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Investing through ongoing inflation uncertainty

Around the table | LGT Crestone Investment Forum

March 2023



Our panellists



Renato Latini
Associate Portfolio Manager
**Brandywine Global
Investment Management**

Renato is an associate portfolio manager and senior research analyst on the Global Fixed Income team. He is responsible for providing global macro analysis, credit research and portfolio management decisions.



Martin Emery
Portfolio Strategist
GMO

Martin is a portfolio strategist for GMO's Systematic Global Macro team. He currently serves as an Adjunct Professor in Economics and Finance at the City University of Hong Kong. He has a Master's and a PhD in Finance from the University of New South Wales.



Marigold Look
Executive Director Infrastructure
IFM Investors

Marigold is responsible for managing IFM Investors' net-zero infrastructure strategy. Marigold has extensive experience in investment evaluation, asset management, corporate finance, and valuations.



John Mulquiney
Portfolio Manager
Lazard Asset Management

John is a Portfolio Manager/Analyst on the Global Listed Infrastructure and Global Equity Franchise teams. He has been working in the investment field since 1997. John holds a PhD from the Australian National University, and a BA (Hons) from Sydney University. He is a CFA® charterholder.



Matthew Brown
Chief Investment Officer
Tanarra Capital

Matthew is the Chief Investment Officer at Tanarra Capital, a diversified alternative asset management platform. He has extensive international investment experience having previously worked in the United States at Makena Capital and in the United Kingdom, where he helped build the Oppenheimer family office after its sale of De Beers in 2012.



Scott Haslem
Chief Investment Officer
LGT Crestone

Scott leads the Chief Investment Office at LGT Crestone, covering strategic and tactical asset allocation, portfolio construction and manager selection across equities, fixed income and alternative assets. He has more than 25 years' experience in global financial markets and investment banking.



Stan Shamu
Senior Portfolio Manager
LGT Crestone

Stan works closely with LGT Crestone's investment advisers to understand individual client goals and to deliver suitable portfolios. With over 15' experience in financial markets and managed investments research across multiple asset classes, Stan has a wealth of experience in constructing portfolios and developing strategies for clients.

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Investing through ongoing inflation uncertainty

As we move beyond early 2023, our view on markets is relatively more constructive than it was in 2022. Indeed, we believe our 'worse macro, better markets' outlook remains the right call for the year ahead. Recent developments, however, suggest that the expected material slowing in growth this year (the 'worse macro'), which would lead to a pause in interest rate hikes (the catalyst to 'better markets') may slip from end-Q1 into Q2.

As discussed at our mid-February Investment Forum, and supported by the ensuing macro data, the path lower for inflation, at least globally, is being challenged by signs of 'sticky' services prices and resilient economic growth. Key central banks appear to believe that they have more work to do in tightening policy. Reflecting this, we now anticipate that a period of volatility and potential equity market drawdown in early 2023 will extend into Q2. We also expect policy rates will tighten slightly more than previously anticipated.

Recent central bank communications have also heightened the risk of overtightening, portending a sharper slowing in growth than we currently expect. Compelling signs of macro weakness (particularly some softening in jobs markets and consumer spending trends), which we still anticipate over the next several months, will be important. This will allow us to assess whether a more defensive portfolio positioning near term is a necessary precursor to a more sustained constructive market outlook later in 2023.

Four key themes emerged from the forum:

- **More work to do on inflation**—The near-term risk-reward favours more tightening by central banks over the coming months. The path for inflation remains highly uncertain, not least due to excess household savings, which are bolstering consumer spending. While members of the panel felt two or three more rate hikes were likely, they also noted this was unlikely to 'break' economies. Markets have also largely absorbed the higher interest rate outlook, given policy was likely at some point in the future.
- **The rotation from equities to fixed income has further to run**—With inflation unlikely to fall rapidly, fixed income returns are likely to remain competitive for some time. The panel believed investors should maintain a quality focus in corporate debt. After a period of ultra-low rates, investors are now being adequately compensated for the risk of default. Tight spreads are likely to cap returns from here, but there are pockets of value in certain sectors of the market.
- **Investors are not being compensated for adding additional equity risk**—Panellists viewed equity valuations as relatively expensive, despite select opportunities. Some panellists believed market beta would be harder to deliver in the current market. Still, there are regions and themes that offer opportunity—these include the energy transition, renewables and infrastructure, China and other selected emerging markets. Unlisted infrastructure is also seen as an attractive capital destination. Investors should focus, among other things, on companies with earnings certainty.
- **Adding to alternatives now is not a consensus view**—The panel broadly agreed that alternatives had proved their resilience in 2022, while their diversifying return drivers justify moving beyond a traditional 60/40 portfolio construct. Manager skill and active operational engagement add to the importance of manager selection. However, less transparency and elevated valuations were viewed by some as a cautionary note, while inflation protection is not uniform across unlisted sectors.

