Entrust

# Quarterly Commentary

September 2023


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Entrust WEALTH MANAGEMENT

## Welcome to our September Quarterly Commentary

These reports are an opportunity for us to consolidate our thoughts around the copious amounts of research we receive from our consultants and other sources and put into words some of the key themes we are considering when building investment portfolios for our clients.

We hope you find our commentary informative but as always if there is anything you would like to clarify or discuss in more detail please do not hesitate to reach out.

In this report we will address the following key points:

- **Look Kids There's Big Ben …**
- **Where to Now for Bond Yields?**
- **Drivers of Equity Valuation**
- **Energy – Structural Upside plus Geopolitical Optionality**
- **Heath Check**

Kind Regards,

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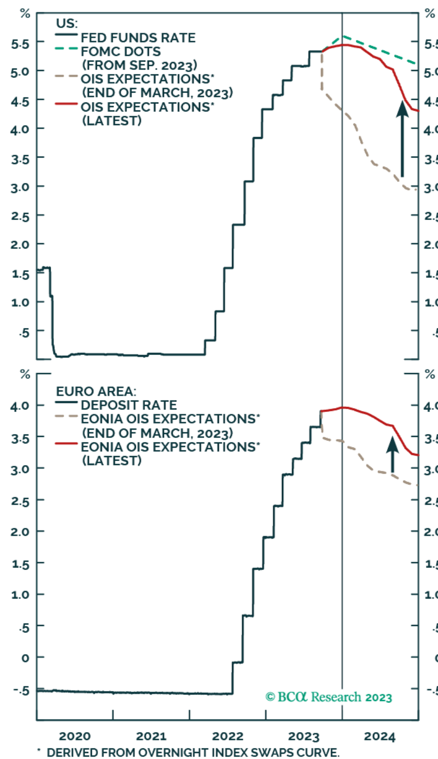
## Look Kids There's Big Ben …

It was a disappointing end to the quarter with portfolios generally experiencing a small pull back in value. The journey to that endpoint was reminiscent of 12 months prior with a strong start only to see those gains given back in the month of September.

On both occasions, the reason for the end of quarter weakness related to changing expectations around interest rates and bond yields.

In September 2022, the catalyst was a speech by the US Federal Reserve Chairman, Jerome Powell, where he reaffirmed the bank's commitment to bringing down inflation. This caused bond markets to sell off as they priced in the prospect of higher rates. This change in expectations was justified given higher cash rates were subsequently delivered. It is worth noting that despite this, equity markets rallied strongly for the rest of FY23.

More recently, bond markets have begun pricing in an expectation that rates will remain higher for longer. As can be seen in the chart below, markets were expecting central banks to begin cutting rates in the back half of calendar year 2023. These expectations have now been pushed out in time and in the case of the US, are more aligned to Feds own expectations.



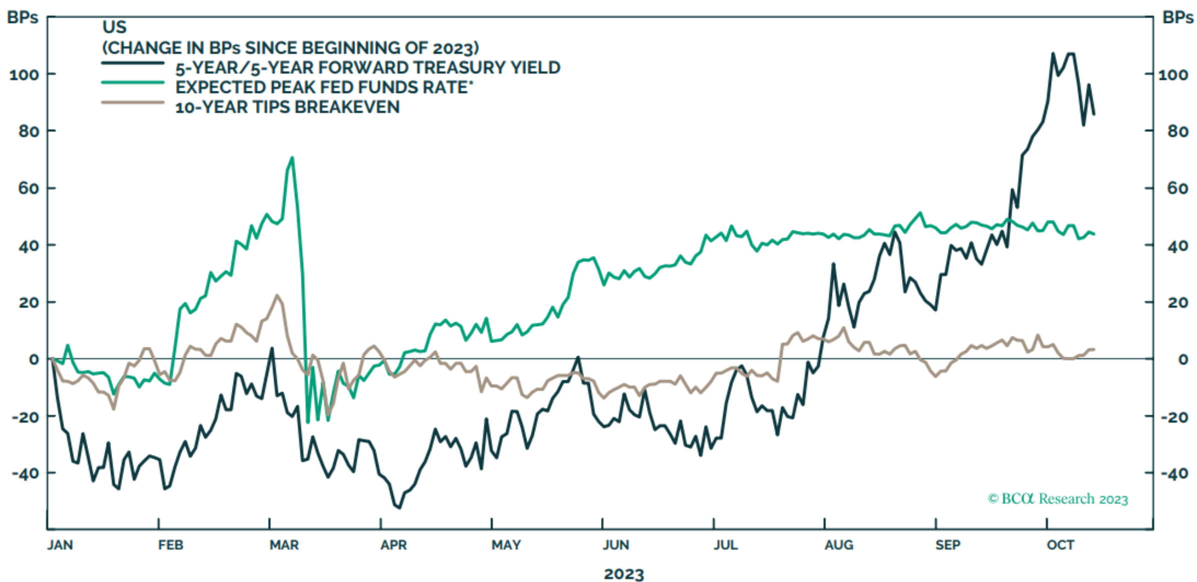

The flow on effects of this saw interest rate sensitive exposures weaker over the September 2023 quarter, with listed Real Estate Investments Trusts (REITs) most impacted, followed by global bonds.

