"Transitory" was the key critical word for June and effectively allowed the US S&P500 to close at a record high. Markets had been fearful over recent months about rising inflation, but the Federal Reserve was very vocal during June reassuring markets that price rises would be short lived as the economy returned to normal. The bond market gave them the benefit of the doubt and lower yields saw solid gains for risk assets, particularly technology stocks. The Australian equity market closed at record highs and delivered the strongest fiscal year since 1987. The outlook remains solid as economies reopen, vaccines rolled out, and corporate earnings growth remains robust.

Policy Watch: Investors continue to analyse the language of central bank minutes and speakers, looking for hints to suggest monetary policy changes might be coming. Investors are also looking for insight on how central banks are interpreting rising inflation numbers. Markets reacted to the release of the FOMC minutes that showed 13 of the 18 person committee see rates rising in 2023 versus only six previously, and with the median forecasting jumping straight to two hikes from none. The Federal Reserve Chair Powell made comments that the FOMC is taking a meeting-by-meeting approach to tapering asset purchases and that they wish to see a "broad and inclusive" recovery of the job market before making any changes. In Australia, RBA Governor Lowe continues to note "*inflation pressures remain subdued and are likely to remain so*", but the market did note a shift in language to when conditions for a rate hike would be met to "*still seems some way off*", instead of the "*at least 2024*" language, raising the prospect of a pivot away from calendar-based guidance.

Politics Update: US President Biden and a group of bipartisan Senators have reached an agreement on an infrastructure package worth $1tn in total over 8 years, though not all new money. Democrat Senators may seek to pass the Biden administration's separate (now $1.8tn) American Families Plan via the reconciliation process without the need for Republican support. This proposed legislation contains corporate and other high income earner tax rises are now embedded. Australia and the UK agreed to a Free Trade Agreement during the G7 in Cornwall, which Australia attended as a guest. NSW's Budget showed stronger than expected fiscal performance in FY21 with stamp duty revenues and a growing GST pool helping. Further expansion of NSW's capital expenditure program will result in generally higher fiscal deficits across the budget's forecast period.

Vaccine Update: The Delta variant of COVID-19 pushed many countries into instituting travel restrictions or restricting travel to those who are now fully vaccinated. Sydney, parts of Queensland, Perth, Alice Springs and Darwin ended June in lockdown, and further afield South Africa has also entered a two week lockdown. Given the highly infectious nature of the variant, countries with low vaccination rates may need to employ aggressive suppression. Australian state premiers remain frustrated with the pace of the Vaccine Rollout while battling new outbreaks.

Inflation Watch: Central bankers are attempting to soothe markets concern on the nature of inflation – insisting that is transitory in nature. US inflation continued its sharp rise in May with the headline number up 0.6% mom taking the annual reading to 5%. The core reading jumped 0.7% mom, above the consensus estimate, lifting the yearly reading to 3.8%. The US core PCE deflator rose 0.5%, below the 0.6% expected but the yearly rate lifted to 3.4% from 3.1% as expected, a smaller jump than CPI. However, other inflation readings did continue the recent pattern of surprising to the upside, UK CPI came in higher than expected hitting the Bank of England's 2% target for the first time since 2018. Canada's May CPI was also higher than expected, with the average of Bank of Canada's three core inflation measures rising to 2.3%, above the 2.1% market consensus and 2.1% in April.

Risk Budget: Volatility jumped mid-month on much stronger than expected US CPI data and on the back of comments from Fed Chair Powell, however, then subsided back to historically low levels. With central banks likely to taper, and inflation numbers likely to surprise on the higher side, we expect volatility to rise over the coming months. We have maintained our current level of risk after de-weighting our aggressive equity position last month.

Call to Action: We are looking for decent pullbacks to add to risk. While we remain confident on the near-term outlook, central bank tapering and higher inflation prints over the next quarter are likely to put some pressure on markets at some stage. Profit taking or risk off events should be well supported with liquidity on the sideline.