Are central banks on the verge of a policy error?

Early 2023 has revealed clearer signs that we are passing the peak in inflation and nearing a pause in central bank rate hikes. However, that narrative has recently come under pressure, with stronger-than-expected macro data seeing central banks become more hawkish. We asked our panellists what their outlook is for inflation, whether policy tightening will likely continue for some time, or if central bank 'panic' could lead to a pause.

What is the outlook for inflation?

Martin Emery, Portfolio Strategist at GMO Investors, reminded the panel that investors should be cognisant that central banks are playing catch-up. Not only is inflation one of the hardest economic variables to forecast, but the 2% inflation target set by many central banks is a "bit of an anomaly" and may lead to disappointment.

Emery explained that over the past 50 years, US inflation has averaged around 3%, while Australian inflation has been closer to 4%. With so much money expecting inflation to fall to 2%, he sees this as a significant risk.

"The biggest risk is the expectation we will lower inflation quite rapidly with minimal impact to the economy—but that's like having your cake and eating it."

Renato Latini, Associate Portfolio Manager at Brandywine Global Investment Management, agreed that it is challenging to forecast inflation and commented that there is a great deal of uncertainty about the speed at which inflation is expected to fall.

Latini explained that central banks are currently trying to work through the impact of stronger consumer balance sheets—a consequence of the COVID crisis. He also acknowledged that a tight jobs market may keep upward pressure on wages, and that job openings remain elevated.

"There is a lot going on with the data. It's messy—but the big forces (i.e. drastically lower money growth, rapidly tightening lending standards, and reduced excess savings) that are acting as a gravitational pull against inflation are in place and should continue to put downward pressure on inflation."

Scott Haslem, Chief Investment Officer at LGT Crestone, acknowledged that inflation will likely be a bit 'sticky' but, at the same time, leading financial indicators, as well as credit and financial conditions, have tightened significantly. While history suggests that a rising unemployment rate often causes angst for central banks, the Reserve Bank of Australia (RBA) has said that a weak labour market reading could drive a strategy re-think.

What could a strategy re-think look like?

Matthew Brown, Chief Investment Officer at Tanarra Capital, believes that from a 'top-down' perspective, a pause in policy tightening would be the logical next step for central banks. However, from a 'bottom-up' perspective, there are several arguments that support the case for a continuation in policy tightening. This includes the amount of opportunistic price-taking that is currently happening, particularly in private companies.

"Businesses are using inflation as an excuse to pass through overdue price increases and that's still rolling through. Wage pressures are coming through and that's also taking time."

Brown argued that passing on price increases is both an inflation and margin issue. In developed markets, corporate profit margins are at an all-time high. However, this will likely come under pressure as cost bases rise, particularly as wages and energy costs increase, and this will feed directly into inflation numbers. However, on the flip-side, supply chain pressures are easing and container rates are falling.

John Mulquiney, Portfolio Manager at Lazard Asset Management, explained that the high levels of debt in developed markets have been a concern for some time. If inflation runs higher for longer, central banks may not necessarily regard this as a bad thing, as it does go some way to solve the debt problem. Rather than lowering inflation rapidly, central banks have a bias towards letting inflation run a bit higher for longer.

"That's what the numbers show us. The reality is that while cash rates are higher, real rates are negative and we're not in a tight cycle—contrary to what the narrative tells us. You have to remember the extraordinarily low levels [of rates] we started at".

Haslem explained that no one remembers Paul Volcker (former Chairman of the US Federal Reserve (Fed)) for sending the economy into a multi-year recession. He is only remembered as the person who lowered inflation. **Haslem** suggested that the world's major central banks could be faced with the same dilemma. Ultimately, they need to decide whether two more rate hikes will 'break' the economy. If they believe it will, then history suggests they will need to take another direction.

How many more rate hikes can we expect?

