House View

June 2021

Commodities continued their strong rally in May, while equities trading in marginally positive territory. Inflation was in focus during May following a higher-than-expected US CPI number, causing a temporary spike in volatility and bond yields, both of which had retraced by month-end. The US Federal Reserve hinted that a discussion on tapering bond purchases may not be far away, while US corporate earnings continued to beat market expectations. Risk markets have now run hard to this point of the year. We believe that further higher than expected inflation numbers are likely to follow as economies continue to reopen. This has the potential to raise volatility and increases somewhat the likelihood of a more pronounced sell-off in risk assets.

Policy Watch: Investors are following the language of central bank minutes and speakers closely with several central banks hinting of future policy changes. The Reserve Bank of NZ now forecasts a rate hike in the second quarter of 2022 while comments out of the Bank of England suggested that rates could rise in early 2022. The Fed Minutes revealed that members of the Federal Open Market Committee believe that should the economic recovery continue to gain momentum, it would be appropriate "at some point" to discuss tightening its accommodative policy. While this meeting occurred before some disappointing employment data, it has been interpreted by markets as a flag that tapering may discussed in July.

Politics Update: The Federal budget was released in May and surprised sharply. The 2021-22 deficit is forecast to be A$106.6bn, well above expectations of A$80bn and little changed from December's MYEFO of A$108.5bn. The Government used an improvement in revenues to increase spending, rather than reduce the deficit. Deficits are forecast all the way to 2031 with the structural budget balance replacing temporary fiscal measures in coming years. The Victorian budget was also released with $15bn identified in "budget repair" over the next four years with the proceeds of cuts, savings and tax increased to be spent on those "hardest hit" by the pandemic. The NSW Labor Party Leader Jodi McKay stepped aside after a bye-election loss in the seat of Upper Hunter, with a 7 percent swing away from her party. This is another instance of an opposition party failing to make headway against a state government during the COVID-19 pandemic.

Vaccine Update: Continuing concerns on blood clots, lack of coordination and supply delays in some jurisdictions continue to slow the rollout of vaccination programs in some countries. Locally, the most recent "snap lockdown" in Victoria has spurred many to go and get vaccinated. Investors are betting that programs will ultimately be successful, and vaccines augmented and adapted as new strains emerge.

Inflation Watch: The debate continues whether higher inflation readings will be transitory or more permanent in nature. Supply constraints continue in some sectors, further pushing up prices. US CPI surprised rising 4.2% year-on-year, driven by rising energy prices and used car prices, with new car production impacts by semi-conductor shortages. The annual reading was the highest since 2008, largely due to base effects, where in April 2020 when prices were falling in some instances. Markets did gain some comfort from a more benign, albeit above expectations, US Core PCE reading of 3.1%. Locally, the Australian Wage Price Index for March showed an increase of 1.5% p.a. suggesting that wage pressures are yet to be seen in Australia. Most central banks continue to publicly state that they believe these price increases will be transitory in nature.

Risk Budget: Volatility spiked mid-month on much stronger than expected US CPI data, however, then subsides back to historically low levels. With central banks likely to taper, and inflation numbers likely to surprise on the higher side, we have actively reduced exposure to risk assets this month.

Call to Action: We are banking some of the strong profits earned over the past 6 months and have moved capital into strategies more resilient to an equity drawdown.

Portfolio

Investors' concerns about rising inflation were again at the forefront in May. The US CPI reading for April came in well above expectations at 4.2% year on year, driven by a recovering energy market and a spike in used car prices. Inflation readings are also being impacted by base effects with markets more concerned with falling prices this time last year.

We have continued to hold our relatively high levels of risk assets through May however we believe that a change is now required. We believe that as the economic recovery continues over the coming months, strong consumer demand coupled with supply chain constraints, labour shortages and wage pressures will lead to inflation prints that surprise on the upside.

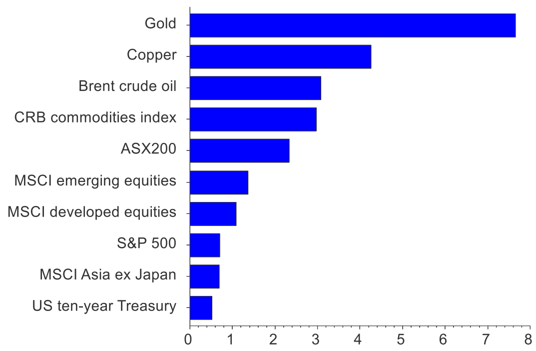
Given the strength of the recovery it is our opinion that central banks will be pushed to begin tapering asset purchases or at the very least bring these discussions forward. There is also the possibility of revised forward guidance, increasing the recent trend of central banks flagging rate rises sooner than initially expected.