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Portfolio

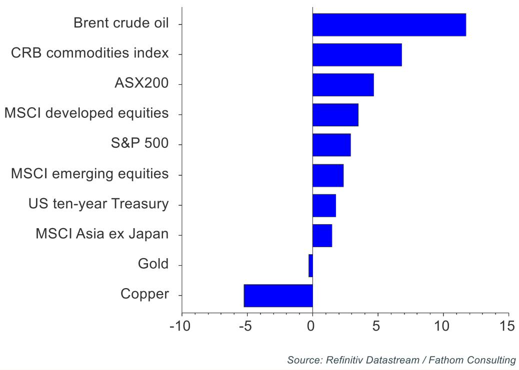
After taking some equity risk off the table in June and deploying that capital to more defensive sectors and alternatives, we continue to feel comfortable with our current risk settings. We maintain a healthy exposure to risk assets and feel reasonably positive on the outlook for the remainder of 2021. While corporate earnings for the second quarter of 2021 will be an important backdrop to markets, the path of inflation and the expected announcement in a change to the Federal Reserve's quantitative easing policy will be the primary driver of markets.
The Fed finished June openly talking about tapering, clearly positioning the market for an announcement over the next couple of meetings. In this environment, particularly after such a strong start to 2021, we expect market gains from here to be harder fought with some occasional bouts of profit taking and risk off activity.

June Review

The market continues to focus on the outlook for inflation and monetary policy as economies continue to reopen and recover. Inflation readings during June across many developed markets continued to surprise to the upside.

Risk markets were moderately positive through the month of June, with commodity markets and developed equity markets performing well. The exception was copper, which fell sharply in June after a very strong price run. Gold also softened a touch as inflation fears subsided and risk assets performed well.

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

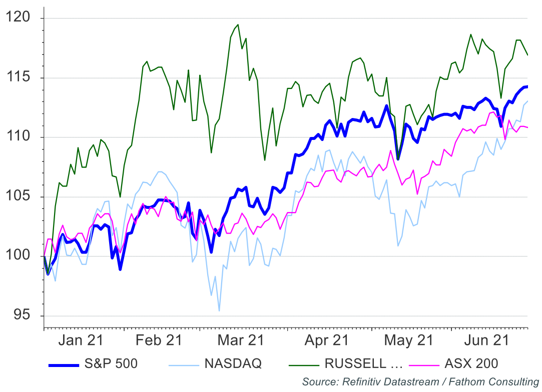


Past performance and performance forecasts are not reliable indicators of future results.

The S&P500 index rose 2.3 per cent in June to be up 14.5 per cent for the calendar year. Technology stocks were well supported during the month by the rally in long tenor bonds which encouraged a pivot from value stocks towards long duration growth companies. The NASDAQ composite rose 5.5 per cent in June to be up 12.5 per cent for 2021.

Small companies moved broadly in line with larger companies, with the Russell 2000 adding a 1.9 per cent for the month and rising 17.5 per cent this calendar year. In Europe, equity gains were a little more modest this month, with Germany rising 0.7 per cent and the French market putting on 0.9 per cent. The UK markets continues to lag this year. It rose a muted 0.2 percent in June and has underperformed the major European markets this calendar year by approximately 3-5 per cent.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2021)



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The Australian market closed at a record high despite financials (-0.2%) and materials (+0.3%) having soft months. Information technology was the standout sector in June rising over 13 per cent for the month. Consumer staples (+5.3%) and cyclicals (+4.5%) performed strongly. The market is up 11 per cent in 2021 with the strongest returns coming from financials and consumer cyclicals.

US Government ten-year bond yields were calmed by numerous central bank speeches reassuring investors that price rises were temporary. Bonds trended down across the month, closing 11 basis points lower in June to finish the month at 1.47%. This was an incredibly benign result given the strengthening of inflation measures released during the month. German yields sold off during June which may signal that global bond managers were rebalancing portfolios away from Europe towards the US.