Latini believes a further two or three hikes seem reasonable, but there is a possibility of one more beyond that.

"It's likely they will hike again in March and May, with rates remaining in the 3.5-4% range for a little longer than expected—but it will be data-dependent. While inflation is trending lower, it's more about the next step down where the heavy lifting will be required."

Emery agreed with this and explained that markets have absorbed the expectation of rate rises because there is also an expectation that they will reverse course afterwards.

Brown believes the base case of two more hikes makes sense and this won't necessarily break the economy.

"Whether you're looking at multiples or margins, this is what has already been priced in by markets. However, it's hard to see a scenario that would surprise to the upside, given where asset prices are. There is more downside risk."

How will the regions fare?

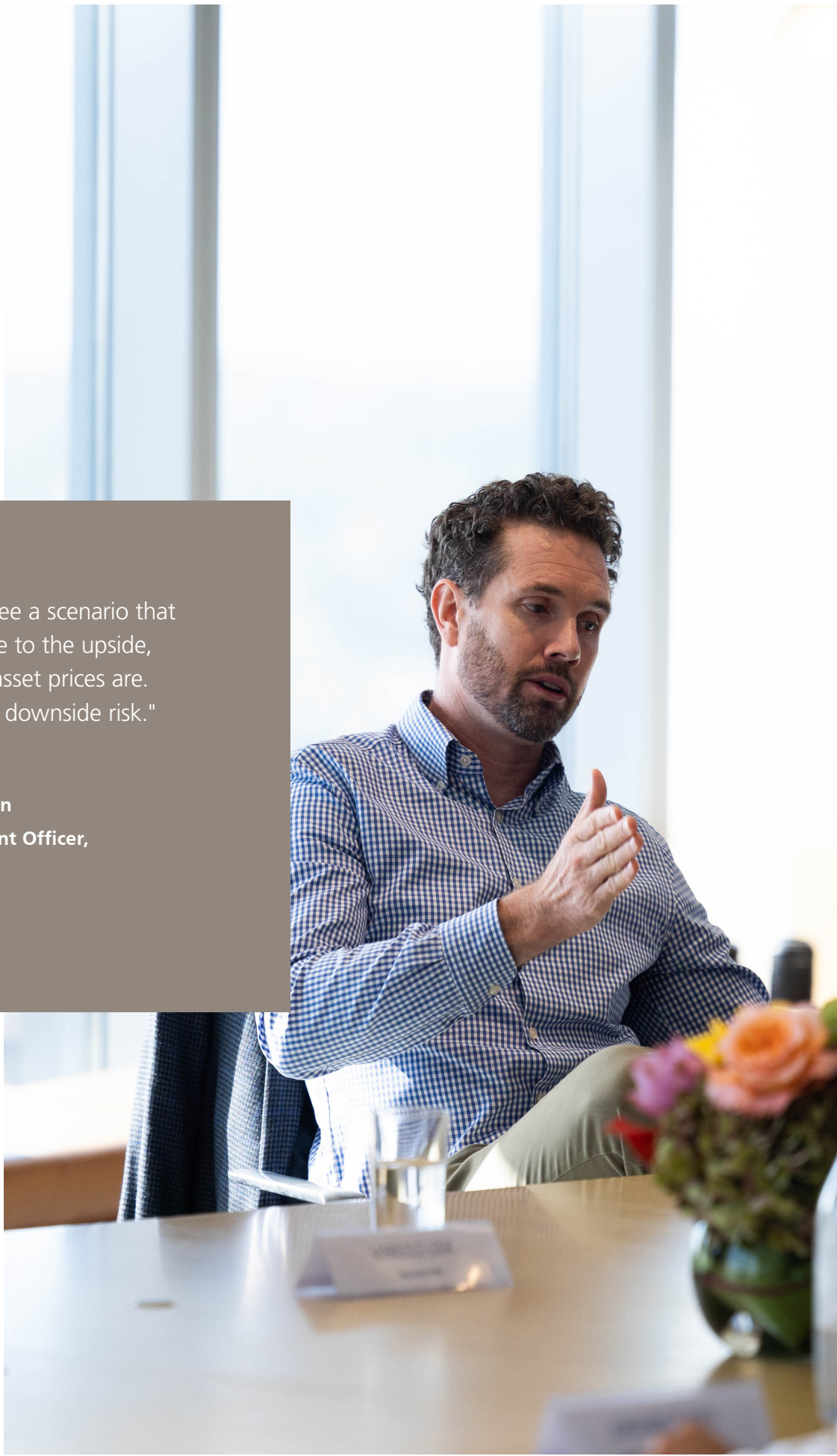
Haslem explained that the European Central Bank (ECB) started on its policy tightening journey later than other central banks. As the ECB is enacting one monetary policy for multiple economies and markets, **Mulquiney** explained that this can create its own challenges. Since many of these economies are highly-leveraged, if inflation is not brought under control, the ECB may need to adopt a financial repression-type model to keep inflation artificially low.

