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Around the table

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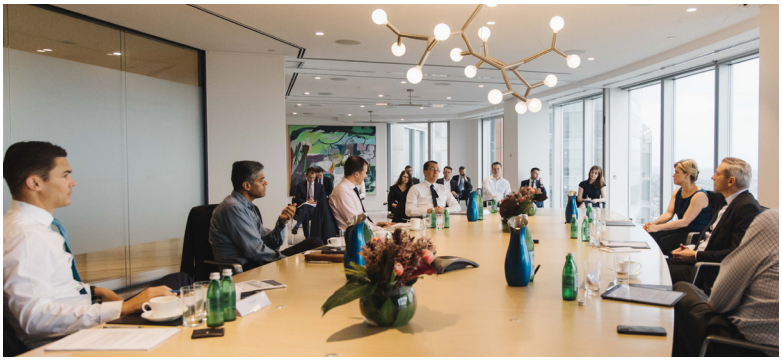
CRESTONE INVESTMENT FORUM / MARCH 2021

Seeking returns
Has everything changed?



Around the table

Carmel Hourigan
OFFICE CEO
CHARTER HALL

Tim Samway
EXECUTIVE CHAIRMAN
HYPERION ASSET MANAGEMENT

Andrew Maple-Brown
CO-FOUNDER AND MANAGING DIRECTOR
MAPLE-BROWN ABBOTT GLOBAL LISTED INFRASTRUCTURE

Vimal Gor
HEAD OF BOND, INCOME AND DEFENSIVE STRATEGIES
PENDAL GROUP

George Tharenou
CHIEF ECONOMIST
UBS INVESTMENT BANK

CRESTONE WEALTH MANAGEMENT

Scott Haslem
CHIEF INVESTMENT OFFICER

Ed Blight
HEAD OF SALES

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Seeking returns

Has everything changed?

At Crestone's most recent investment forum, we asked panellists to debate the risks to an otherwise improving economic outlook and how markets may respond to a near-term spike in inflation. In particular, we asked panellists to discuss where investors should be seeking protection and returns in their portfolios, given elevated valuations and likely volatility.

Overall, our panellists see few headwinds to a strong recovery in growth over the coming couple of years. However, there is a strong sense that "everything has changed" in regards to the rules governments and central banks are following, and this would require investors to increasingly take a long-term perspective when assessing value via equities.

Moreover, most panellists believe a post-virus world would continue to exhibit lower trend growth and inflation than last century. As such, returns in fixed income would continue to be challenged, while unlisted real assets (property and infrastructure) are viewed favourably as a means to protect against inflation and lift returns with relatively defensive assets.

Four key themes emerged from the forum

- **We are no longer in a world of policy conservatism**—There are few headwinds to a strong rebound in global growth in 2021, as economies reopen on the back of an increasingly successful vaccine rollout and massive policy stimulus. For now, medium-term fiscal rules, such as balanced budgets, are largely being ignored while central banks flag a long period of free cash. Australia looks well placed to outperform, with activity likely to regather to levels not seen prior to COVID-19 by mid-year.
- **Near-term inflation pressures are likely to recede in H2 2021**—While inflation is likely to rise materially in coming months, led by a rebound in oil prices and supply pressures as consumer demand recovers, elevated debt burdens, ageing demographics and advances in technology are widely seen as likely to keep inflation contained over the medium term. Globally, unemployment rates remain above pre-COVID levels.
- **Valuations may be less stretched when you dig below the surface**—Equity investors need to focus on businesses with long-term earnings streams, rather than labour over short-term price earnings ratios. In contrast, the fixed income asset class is seen as a difficult place to find returns, with credit markets increasingly being driven by flows. Despite a likely rise in bond yields, bond rates are likely to remain low and valuations within property and infrastructure have not increased materially.
- **Unlisted real assets can provide a meaningful hedge to inflation risk**—The search for defensive assets with yield is increasingly leading investors to look at unlisted property and infrastructure assets. While discipline is required in regard to market segmentation, inflation-linked revenue is increasingly favoured. Real assets also capture opportunities around online purchases, decarbonisation and electrification.

IS THE GLOBAL RECOVERY STILL ON TRACK?

After 2020's global recession, ongoing massive stimulus and progress on a vaccine, we believe growth will recover mid-year or in H2 2021. We asked our panellists what the likely strength of the recovery is and when pre-COVID activity levels be regathered.

