Harbourlight PWM Investment Review and Outlook.

A brief review of investment markets and broader factors affecting clients. **January 2023**

The outlook is clearing, but there is still conflicting data. We prefer neutral to slightly growth leaning portfolios and welcome fixed income back as a relevant investment option.

As we make our way into the first few weeks of 2023, economic data allows us to better evaluate how the final stages of the Covid-19 pandemic and subsequent inflationary outbreak are panning out.

Central banks have changed their approach to monetary policy from stimulating the Covid economy to slowing the inflation economy. Global interest rates are rising and in the US, official cash rates are now approaching levels not seen since before the Global Financial Crisis of 2007.

Initial increases in interest rates seem to be working. Slowing GDP growth, softening consumer sentiment and reducing household savings to pre Covid levels are feeding through to cooling inflation in some parts of the world. It still however looks likely that inflation will remain higher than central banks are comfortable with for the medium term and further rises in rates are possible.

In contrast, China which represents almost 20% of global GDP is coming out of lockdown, employment remains strong and corporate profits are looking reasonable as we go into the next earning season, though these could be the next places strain shows.

Politically we seem to be swaying away from authoritarian governments in the western world. Whilst in the east, further tensions arise to hold on to power. Russia continues its war of never ending missiles in the Ukraine and China remains staunch but has at least abandoned its zero Covid regime resulting in the reopening of borders.

Ongoing political tensions and a trend towards deglobalisation will continue to feed into economic inefficiency and supply demand imbalances.

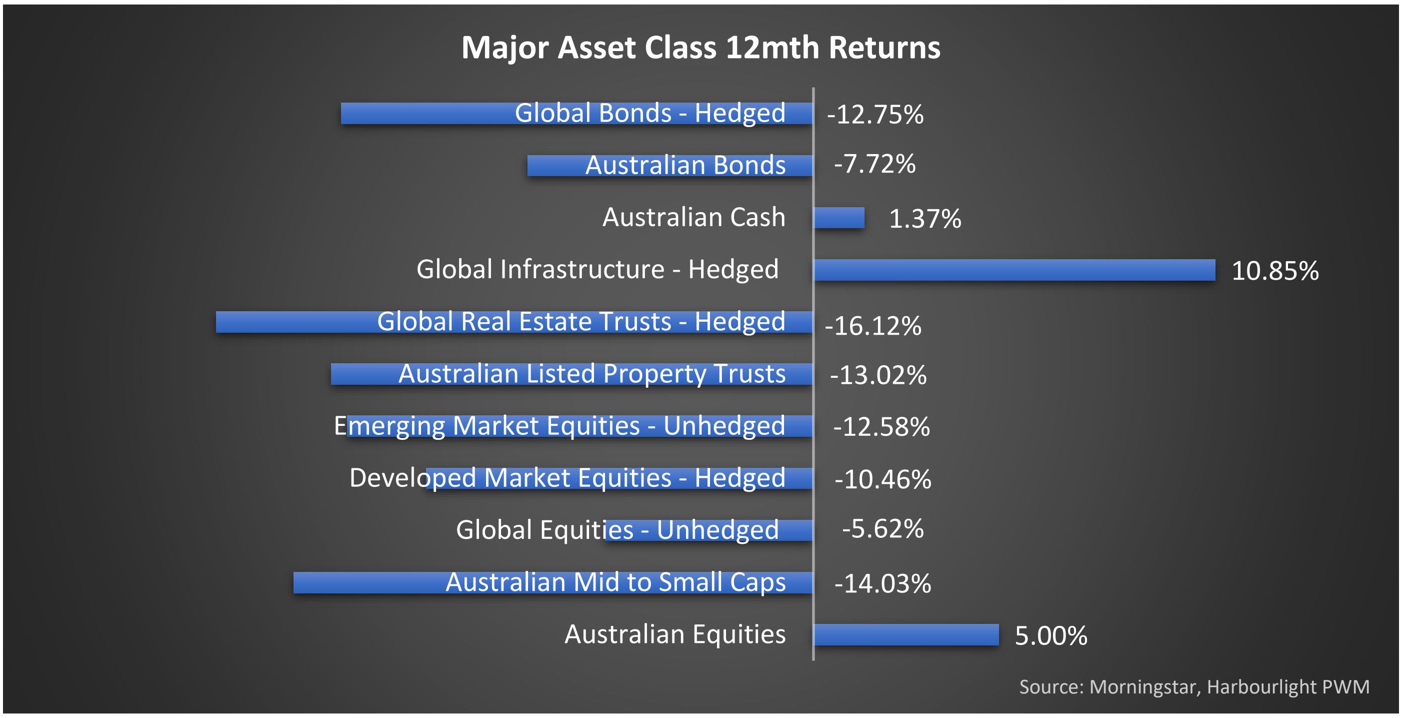
Rises in fixed income yields and estimated forward looking portfolio returns are the highest they have been in 5 years making diversified and conservative investing a much easier proposition. Fixed income indices now offer yields of 4% to 9% depending on your risk appetite. Opportunities also seem to be emerging in mid to small cap growth stocks and overall portfolio expected returns are rising.