Mulquiney added that Australia is in a similar situation, given its levels of leverage and high housing debt.

"If rates rise above 4%, house prices may fall 25-30%, which would be challenging."

Latini does not believe we will shift to a higher inflationary environment over the long term. Structural factors, such as an ageing population and labour dynamics, will likely put downward pressure on inflation over the long term.

The LGT Crestone view: We believe that inflation volatility is likely to persist. While inflation is falling near term, the fading impacts of globalisation, structurally tight labour markets, and geo-political impacts on supply chains suggest less deflation and more inflation. Peaking inflation is likely to foster a near-term peak in central bank hikes. But stickier inflation than over the past two decades is likely to limit a return to near-zero interest rates.

A man with dark, curly hair and a beard, wearing a blue and white checkered button-down shirt, is seated at a light-colored wooden table. He is gesturing with his right hand while speaking. On the table in front of him is a clear glass of water and a small white card. To his right, a vase contains a bouquet of orange, pink, and yellow flowers. The background is a bright, out-of-focus interior space with large windows.

"It's hard to see a scenario that would surprise to the upside, given where asset prices are. There is more downside risk."

Matthew Brown
Chief Investment Officer,
Tanarra Capital

Are bonds back for good?

Over the past 12 months, bond yields have been rising as markets have priced in higher terminal rates. With inflation likely to remain above central bank targets for some time to come, yields are expected to remain higher for longer. However, as we enter a period of slowing economic growth, default rates among corporate issuers are also likely to rise. We asked our panellists whether investors are being adequately compensated for this risk, and how they should be positioning within fixed income over the next 12 months?

Does fixed income currently provide good value?

According to **Latini**, the margin of safety that corporate debt offers is much better than it was a year ago. During the COVID pandemic, spreads were tight and new issuance was low, but a rise in duration risk saw the asset class sell off aggressively. This means that the yields on offer versus the risk of default is now more attractive.

Brown explained that quantitative easing had made cash and fixed income unattractive for a long time, pushing large pools of capital up the risk spectrum. This led to higher multiples and asset price inflation across the board. Now, with the short end of the yield curve rising, **Brown** believes we will see a slow, multi-year rotation out of equities into fixed income by insurance companies and pension funds, which will potentially lower long-term equity multiples.

Are there signs of an impending distressed cycle?

From a macro-economic perspective, **Brown** believes the volume of distressed debt is lower than pre-COVID, but there are early signs of an impending distressed cycle. The team at Tanarra Capital has seen an increase in inbound enquiries from companies looking for capital solutions. Among the sectors experiencing pressure are construction and development, as well as aged care.

"The first movers naturally come with more complexity in structuring a solution, so you have to be diligent and pick through the pieces to see if it will work."

Which regions and sectors present the best opportunities?

Latini emphasised how important it is that investors know what they are investing in, particularly as cash rates and Treasury bills are offering a competitive return, and it is unlikely that we are on the cusp of a pronounced spread tightening cycle.

Although he feels the outlook for high yield debt is tepid because spreads are tight and the outlook is worsening, there are opportunities in certain areas (such as in oil, gas and mining) that are benefiting from structural tailwinds.

Within investment grade credit, he feels it is more challenging to find pockets of value, but prefers higher quality high yield issuers, whose management teams have acted responsibly throughout the cycle by paying down debt.

"In shorter-end high yield (the three to five-year part of the curve), you can get 7-9% compensation...while intermediate and long-term investment grade corporate bond yields are struggling to compete with T-bills [Treasury bills]."

Brown agreed with **Latini** that it is important investors know what they are investing in. He prefers floating rate notes over fixed rate debt, as this enables the investor to bypass duration risk.