George Tharenou, Chief Economist at UBS Investment Bank, has been relatively bullish on Australia since late last year—this is due to the shift by policymakers away from traditional fiscal conservatism (i.e. balanced budgets, surpluses and medium-term fiscal rules). He expects Australia's growth to return to pre-COVID levels around mid-year, which is now in line with consensus. What will be key is if the growth rate continues to beat expectations (which he expects it will). He sees the backdrop of policy support as strong and as continuing to underpin growth.

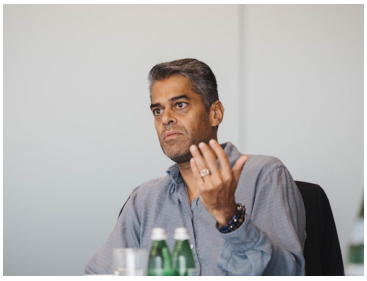
Tharenou added that Australia is in a relatively better position than the rest of the world as the economy has been opened and economic mobility normalised quicker than elsewhere. The ability to recover from COVID-19 is also likely to be more sustainable in Australia, as the hit to the labour market has been less than in other major economies. Direct wage subsidy measures, like JobKeeper, have maintained the connection between activity and employees. He also sees the labour market as close to the point of a self-sustained recovery, and that it is already not far off pre-COVID levels.

Vimal Gor, Head of Bond, Income and Defensive Strategies at Pendal Group, is unsure whether the inflationary pulse and reflation we are seeing can last. The recent pick-up in yields has led to a technical washout (i.e. selling) of small positions. **Gor** cannot see the Reserve Bank of Australia (RBA) or US Federal Reserve (Fed) moving rates any time soon. While the market is beginning to price rates remaining on hold before rising aggressively, he does not see this happening. **Gor** explained that the carry trade in some yield curves has become very attractive. In terms of inflation, he sees this remaining strong for the next three or four quarters—however, he feels the key question is what level inflation reverts to. "Prior to COVID-19, growth was low, as was inflation, but the pandemic has muddied that picture. The question to grapple with is whether we gravitate back towards where we were in 2018 or where we were 10-20 years ago. "

WILL A PICK-UP IN GROWTH LEAD TO A STRUCTURAL RISE IN INFLATION?

Gor does not see a pick-up in growth leading to a structural rise in inflation, as the ageing demographics and increased debt burden are likely to supress any material pick-up in bond yields. He also expects the RBA and Fed will eventually take a more aggressive approach to holding back bond yields than they have to date. Real yields initially fell but now nominal yields have risen faster than break-evens, which has caused real yields to rise. He sees this as a threat to risk assets and the economic growth picture. He, therefore, questions how long the Fed will be willing to let real yields rise.

Carmel Hourigan, Office CEO at Charter Hall, echoed similar views, noting she has observed a pick-up in activity in real estate. "There is a lot more confidence and money is flowing through freely. Maintaining cost-outs, which were implemented by businesses due to COVID-19, will be important going forward."



VIMAL GOR

HEAD OF BOND, INCOME AND DEFENSIVE STRATEGIES

PENDAL GROUP

"The question to grapple with is whether we gravitate back towards where we were in 2018 or where we were 10-20 years ago."

CARMEL HOURIGAN

OFFICE CEO

CHARTER HALL

"There is a lot more confidence and money is flowing through freely. Maintaining cost-outs, which were implemented by businesses due to COVID-19, will be important going forward."

Scott Haslem, Chief Investment Officer at Crestone Wealth Management, noted that there was likely to be a fair amount of leverage for business profitability. This was because many businesses went through cost-outs but are not necessarily going through the cost-back process that you would ordinarily expect. This could also support the growth outlook if it led to a faster pace of business investment.

Tim Samway, Executive Chairman at Hyperion Asset Management, expanded on this point. He feels capital-light businesses will accelerate particularly quickly. "While it is terrific news, the better news is the next 20 years looks pretty flat and there will be opportunities to pick up great investments as they will stand out in a dislocated market."

SCOTT HASLEM

CHIEF INVESTMENT OFFICER

CRESTONE WEALTH MANAGEMENT

"Many businesses went through cost-outs but did not necessarily go through the cost-back process that you would normally expect."

HOW MIGHT AUSTRALIA'S RELATIONSHIP WITH CHINA CHANGE OVER THE NEXT THREE TO FIVE YEARS?