Chart 3: 10 Year Bond Yields (%)

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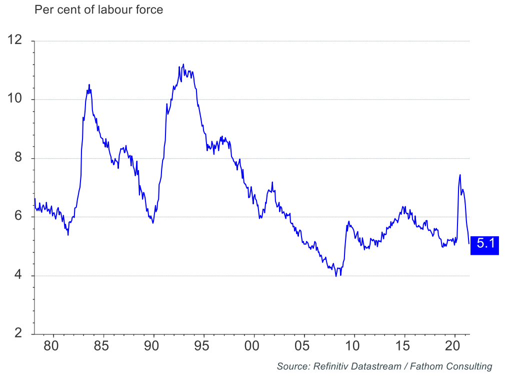
The Australian economy continues to perform strongly, supported by massive fiscal and monetary policy support. Despite lockdowns and border closures, unemployment has survived the end of the Job Keeper program and employment growth has pleasingly surprised on the upside. The unemployment rate has now fallen back to pre-pandemic levels.

Chart 4: Australia Unemployment Rate (%)



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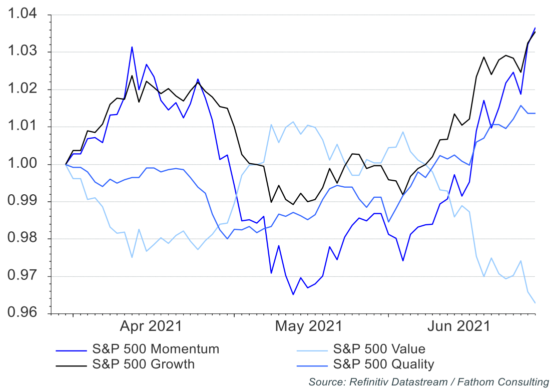
The factors driving the market dramatically pivoted in June. Growth and Quality outperformed Momentum while Value was a significant underperformer. The market appears to be looking through the reopening trade and focusing on a post Covid normal economy with long duration assets being preferable to cyclicals more dependent on GDP growth.

Chart 5: S&P500 Equity Factor Relative Performance (3 months)



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Risk

The CBOE VIX index — a measure of investors' expectations for future volatility — spiked in the middle of the month following strong US CPI data but settled again below 16%. Option skew eased as the cost of buying downside protection fell. This supports the view that market participants remain comfortable about the outlook and evenly balanced on upcoming US corporate earnings season.

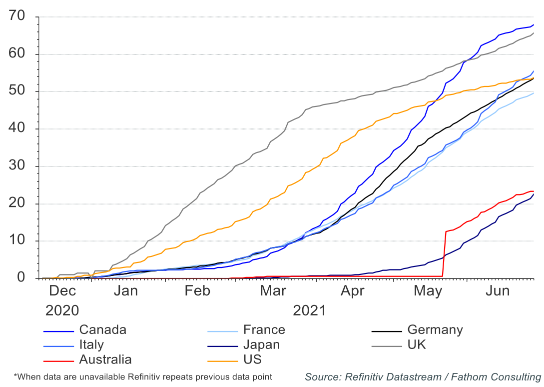
Chart 6: S&P 500 Volatility Index (VIX)

Past performance and performance forecasts are not reliable indicators of future results.

Outlook

Developed economies more severely hit by the Covid-19 virus have been very quick to roll out vaccine programs and greater confidence is building in their economic outlook. There are now significant percentages of the population in the G7 economies now with at least one shot of a vaccine.

Chart 7: Vaccine Rollout (% of population with at least one dose)



Past performance and performance forecasts are not reliable indicators of future results.

While the Australian vaccine rollout took a more cautious approach in the early days due to the success of our suppression strategy, implementation delays and confusion and supply restraints has seen our program lag behind global peers, and we now run the risk of continued periodic shutdowns and border closures.

While these border closures and lockdowns are disruptive to the community, and particularly difficult on the tourism and hospitality sectors, we have seen overall spending patterns change and result in an overall increase in household savings. After previous lockdowns, we have seen these savings buffers get released and drive large uplifts in economic activity as pent-up demand gets satisfied.