Brown explained there has not been much of a price correction in Australian private credit, particularly for the low- to mid-cap issuers, given competition in the market. Spreads have widened around 50 to 100 basis points, and provisions from covenants have become slightly stricter. He explained that larger-sized companies within private credit had experienced more of a price correction.

The LGT Crestone view: At an asset class level, we are currently overweight fixed income. At a sub-asset class level, we are overweight investment grade credit and government bonds, supported by yields appearing to remain higher for longer. We have moved slightly underweight high yield credit, as higher-than-expected rate hikes may underpin a deterioration in the high yield credit market.

Are we being adequately compensated for equity risk?

The competitiveness of fixed income as an asset class has been a headwind for equities. This has led many investors to question whether they are being adequately compensated to take on equity risk. We asked our panellists whether equities currently represent good value, which sectors should perform best over the next three years, and whether emerging markets and China will continue to be strong growth drivers.

Are equities good value?

Mulquiney does not believe investors are being adequately compensated to take on equity risk. He explained that equities are still generally expensive—but there are individual pockets of value. Lazard Asset Management Franchise and Infrastructure funds is focusing on businesses that are trading at discounts to fair value, but that have issues that are easily solved. He explained that it is important to have an understanding of what companies are doing with any excess cash flow and how efficient management is at managing capital.

“The beta trade will lose you money. It’s a stock-pickers market.”

Brown added that the relative value trade has become more important than the beta trade.

“At a macro level, because of COVID and the economic disruption caused by that, there are pockets of value—but you have to be selective.”

Haslem reflected on the last 10 years and how equity markets have benefited from several growth drivers, such as the middle-income consumer in emerging markets, as well as technology drivers. However, looking ahead, the path looks less certain from a growth perspective.

Which sectors should perform best over the next three years?

Mulquiney said that the move to net-zero is an interesting area with the potential for growth. This should create opportunities in energy and infrastructure, given the significant spend that will be required. However, with so much capital flowing into this area of the market, investors should be cognisant of value, and should avoid being blinkered by the growth potential. He feels investors should be focussed on companies with a high degree of earnings forecastability.

“The returns are quite low and there is a lot of competition for those investments, with a lot of money being raised on the sustainability-type thesis.”

Marigold Look, Executive Director, Infrastructure at IFM Investors, agrees that the energy transition will likely drive growth in infrastructure and other unlisted assets. She believes the shift towards renewables and other technologies that support the decarbonisation story will be key for infrastructure going forward.

What is the outlook for emerging markets and China?

While emerging markets have been a growth area over the past decade, **Haslem** explained that the challenge now is that China appears to be on a different cyclical path to the rest of the world.

“China is confronted by many challenges, and Asia more broadly is confronted by slowing global growth, slowing trade, and slowing exports.”

Emery feels that certain parts of emerging markets are better than others from an investment standpoint—but one of the challenges that investors face is that it is hard to identify the leaders. In terms of China, he feels that the real question that needs to be asked is whether this market has been over-discounted.

“It was clear that [China] could not maintain a COVID-zero policy indefinitely. When you look at emerging markets generally, there are usually policies that suppress valuations. Some of these are temporary and have a lifespan that presents an opportunity. However, patience is key as it could take longer to be rewarded.”

Brown believes there are some cyclical and long-term growth drivers in China, which create opportunities for investors. Undoubtedly, China has experienced certain pressures, such as geo-political risk and an outflow of funds from global investors. He feels it would be a mistake to withdraw from this market entirely, given long-term fundamentals.

The LGT Crestone view: We have moved underweight equities. We are underweight Europe ex-UK (due to a weaker earnings outlook) and US equities (due to the recent rally and ‘full-ish’ valuations). We are overweight domestic equities and emerging markets due to attractive valuations in Australia and China, as well as the potential for tailwinds associated with China’s re-opening.

The role of alternatives and the 60/40 portfolio

Last year proved a strong testing ground for alternative assets, but the asset class continues to see capital flows. We asked our panellists whether the current dynamics warrant a greater allocation to alternatives and a revisiting of the traditional 60/40 portfolio. We also discussed which unlisted assets will likely provide the best protection against inflation.

Public or private – why invest in alternatives?

Brown explained that alternative investments provide diversification and different return drivers from traditional asset classes. Ultimately, **Brown** feels that the factors affecting public companies are also likely to affect private companies, but private investments (i.e. alternatives) are unlikely to experience the same level of volatility as their public counterparts. Private companies can avoid the short-term pressures that public companies face and focus on long-term agendas to create value for shareholders.