When asked if our relationship with China should still be regarded as a benefit, **Tharenou** noted that our exports to China are still very high. For all the negative rhetoric about the relationship, Australia is actually generating a very large trade surplus, which is supporting the currency and growth. While this is a good result, it does limit the impetus on the Australian Government to rethink or redirect its strategy. This is something that could be negative in the long run. **Tharenou** also observed that we have seen resilience in commodity prices, particularly iron ore—while for more challenged commodities, such as coal, Australia has managed to redirect supplies to other countries. However, for some small sectors, and at the company level, the impact has been severe. While **Tharenou** originally thought the problem would resolve itself, he is now not so optimistic.

ARE THERE ANY 'BLACK-SWAN' EVENTS THAT COULD SET US OFF THE ROAD TO RECOVERY?

Hourigan believes the biggest threat to recovery is a new COVID-19 variant, which could derail the vaccine roll-out, cause another lockdown, and create a stop-start scenario, which is not ideal for corporates.

Gor suggested that if US policy makers were to aggressively increase stimulus, as opposed to the Fed hiking rates or tapering, this could pour fuel on the fire and push asset prices higher, which may be difficult to control. He suggested that climate change stimulus and equality stimulus are some of the ideas that have been floated as possible additional fiscal spending forces in the US.

The Crestone view: *Highly accommodative policy, together with a likely successful vaccine rollout, should underpin a strong growth recovery both in Australia and globally in 2021. Near-zero policy rates are also likely to provide more impetus to rising asset prices than rising consumer prices. We still favour returns in equity over fixed income. Other than equities, we believe property (residential and non-residential, listed and unlisted) is likely to be an increasing beneficiary of low rates and a hedge against inflation risks.*

HOW SHOULD WE THINK ABOUT VALUATIONS?

We asked panellists how we should think about valuations now that cash rates are close to zero. What are some of the risks building in fixed income markets, and could rising yields thwart equity markets? We also sought their views on some of the key themes from this reporting season.

Samway agreed with Haslem's take that price to earnings ratios are a poor valuation metric for long-term investing. He went on to note that, historically, the challenge has been that investors are reluctant to look beyond a couple of years. However, as business models have improved and technology has become more advanced, it is becoming easier in some areas to look beyond a couple of years with a greater degree of certainty. Unlike 30-40 years ago, businesses have now become more global and platform-based, and many markets have evolved to a 'winner takes most' scenario and it is very hard for new entrants to join.

"It's easier to get a clearer view of a dominant player in a dominant market for a longer period of time. That's driven a lot of the rise in these shares and I'm confident they can continue to deliver and do exceptionally well."

Samway feels that platform-based businesses have done reasonably well in a terrible year and should do exceptionally well in a good year. He feels comfortable with where valuations are now and thinks they look better than they did in pre-COVID. This was because income for thematics, such as e-commerce, digital payments and workforce management, has actually been brought forward by the pandemic and this has validated Hyperion Asset Management's thesis.

ANDREW MAPLE-BROWN

CO-FOUNDER AND MANAGING DIRECTOR

MAPLE-BROWN ABBOTT GLOBAL LISTED INFRASTRUCTURE

"For the last 30 years or so we've had lower lows and lower highs, so the bond rate environment continues to come down."

IS THE RECENT PULL-BACK IN PERFORMANCE FOR SOME OF THESE NAMES LIKELY TO BE SHORT TERM OR LONGER TERM?

Samway sees short-term pull-backs as a buying opportunity. "While we've seen a small pull-back in economic growth, one the main drivers has been low population growth. What worked in the last 10 years is likely to work in the next 10 years, underpinned by low population growth."

Andrew Maple-Brown, Co-Founder and Managing Director at Maple-Brown Abbott Global Listed Infrastructure (MBA), highlighted that the drop in bond yields supports valuations. However, MBA looks at enterprise value/EBITDA (earnings before interest, tax, depreciation and amortisation) and, on average, its portfolio has been trading the same as it has been over the past 15 years. He acknowledged that this has been a surprise as he would expect long duration assets to be supported by low discount rates (raising valuations). Also, in the US, tax rates and interest costs have come down. One would normally expect these factors to push up multiples, but they are not seeing this in listed infrastructure and so they remain reasonably comfortable.

When asked about the discount rates analysts are currently using, **Maple-Brown** said that not many people in equity markets have been using spot rates. While bond yields have doubled, they are still lower than where they were at the start of last year, so we are still operating in a low bond rate environment.