May Review

Risk markets were moderately positive through the month of May. Equity markets finished the month marginally positive.

Copper and the broader commodity suite rallied strongly again in May, however gold was the standout in this space rallying nearly 8% for the month with inflation in focus and a falling USD. Emerging market equities outperformed developed markets by a narrow margin.

Chart 1: May Asset Class Performance
Percentage Change (total return in local currency)



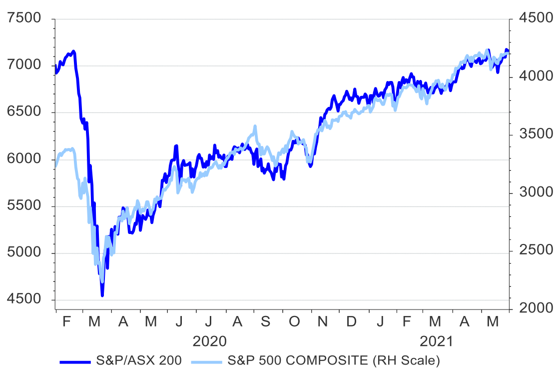
Source: Refinitiv Datastream / Fathom Consulting

The S&P500 index rose 0.55 per cent in May to be up over 11 per cent for the calendar year. The NASDAQ composite gave back some of its recent gains, losing 1.53 per cent over the month.

For another month, small companies took a bit of back seat to the larger companies, with the Russell 2000 adding a modest .1 per cent but remains a strong 15 per cent for the calendar year. In Europe, Germany increased 1.5 per cent and the French market rising over 2.8 per cent, UK markets had a more modest increase of .76 per cent.

In the Australian market, banks were the standout sector rising over 7 per cent for the month. Materials (+1.69%) had a more modest month as the recent iron ore price rise took a breather. IT (-9.86%) and utilities (-6.98%) were the weakest sectors in the Australian market during May.

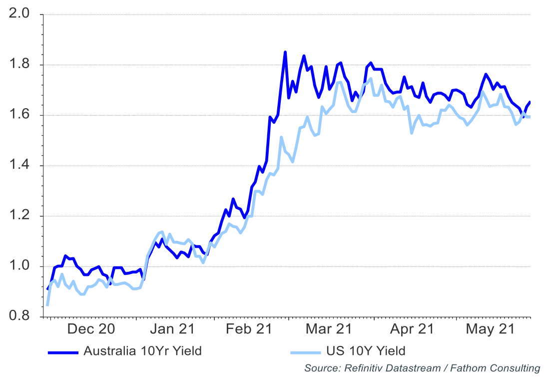
Chart 2: US and Australian Equity Markets



Source: Refinitiv Datastream / Fathom Consulting

US Government ten-year bond yields continue to trade in the ~30bp range, falling 5 basis points over the month. With some inflation data surprising to the upside during May 10 year yields peaked over 1.7% before retreating throughout the second half of the month. Bond markets did not react violently to the suggestion that the Federal Reserve is starting a conversation about tapering bond purchases.

Chart 3: 10 Year Bond Yields (%)



Risk

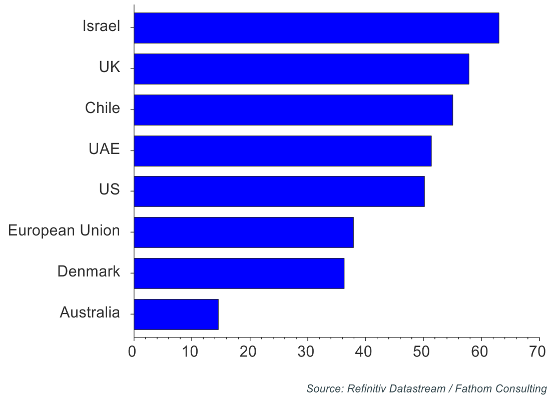
The CBOE VIX index — a measure of investors' expectations for future volatility — spiked in the middle of the month following surprising US CPI data but settled again around 16%.