Look added that at IFM Investors, they play a role in managing the underlying assets and work very closely with management. In some of their investments they aim to add value by assisting in managing the cost base. As an example, on-site solar installations have provided energy cost savings to airports, and have provided energy certainty. IFM Investors also engages third-party valuers on a regular basis, and these valuers generally take a long-term view on risk-free rates, which smoothes out short-term rate volatility.

Mulquiney feels there is more transparency in public markets. With private companies, there is a heavy reliance on the manager to provide sufficient transparency. Incentive structures are also different for private companies.

Why invest in unlisted assets now?

Mulquiney explained that a lot of money has chased a limited amount of unlisted infrastructure deals. This has caused the valuation relationship to flip, with these assets now trading at a premium to public markets.

Look feels there is still value in having a healthy allocation to unlisted real assets, particularly given current market volatility. She also believes there is still a lot of capital ready to be deployed into unlisted infrastructure.

“Unlisted infrastructure has strong inflation linkages and underlying growth drivers. The mid-risk nature of these investments and strong potential cash yields are particularly beneficial in this environment.”

However, despite the defensive characteristics of these assets, **Look** explained that it is prudent to constantly

stress-test portfolios to help maintain resilience through various market cycles. The key is to maintain a diversified portfolio.

Emery suggested that given the challenges that traditional asset classes face, the approach of starting with a 60/40 portfolio (split 60% equities and 40% bonds), then gradually adding alternatives might not be optimal.

“Perhaps 60/40 is now just an anchor and not the core capability. Alternatives are now extremely important. The challenges in traditional asset classes compel investors to adjust their thinking.”

Which assets provide the best inflation protection?

Although unlisted infrastructure is known for its strong inflation linkages, **Look** explained that its ability to provide inflation protection does vary across sectors.

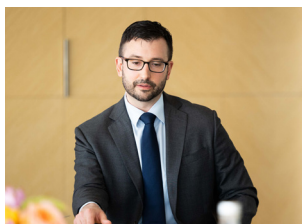
The sectors that tend to provide the greatest protection against inflation are regulated utilities (which have inflation protection via the regulatory regime), toll roads (where toll prices are contractually linked to the consumer price index) and public private partnerships (which provide concession payments from government, which are indexed to inflation).

Port assets are less explicitly linked to inflation, but they are generally able to pass on rising costs through port charges, as these represent a small proportion of the total value of goods being transported.

While the performance of airport assets are linked to GDP, they are less able to immediately pass on rising costs to the consumer. However, airports are generally diversified businesses, and the property and commercial businesses within airports are more responsive to inflation. Moreover, an increase in air passenger numbers provides a significant growth cushion from the negative impact of inflation.

The LGT Crestone view: The return outlook for alternatives looks more attractive, given a meaningful recalibration in broad valuations and long-term interest rate expectations. We favour hedge funds and real assets, with deployed private equity least preferred.

Where would you allocate your incremental dollar?



Renato Latini
Associate Portfolio Manager
**Brandywine Global
Investment Management**

"I would bar-bell long-dated US government bonds with income opportunities at the front end of the yield curve."



Martin Emery
Portfolio Strategist
GMO

"Spread trades in equities."



Marigold Look
Executive Director, Infrastructure
IFM Investors

"Energy transition infrastructure."



John Mulquiney
Portfolio Manager
Lazard Asset Management

"Equity value with the ability to forecast strong cash flow."



Matthew Brown
Chief Investment Officer
Tanarra Capital

"Cash (because some caution is warranted), distressed debt and private equity. Private funds raised in 2023 will deploy into any weakness that eventuates over the next 18-24 months."

Contact us

LGT Crestone Wealth Management Limited

ABN 50 005 311 937
AFS Licence No. 231127

info@lgtcrestone.com.au
lgtcrestone.com.au

Adelaide

Level 26, Westpac House
91 King William Street
Adelaide SA 5000

+61 8 8403 9400

Brisbane

Level 18, Riverside Centre
123 Eagle Street
Brisbane QLD 4000

+61 7 3918 3600

Melbourne

Level 17
101 Collins Street
Melbourne VIC 3000

+61 3 9245 6000

Sydney

Level 32, Chifley Tower
2 Chifley Square
Sydney NSW 2000

+61 2 8422 5500

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