Whilst there is still the risk of further negative returns this year, the possibility of inflation feeding through to corporate profits and rents, combined with the likelihood of a mild recession which achieves central bank goals leads us to our neutral to slightly aggressive asset allocation stance.

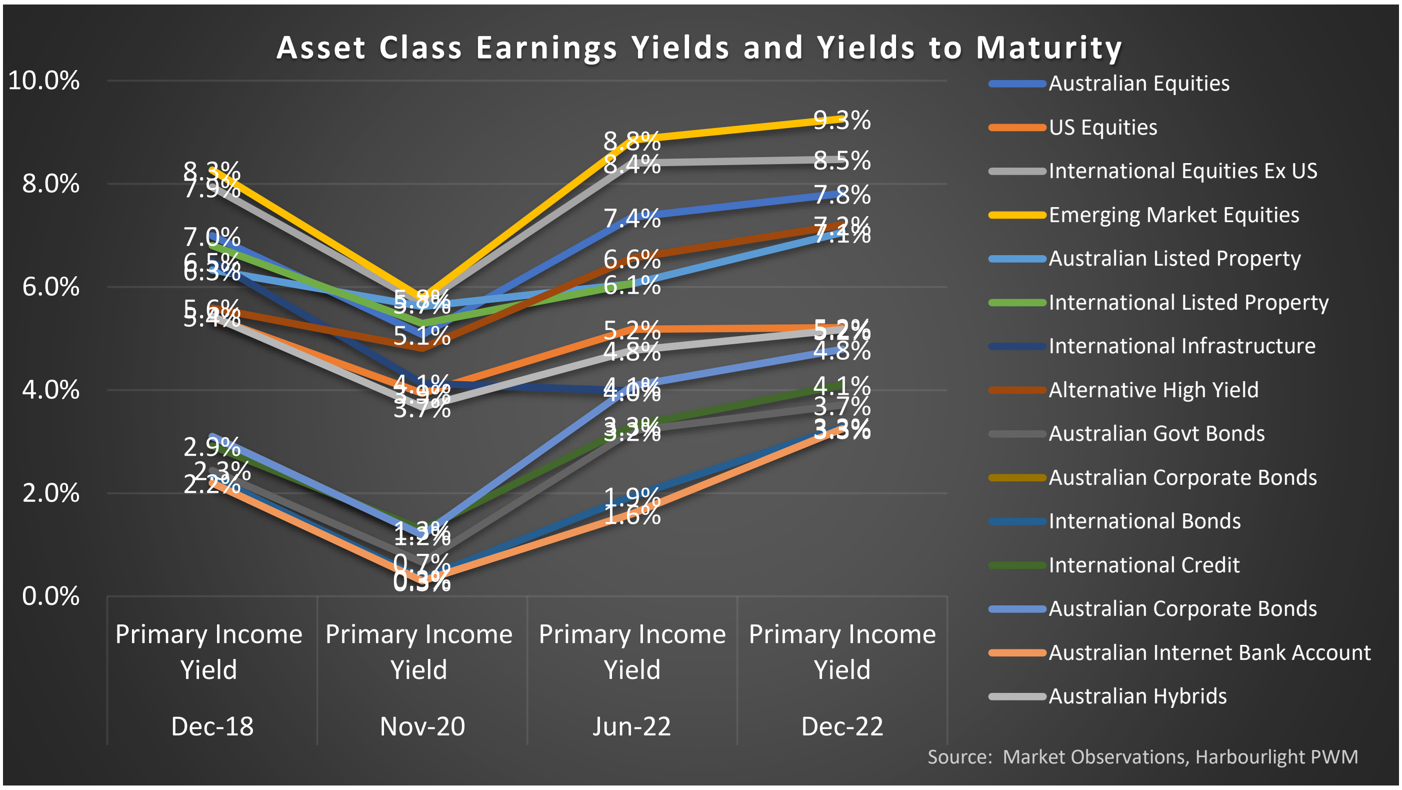
We expand below with charts and themes likely to be important for the year ahead.