"For the last 30 years or so we've had lower lows and lower highs, so the bond rate environment continues to support valuations." **Maple-Brown** explained that even if inflation were to break out, monetary policy is still very loose so central banks would be able to control inflation pretty quickly. At MBA, he explained that they are using long-term US bond yields of around 3.5%, while equity discount rates for the lowest risk stocks are around the mid-7% range. Therefore, a 40-50 basis point move in US Treasuries would mean very little from MBA's perspective. Within real estate, **Hourigan** is comfortable with where valuations are. "When you think about where bond yields are and where the premiums are on cap rates, at historical highs, valuations have really not budged."

She explained that some of the weakness in the real estate sector through the pandemic has been offset by a compression in cap rates and discount rates, which has actually helped property funds. At Charter Hall, they feel comfortable with where valuations are—particularly for assets such as government leases, secured cash flows and long-term leases, where they are seeing a lot of demand from buyers. While retail is interesting, she is nervous about regional shopping centres and the impact of e-commerce. However, cap rates have been unwinding in these sectors and there will come a time when the value of land increases the attractiveness of these assets.

ARE THERE RISKS BUILDING IN FIXED INCOME MARKETS?

The picture is not as clear in fixed income markets where we have seen credit spreads continue to tighten. **Gor** now feels credit is a non-economic asset class, where valuations do not reflect what is happening in underlying economies. This is for a couple of reasons. Firstly, central banks have come out to support high yield markets when spreads were already at all-time tight levels. Secondly, Gor flagged the death of government bond markets, with the 'jack-hammerfication' by governments holding yields low, driving people to move money from government bonds into credit. "That's a been a tailwind for the asset class. It all lines up for credit spreads to remain tight and potentially tighten even further. It's just a story about fund flows and not necessarily a valuation issue."

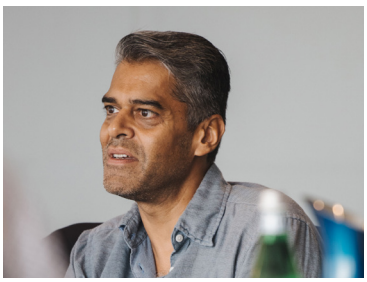
Gor emphasised how challenged fixed income markets have become, and that it is difficult to trade currency as everything has become a US dollar trade. While he believes it is still possible to make money from trading rates, from a long-term perspective, there are not many places in the fixed income asset class where you can earn much of a return. He sees the majority of moves within government bonds as just 'noise', and that within credit, investors are effectively playing the 'flow of funds'. The way Gor thinks about adding value is completely different to how he thought about it three years ago. He is now looking at crypto currency and other digital assets, and says that most investment opportunities within fixed income are 'below the surface' and no longer at the asset class level.

WHAT ARE SOME OF THE KEY THEMES FROM THIS REPORTING SEASON?

Samway reinforced the view that companies have done remarkably well in a challenging environment. "Once COVID-19 is behind these companies, they'll do even better. However, it needs to be a long-term earnings story, as businesses are being priced as long duration assets now." He explained that the S&P/ASX 300 is still 4% or so behind where it was this time last year, while the MSCI World index is about 10% higher over the same period. At these levels, he sees plenty of room for further movement within domestic equities.

Tharenou added that dividends could be the key ingredient going forward. While consensus was for payout ratios to decline, there had actually been upgrades to dividends, which was a big surprise. "The market was not expecting dividends to get back to pre-COVID levels for another three years, whereas we could actually only be a year away." He explained that dividends could also surprise to the upside and give equities a further jolt, providing a lot more income to investors.

The Crestone view: *Valuations in traditional asset calsses remain above long-term averages, suggesting heightened volatility in 2021 as investor sentiment shifts around. We continue to focus on quality companies and non-US equity exposures which would benefit from an expected cyclical recovery globally, while also remaining short duration in fixed income. We continue to favour selected unlisted real assets (property and infrastructure) where valuations are more attractive.*

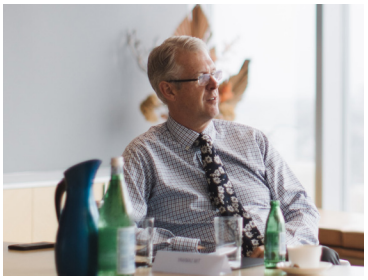


VIMAL GOR

HEAD OF BOND, INCOME AND DEFENSIVE STRATEGIES

PENDAL GROUP

"With credit, it's just a story about fund flows and not necessarily a valuation issue."



TIM SAMWAY

EXECUTIVE CHAIRMAN

HYPERION ASSET MANAGEMENT

"Once COVID-19 is behind these companies, they'll do even better. However, it needs to be a long-term earnings story, as businesses are being priced as long duration assets now."

