconomic backdrop (war, inflation, interest rates).
- The direction of equity markets will hinge on inflation data over the short-term.
- US corporate earnings look to be slowing. High-profile downgrades from U.S. companies in June 2022 suggests earnings momentum is likely to slow.
- Europe and EM are most vulnerable to the Russia-Ukraine conflict. Globally, however, safeguarding portfolios against this energy shock will be imperative.

## Strategy

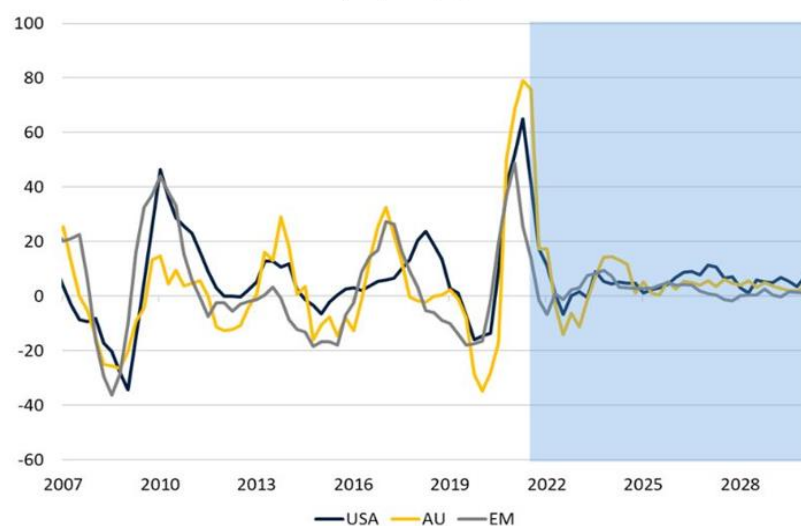
- Maintain our **neutral** position to Global equities with less conviction on Developed markets over the short-term given multiple uncertainties.
- We exited our direct European investments earlier in the year and maintain exposure to other developed regions (U.K. and U.S.).
- We prefer developed markets relative to emerging markets due to these regions being severely impacted by geopolitical and macro economic issues.

## Positioning

- **Neutral** – developed market valuations are now back to normal with a preference for quality/growth strategies as the cycle matures.

### Earnings Growth Forecasts

(YoY) End of Cycle



Source: Drummond Capital, June 2022.



# Property

## Themes

- Listed property assets underperformed equities by a wide margin during the quarter, with Australian REITs down -17.24% and Global REITs -10.84%.
- For now, investor apprehension over higher interest rates looks likely to be the dominant influence on listed property. We expect deal flow to slow over the next 6-12 months, a headwind for asset managers that rely on performance fees.
- AREITs are currently trading on an estimated 12-month dividend yield of 6.6%, a significant premium to current cash rates.
- Residential property faces several emerging headwinds with higher rates, including slower building approvals and weakening house price growth.

## Strategy

- We maintain our **neutral** position to Property, however, believe valuations are starting to look attractive on a risk/return basis.
- We see value in some listed REIT's that are trading at a discount to NTA and provide some earnings growth exposure, including inflation-adjusted rents.

## Positioning

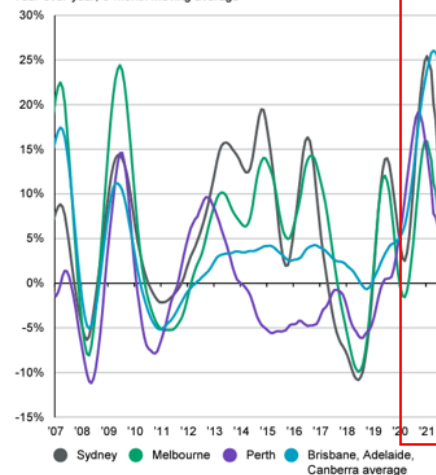
- **Neutral** – maintain neutral for relatively attractive income returns.