Investment Markets.

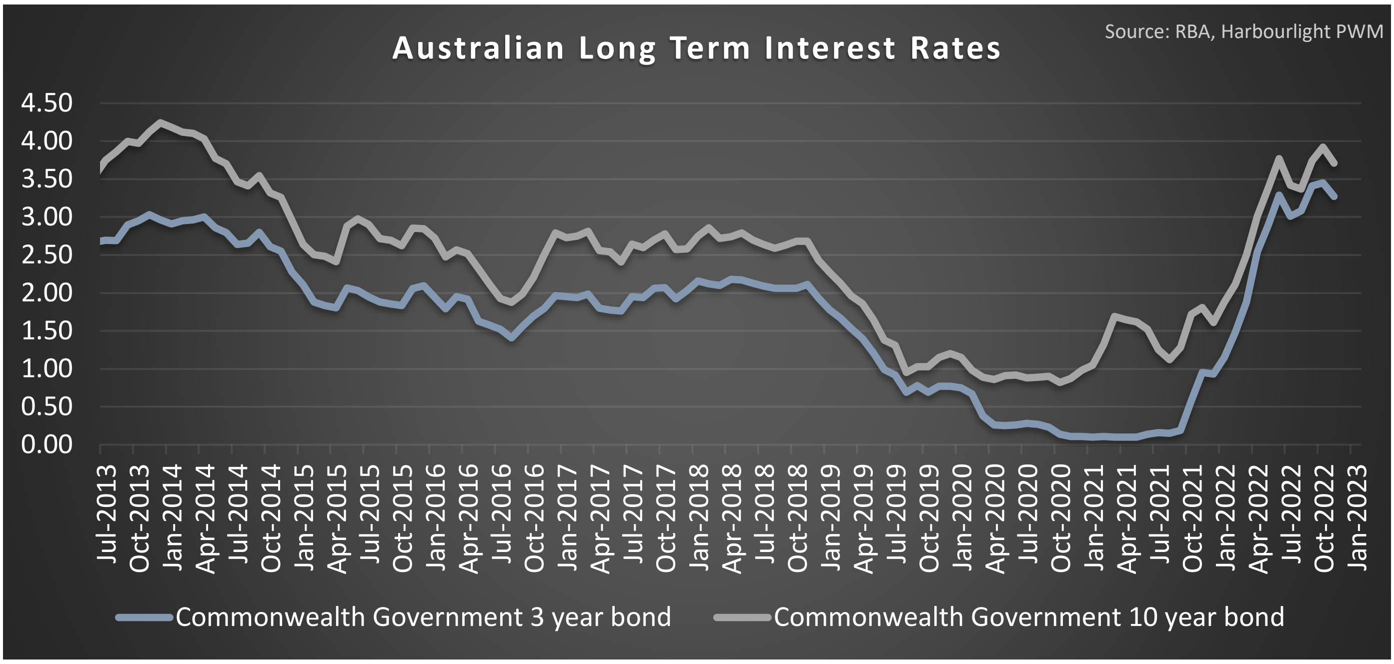
Broadly it has been a tougher year for investment returns with most equity and fixed income segments posting negative returns.