Global Equities also moved lower, however, a falling AUD largely negated that weakness for unhedged exposures. Australian Equities proved to be relatively resilient.

## Where to Now for Bond Yields?

As discussed above, the recent lift in longer term bond yields has largely been driven by a realisation that yields are likely to remain higher for longer. The chart below further highlights this,

demonstrating that the lift in US bond yields wasn't due to rising expectations for the cash rate or inflation, but rather, where yields are expected to be if we look 5 years into the future.




This change in expectation is due in part to the economic resilience we have experienced over the past 12-18 months. However, given strong employment, low housing vacancy rates and improving capex intentions, there is an argument that moving forward, the 'neutral' setting for interest rates is likely to be higher than we have become used to since the GFC. Therefore, this lift in yields could also be attributed to markets adjusting to this structural shift.

Regardless of the reasons, we have always felt that the assumption yields would fall away rapidly from 2023 was ambitious. This, together with consensus positioning by investors in bonds, made us cautious over recent quarters about the near-term upside risk to yields. As a result, we haven't lifted our target position size for bonds since the March 2023 quarter. Following the recent repricing, signs that economic growth is slowing and a reasonably high probability of recessionary conditions in 2024, we believe further upside to yields (downside to bond prices) is likely to be modest.

The recent conflict between Israel and Hamas does pose some near-term upside risk to inflation expectations (via higher oil prices) and therefore, bond yields. However, as the 10-year government bond yield in the US approach and perhaps push above 5%, the risk/reward payoff looks compelling. The RBA in Australia, is arguably a bit behind the eight ball so there may be more upside risk to interest rates closer to home, but overall we feel that the time is getting closer where will be looking to once again lift our position size in bonds.

## Drivers of Equity Valuation

Valuation is a key element of our investment philosophy, where our preference is to invest in quality assets at reasonable valuations.

Valuing assets like equities is not black and white, it requires elements of both art and science. To help navigate this complexity we like to bring our thinking back to what we believe are the three core drivers of valuation:

- risk-free interest rate;
- equity risk premium; and
- earnings growth rate.

When defining these drivers, the yield on a 10-year government bond is often used as a proxy for the *risk-free rate*. The *equity risk premium* is the additional return investors demand above the risk - free rate for the higher risk of investing in equities, and earnings growth is the cumulative average annual rate that a company's earnings are expected to grow in the future.

The table below outlines how movements in each of these drivers work, in isolation, to drive valuation outcomes.

| Valuation Driver | Rising/Falling | Impact on Valuation | Rising/Falling | Impact on Valuation |
|---|---|---|---|---|
| Risk- Free Rate (Rf) | ↑ | ↓ | ↓ | ↑ |
| Risk Premium (ERP) | ↑ | ↓ | ↓ | ↑ |
| Growth (g) | ↑ | ↑ | ↓ | ↓ |

In the financial year ending 2023, equities posted strong gains despite a sharp lift in bond yields. The main driver of these returns was a fall in the risk premium (ERP) being demanded by investors (observed through higher PE ratios), as well as the delivery of better than expected earnings growth.

From a top down view, we believe the ERP is likely to be more of a headwind than a tailwind moving forward, given a relatively low starting point.

We also expect earnings growth will face more headwinds as the delayed impacts of higher interest rates begin to bite.

That leaves us with the risk-free rate. As discussed above, we believe the upside to yields from current levels will be more subdued. We also believe that central banks will not cut rates until unemployment is meaningfully higher than where it is today. If that is the case, economic growth is likely to be negatively impacted. Therefore, the influence of yields on valuations in the near term could range from neutral, to any benefit being offset by falling growth.

When looking at the three drivers together, from a top-down perspective, we believe equity markets face some headwinds, while the probability of a pullback in value looks to have increased.