Chart 8: Australian Net Savings (AUD Billions)

Past performance and performance forecasts are not reliable indicators of future results.

As economies continue to reopen, the lingering question over whether price increases are transitory or more persistent and permanent is likely to emerge. While there have been some sectors where supply responses have triggered prices falls after sharp rallies (eg lumber), others where supply chains remain disrupted or a supply response remains well off continue to experience on going pressures.

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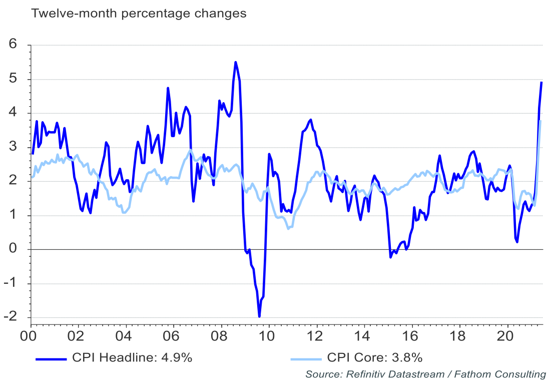
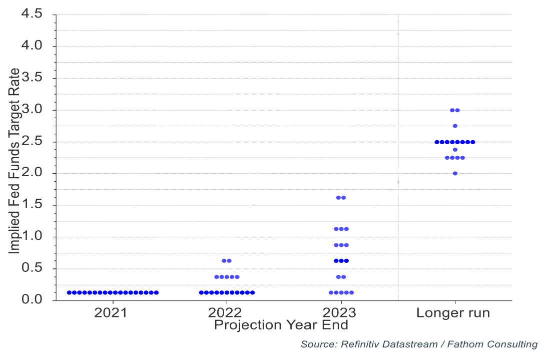
Chart 9: US CPI Inflation Rate (4 quarter percentage change)



Past performance and performance forecasts are not reliable indicators of future results.

The Fed have already signalled via the release of the Dot Plot Chart in June that rates are likely to rise in 2023 and recent commentary has suggested tapering likely to start in the next few months. While we do expect some modest selloff in bond yields in the back half of 2021, it is unlikely to significantly derail equity market valuations, but should lead to some moderation in the market multiple over the course of the year.

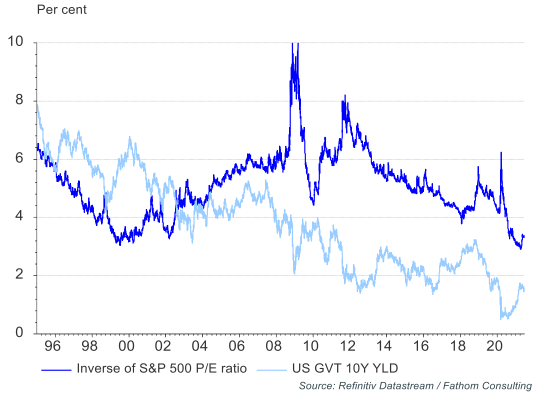
Chart 10: US FOMC Dot Plot of Predicted Interest Rates



Past performance and performance forecasts are not reliable indicators of future results.

Second-quarter earnings season gets unofficially underway during the second full week of July. Consensus analysts estimate an earnings growth rate of around 60% for S&P 500 companies, which would mark the highest year-over-year earnings growth rate reported by the index since Q4 2009. While we remain confident that corporate earnings should be strong, with such lofty expectations already built into the market, there may be grounds for anticipating some disappointment should companies not deliver.

Chart 11: US 10Y Treasury Yield v S&P500 Earnings Yield



Past performance and performance forecasts are not reliable indicators of future results.

With the underlying economic backdrop improving, and policy makers committed to a very gradual withdrawal of stimulus, we continue to believe that this should be a constructive period for markets. Any draw downs on profit taking or short-term inflation concerns should attract bargain hunters as there remains significant liquidity on the sidelines in the system.

James Wright and Luke Hansen
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