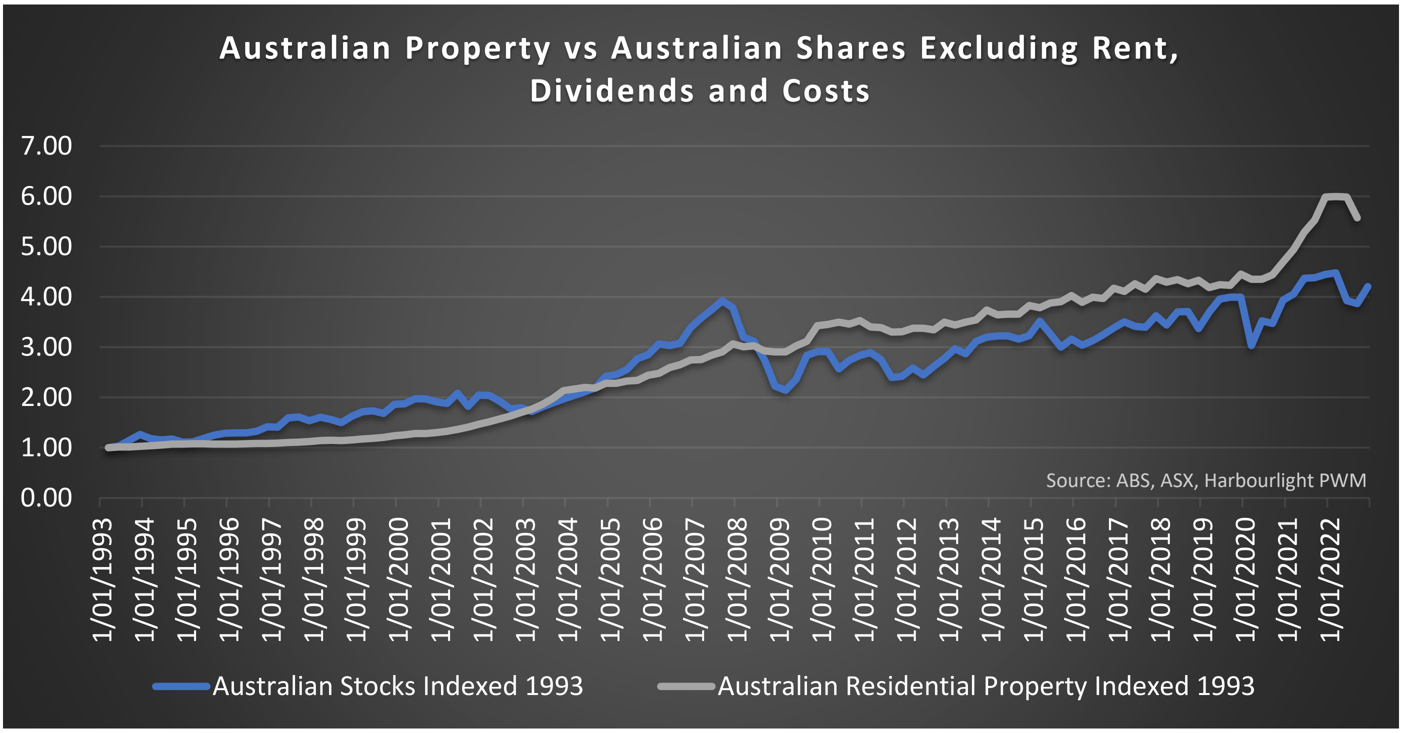
Overall investment valuations look fair to attractive. Whilst earnings remain volatile and subject to shorter term shock risk, over a 3 year outlook we expect inflation to feed into reasonable levels of earnings growth and subsequent asset price inflation. Simple earnings yield calculations are showing the highest levels we've seen in 5 years.