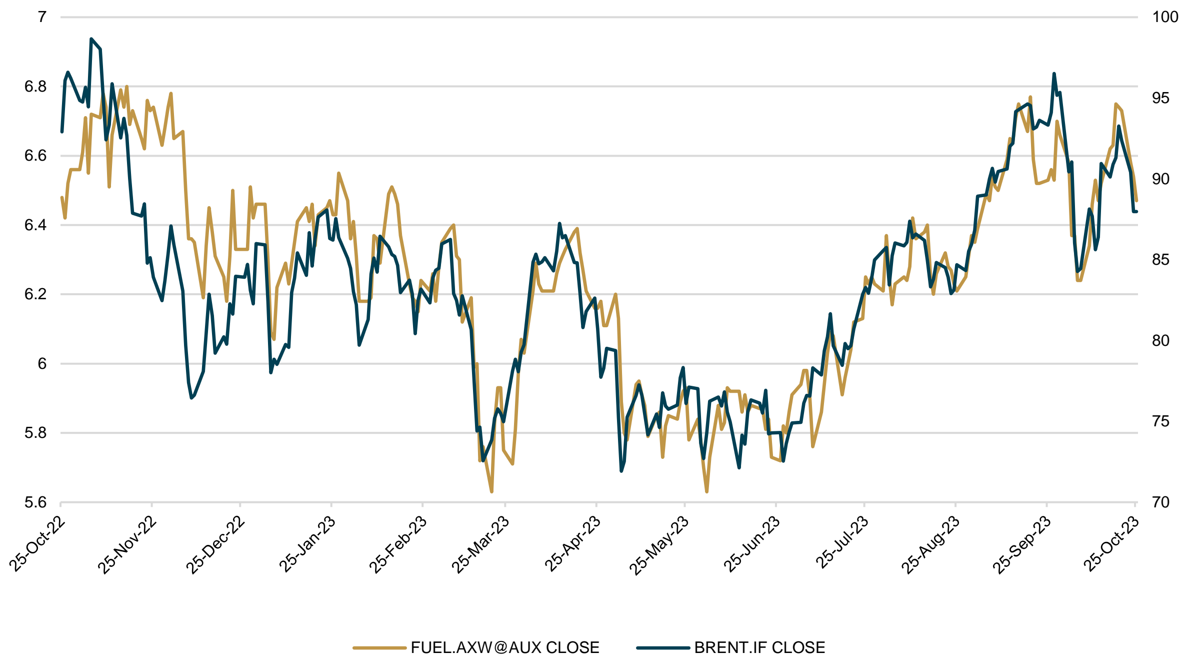
From a bottom-up, stock and sector specific perspective, we see a greater dispersion of potential outcomes. This provides the opportunity for more tactical positioning within equities. Reflecting this, our current focus is on high quality, defensive exposures alongside investments that should benefit from our positive structural outlook for commodities and energy.

We will discuss our thinking around some of these tactical opportunities below.

## Energy – Structural Upside plus Geopolitical Optionality

We noted in our June 2023 Quarterly Commentary that we had increased our exposure to energy equities due our view of the positive long-term structural outlook for energy markets together with a change in the momentum of the price of oil.

This move has been a positive contributor to performance with the Global Energy Companies ETF (FUEL) up nearly 13% for the quarter on the back of a 27% lift in the price of Brent.




Despite these gains we remain positive on energy as we believe, the tight demand / supply equation, combined with geopolitical uncertainty is not yet fully reflected in current pricing.

As we head into 2024 and another US election, it would not surprise us to see certain political regimes use the oil price as a tool to try and influence the outcome.

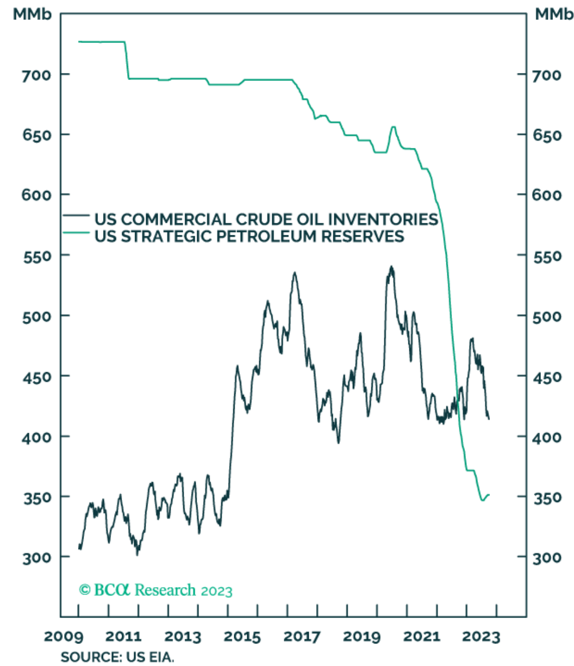
History suggests that the odds of winning a US election sits in favour on an incumbent seeking a second term. What has tended to upset this balance of probabilities is when voters are being impacted buy a poor economic environment, causing them to blame the government and vote for change.