CAN PROPERTY PERFORM EVEN AS INFLATION RISES?

The panellists discussed the risks of a rise in structural inflation, and provided their views on central bank's desire to drive up inflation and whether property can provide some return protection.

Hourigan explained that Charter Hall is focused on increasing the weighted average lease expiry of its portfolio to enhance financial security. While there are some sectors, such as retail, that have been challenged, opportunities abound in global thematics. She explained that buyers are looking for triple-net leases, government-backed leases, and high-quality offices. "The big lesson from the past year is that you have to have more discipline with what you own."

She explained that the Australian market has been a leader in sustainability and there is pressure on property managers to deliver on that front. While working from home is a significant theme, **Hourigan** sees the office as remaining the primary place of work, and that the right type of product will still attract clients.

Maple-Brown is focusing on infrastructure assets with low cash flow volatility and natural links to inflation, and said that listed assets are trading at discounts to where they are in direct markets. Toll roads are interesting as they underperformed global equities by 30% last year due to lower levels of traffic, but traffic levels have since bounced back quite quickly. He explained that toll roads are well protected from an inflation perspective as their revenue stream increases with inflation. Decarbonisation is likely to drive significant investment, along with electrification. He sees a lot of investment needed in renewables and the transmission network, particularly in the US.

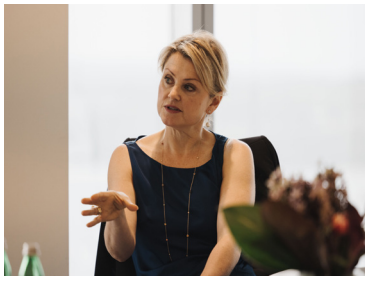
HOW WILL THE MARKET RESPOND TO INFLATION POTENTIALLY MOVING ABOVE BASE-CASE TARGETS?

Tharenou feels we will see a burst in short-term inflation—however, the ability of markets to play this is unclear. As long as central banks can communicate effectively, this should help to calm markets. Tharenou feels that markets are challenging the idea that central banks globally have got this under control.

"Short-term bursts in inflation would effectively cause a squeeze in market positioning that generates volatility. Markets tend to extrapolate and there could be a point where we have more stimulus coming through and employment normalising, which could lead to more inflation being priced in." However, he still sees this scenario as unlikely, particularly given the current high level of debt. He explained that the hit from COVID-19 was so large that it is going to take several years for central banks to achieve their goals.

As low rates can easily go from improving financial stability to causing financial instability, the aim should be to avoid an economic contraction that destroys the labour market and causes a decline in asset values. He feels that governments and central banks are showing the willingness and ability to do whatever it takes in a more direct way.

The Crestone view: *Exposure to unlisted property and infrastructure can help stabilise cashflows through the cycle and provide a hedge to higher inflation. Investors should ensure they have an appropriate allocation to core real assets and infrastructure to smooth economic volatility—and capture opportunities around on-line, decarbonisation and electrification.*



CARMEL HOURIGAN

OFFICE CEO

CHARTER HALL

"The big lesson from the past year is that you have to have more discipline with what you own."

GEORGE THARENOU

CHIEF ECONOMIST

UBS INVESTMENT BANK

"Short-term bursts in inflaton would effectively cause a squeeze in market positioning that generates volatility."

WHERE WOULD YOU INVEST YOUR MARGINAL DOLLAR ON A 12-MONTH VIEW?

CARMEL HOURIGAN

OFFICE CEO

CHARTER HALL

"Real assets and residential housing."

TIM SAMWAY

EXECUTIVE CHAIRMAN

HYPERION ASSET MANAGEMENT

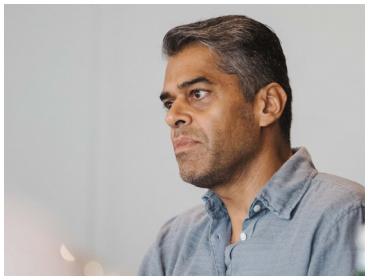
"Sustainable growth equities and real assets."

ANDREW MAPLE-BROWN

CO-FOUNDER AND MANAGING DIRECTOR

MAPLE-BROWN ABBOTT GLOBAL LISTED INFRASTRUCTURE

"Toll roads and electric utilities."



VIMAL GOR

HEAD OF BOND, INCOME AND DEFENSIVE STRATEGIES

PENDAL GROUP

"Bitcoin."

GEORGE THARENOU

CHIEF ECONOMIST

UBS INVESTMENT BANK

"Residential housing."

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