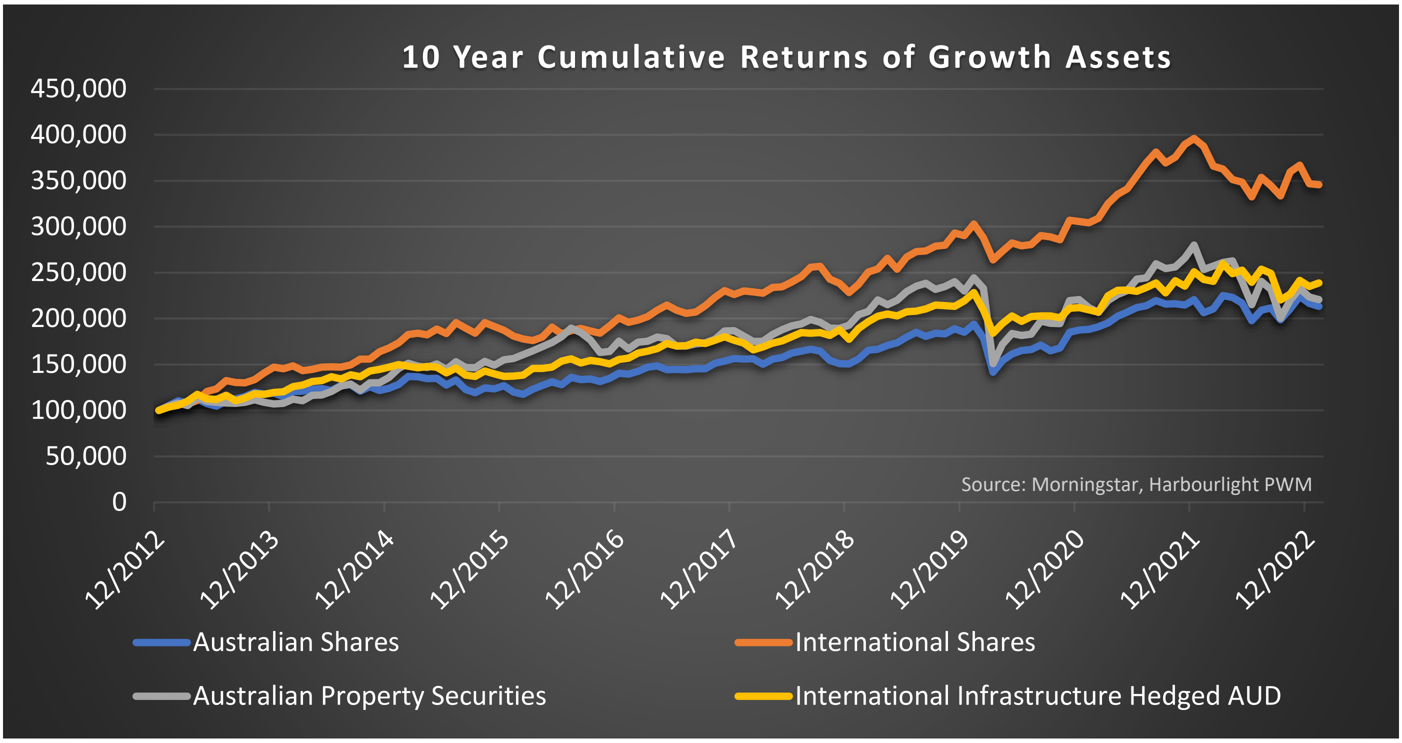
Interest rates have stabilised in the last six months, following a steep rise in the previous financial year and less alarming monthly inflation readings in some major economies. This has resulted in steep declines in bond prices which are now providing yields of 4 - 9% and an increase in mortgage rates.



Australian residential property prices show a fall in value of roughly 8% over the last 12 months. In the context of the first meaningful rise in interest rates in 25 years, this is not unexpected. We could easily see further falls here as the effects of rising interest rates are fully realised. The full impact of these rate increases is likely to be delayed over the next 4 to 5 years as nearly half of the Australian mortgage market moved to fixed rates over the period between 20-22. This will provide a buffer to many people and the economy but will slowly reset over time. Rising wages and inflation should buffer this somewhat.