Chart 4: S&P 500 Volatility Index (VIX)

Outlook

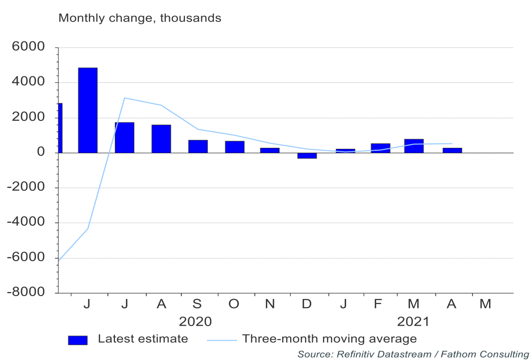
While vaccine rollouts are continuing to ramp up, and those countries further advanced with their programs are experiencing material falls in new cases, in May new cases in the US reached their lowest point in almost a year. The situation in India remains deeply concerning, although appears to be slowly improving. We are watching the situation in Asia closely, with some countries such as Taiwan and Vietnam, who have escaped large infection numbers to date, experiencing larger second or third waves.

Chart 5: Vaccine Rollout (% of population with at least one dose)



In the US, the trend of job creation continues, although the April non-farm payrolls number did disappoint. Locally, the unemployment rate dropped to 5.5%, the lowest level since the beginning of the pandemic, however the number was driven by a drop in the participation rate. The Australian Wage Price Index for March showed an increase of 1.5% p.a. suggesting that wage pressures are yet to be seen in Australian data.

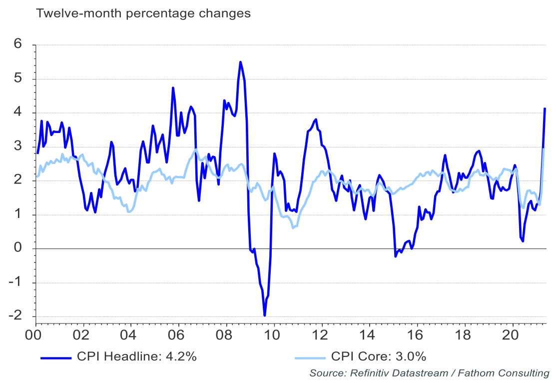
Chart 6: US Non-farm Payrolls



Inflation was a focus for the market during May with US Headline CPI surprising. We expect future CPI and PCE Deflator prints to be a catalyst for future market direction and an input into how the Federal

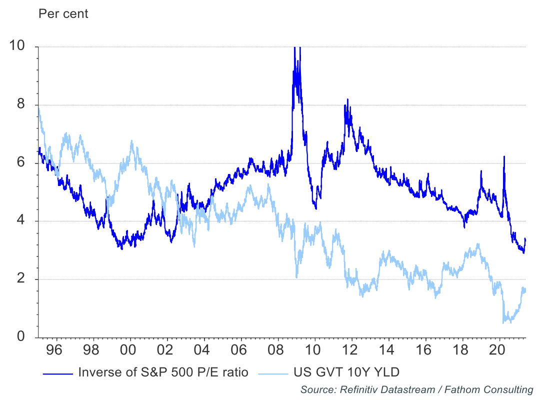
Reserve approaches tapering its bond purchasing program. For the moment, most central banks continue to publicly state that they believe these price increases will be transitory in nature.

Chart 7: US CPI Inflation Rate (4 quarter percentage change)



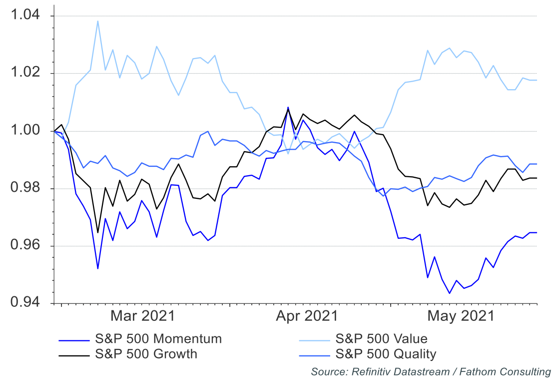
The selloff in bond yields since the start of 2021 has not adversely impacted the earnings yield on equities. However, we expect bond yields to rise over the next few months which will put pressure on equity market multiples and ultimately share prices.

Chart 8: US 10Y Treasury Yield v S&P500 Earnings Yield



Value and Quality Factors outperformed Growth and Momentum during May. With economic data in the US showing the economic recovery and reopening gaining pace, along with dropping new Covid-19 cases, investors may again be betting that companies leveraged to a reopening are likely to outperform the rest of the market.

Chart 9: S&P500 Equity Factor Relative Performance (3 months)



Liquidity in the system for now remains high and continues to be supported by central banks. We believe that there is sufficient liquidity sitting on the sidelines of risk markets, any pull back in equities is likely to be a shallow one.

James Wright and Luke Hansen

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