### Residential Real Estate Prices

Australian Prices & Clearance Rates

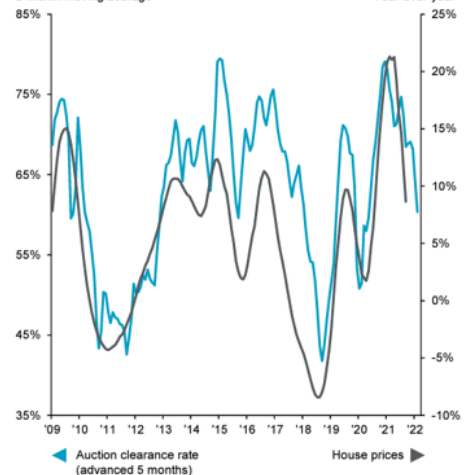
Capital cities house prices

Year-over-year, 3-month moving average



Auction clearance rate and house prices

3-month moving average



Source: JP Morgan Asset Mgmt, July 2022



Overweight

Neutral

Underweight

# Alternatives

## Themes

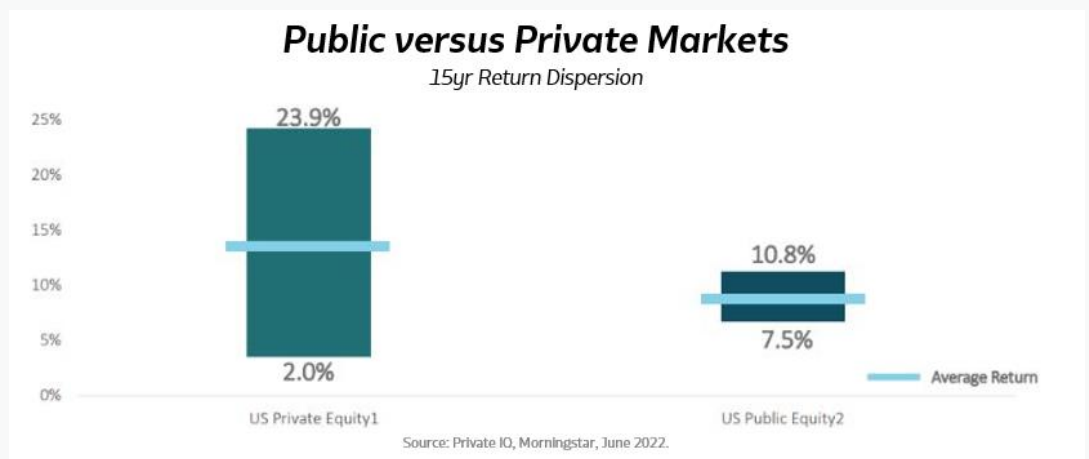
- Infrastructure outperformed over the quarter, delivering -0.49%.
- Private market strategies delivered positive returns of 1.0-1.8% over the period.
- Hedge funds performed exceptionally well, with our selected exposure achieving a return of 18.1%.
- Private market and Hedge fund strategies have been resilient in the face of tighter financial conditions.

## Strategy

- We maintain a **neutral** allocation to Alternative strategies. We are using the recent outperformance to take profits and reinvest into Fixed Interest post a significant increase in bond yields.
- This change reflects our view that liquidity is important over the short-term, and Alternatives can be used as a funding source.
- Notwithstanding, we continue to allocate a full weight to various Infrastructure, Private Market and Hedge Fund strategies. These strategies provide a viable return with a low correlation to public markets.
- Hedge Funds have provided a tail risk hedge to recent falls in equity markets.

## Positioning

- Neutral – taking profits post a period of strong returns, maintain full allocation.





# Positioning

As of July 2022	Positioning (DAA)		
Asset Class	Underweight	Neutral	Overweight
Cash			
Fixed Interest			
Australian Fixed Interest			
Global Fixed Interest			
Australian Equities			
Global Equities			
Developed Market Equities			
Emerging Market Equities			
Property			
Australian Property			
Global Property			
Alternatives (Inc. Infrastructure)			
Infrastructure			
Other Strategies (Private Markets, Hedge Funds)			

## Positioning Definitions

**Overweight**  $\geq 2.0\%$  above benchmark strategic asset allocation weight

**Neutral**  $\leq 2.0\%$  versus benchmark strategic asset allocation weight

**Underweight**  $\geq 2.0\%$  below benchmark strategic asset allocation weight



## Independent Advisory Board

The Advisory Board believe a robust governance framework is critical in forming a House View and making effective Asset Allocation decisions. The process is governed by an Advisory Board charter and comprises experienced investment professionals with diverse areas of expertise, reflecting an industry best practice in decision making.

The Advisory board is responsible for setting and reviewing the House View, upholding the fundamental values and investment philosophy of Mackay Private.

The Advisory Board meets quarterly to meet intra-quarter as required. Voting members make all dynamic asset allocation decisions of the Advisory Board. Please visit our webpage [www.mackayprivate.com](http://www.mackayprivate.com) or contact us directly at [info@mackayprivate.com](mailto:info@mackayprivate.com) or 1300 721 986.

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