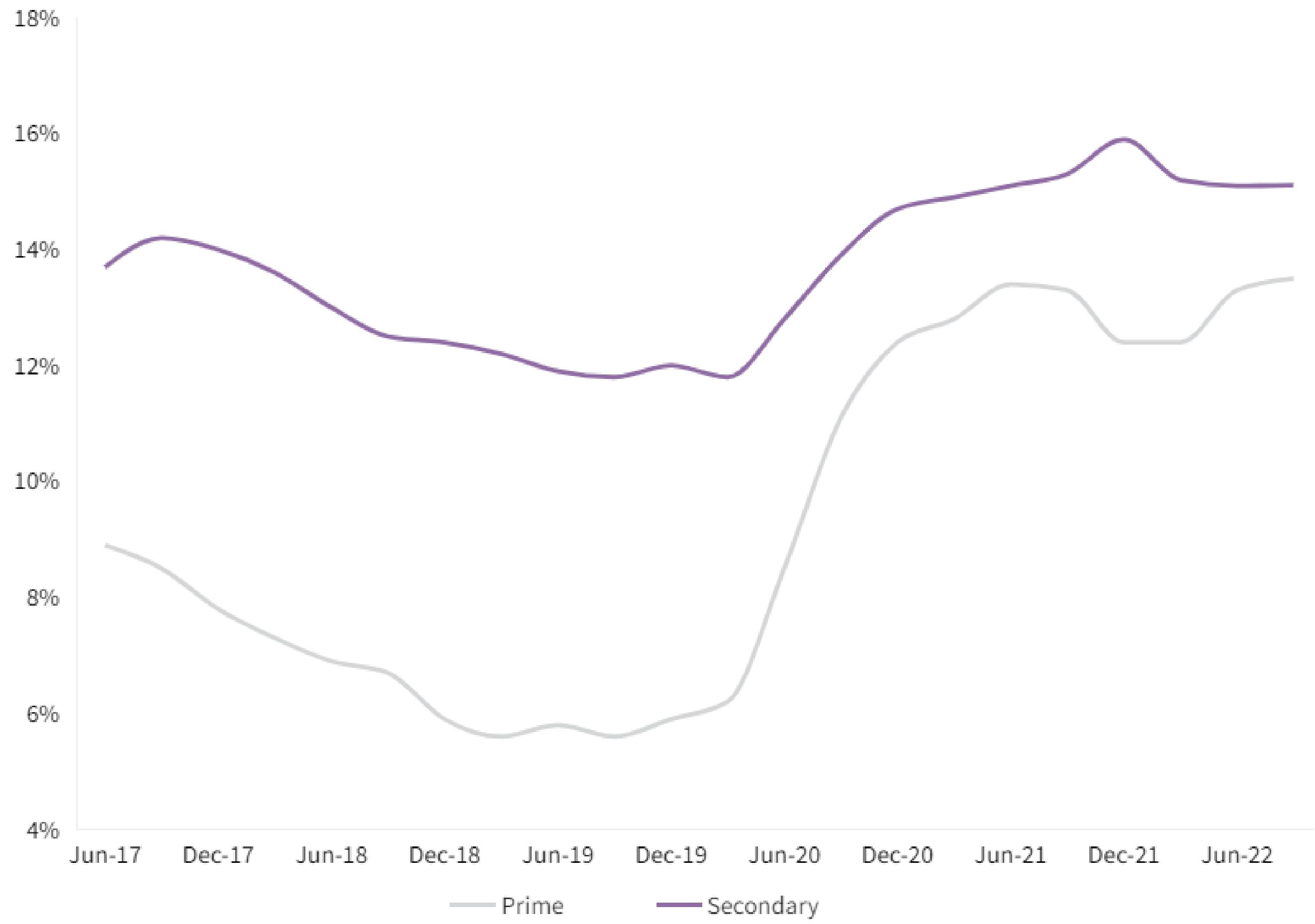
In equity related markets international shares have fallen the most in value over the year though by historical context the falls broadly have been on the milder side.



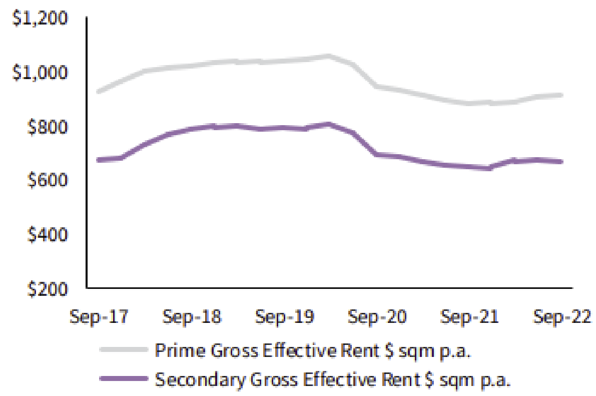
The fall in technology stocks was the most pronounced in 2022, particularly in mid to small cap stocks. With concerns of slowing growth, earnings uncertainty and investors higher required rates of return, shares in this sector saw falls of between 30% and 70%. Many of these stocks continue to have highly attractive earnings growth potential, making the sector look the most attractive it has since the start of Covid.