On this front, Biden looks vulnerable. Despite a relatively resilient economic environment, Biden's approval rating is low. If we do see a deeper economic slowdown pre the election, voters may use that as a reason for change. Something that could exacerbate this risk for Biden is a higher oil price that feeds higher inflation and interest rates, causing a deeper than expected slowdown.

There is a wide belief that Russia attempted to influence the outcome of the 2016 US election via cyber attacks and false social media campaigns. To us it would seem plausible that Russia (or others) might attempt to weaponise oil to similarly influence the 2024 election.

The recent conflict between Israel and Hamas only adds to this risk, particularly if Iran becomes involved. Not only could this mean that the US would more strictly enforce sanctions against Iran, but oil supply from the broader region could also be impacted. The result would be a much higher oil price.

If there is a spike in the oil price, the US will have less ability to counteract the move after significantly reducing its strategic reserves following the rally in the price of oil as the Russian and Ukraine war unfolded.

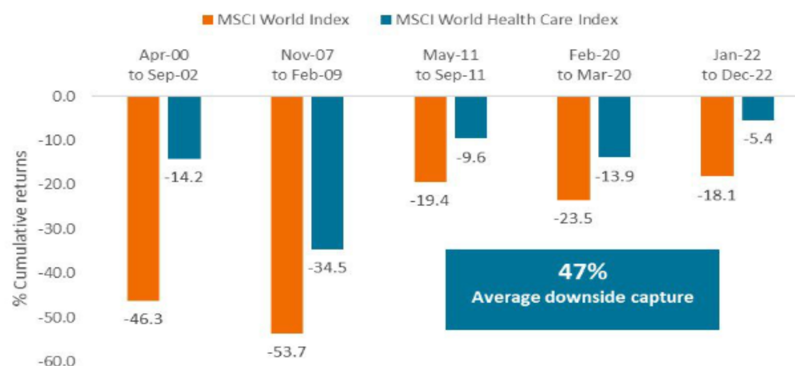



Given the above, we feel an overweight exposure to energy continues to make sense. As part of this we recently added Santos to our Australian Equities portfolio, as a complement to our existing holding in Woodside Energy Group (WDS).

## Health Check

When investors reach for defensive equity exposures, the health care sector is usually near the top of the list. This is due to revenues that are relatively resilient to the ups and downs of economic cycles and attractive earnings growth prospects, thanks to an aging population and new innovative product developments.

From a performance perspective, these defensive characteristics has meant health care has historically outperformed during large market sell-offs.




Source: Janus Henderson, FactSet. As of 31 December 2022.
Note: Chart reflects market declines of 15% or greater in the MSCI World Index since 2000. Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.**

Given a preference for defensive equity exposures in the current environment, health care is a sector we are attracted to.

When looking at global equities, health care has outperformed broader global markets in the recent pullback. Unfortunately, the same cannot be said for the Australian market where it has been one of the poorest performing sectors over the same period.

There are a few reasons for this underperformance. One is simply that valuations were pushed too high as investors sought out the defensive qualities of the sector.

Secondly, during the recent reporting season a number of health care stocks reported lower than expected margins on the back of cost and wages inflation.

Thirdly, some of the key stocks in the sector have been negatively impacted by news flows around GLP-1 diabetic drugs and their broader use as treatments for weight loss and liver disease.

CSL, as the dominant health listed health care stock in Australia has not been immune to these factors. We view CSL as a core holding given the quality of its global business and its ability to generate strong earnings growth over the long term. Over the past 10 years CSL has grown its earnings per share (EPS) at 11.30% pa. For the next two years consensus estimates are for an average of 15%+ pa earnings growth. Despite this, CSL is trading at a PE of 23x, well below its 10-year average 30x.

Resmed (RMD), is another Australian healthcare company with a global footprint that has also been negatively impacted. Like CSL, RMD also has a history of strong earnings growth, generating 16% pa over the last 10 years while current estimates for the next two years are 13% pa. RMD is also trading well below is 10-year average PE of 28x at only 20x currently.

In our last quarterly we discussed how markets are impatient and often rapidly price in the potential of longer-term themes. This can lead to increased volatility in the short term and present mid to long term investment opportunities. We view the recent sell off in the Australian health care sector and CSL and RMD in particular, as examples of this. As a result, we have been adding to both recently and will continue to look for opportunities on this build this exposure.

| | CSL | RMD |
|---|---|---|
| **2 Year Forward Average EPS** | 15.80% | 12.94% |
| **10 Year Historical Average EPS** | 11.30% | 16.00% |
| **1 Year Forward PE** | 23 | 20 |
| **10 Year Historical Average PE** | 30 | 28 |

Source: FactSet

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