Office property vacancies remain high post Covid, with effective rents looking stable and yields up slightly. It would generally be expected that inflation leads through into increases in rents and yields rise on a lagged basis following interest rates.

Australian CBD office vacancy rate, by grade, 2017 to 2022

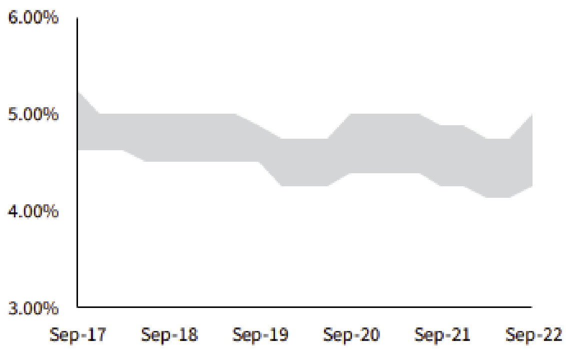


Gross Effective Rent



Source: JLL Research as at 3Q22

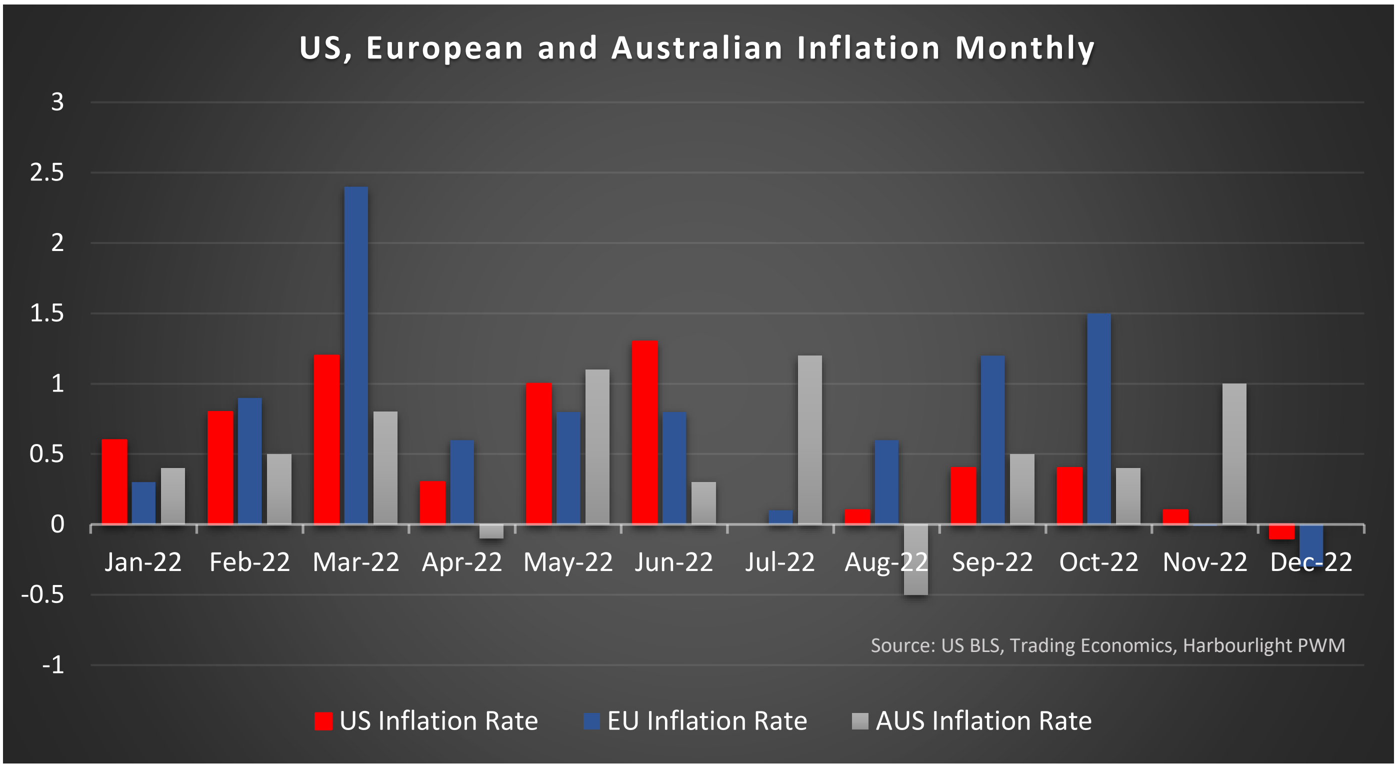
Prime Yield Range



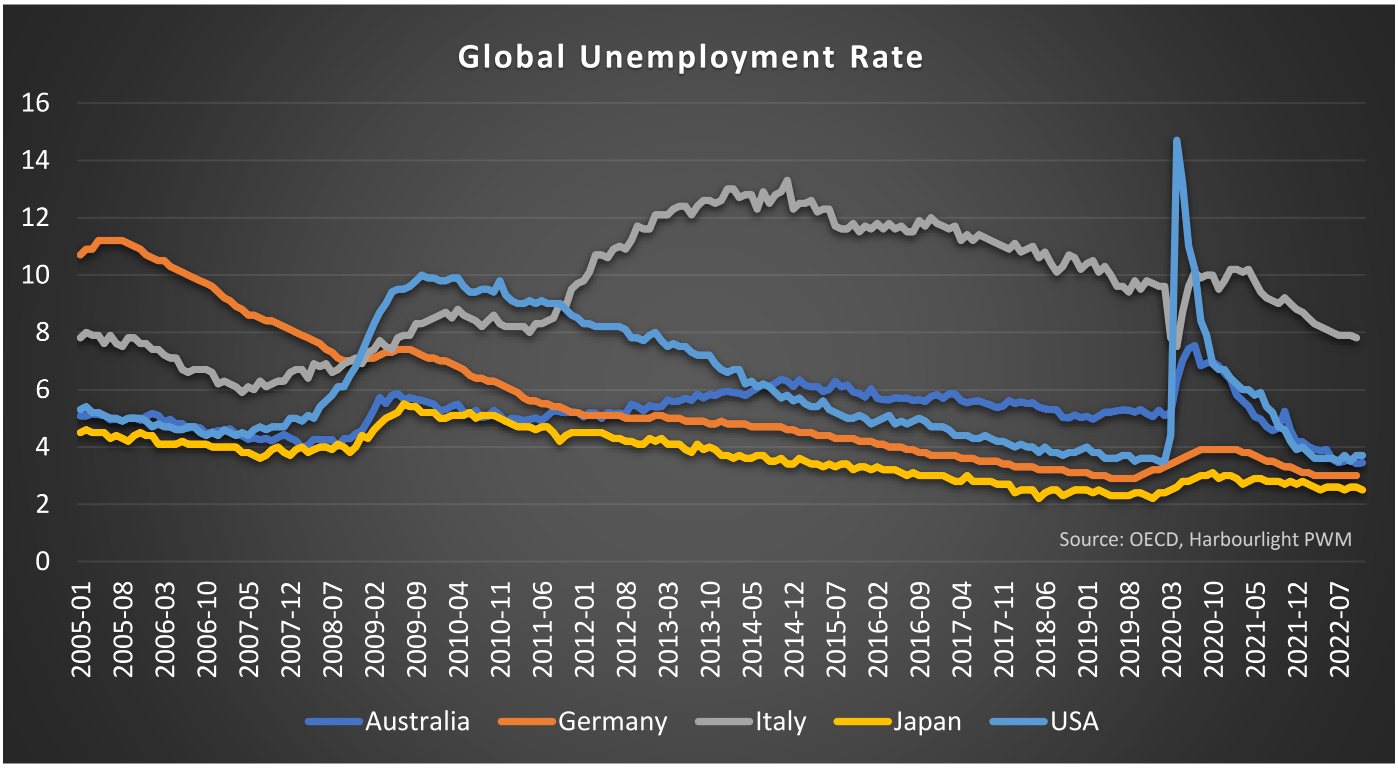
Source: JLL Research as at 3Q22

Economic Data

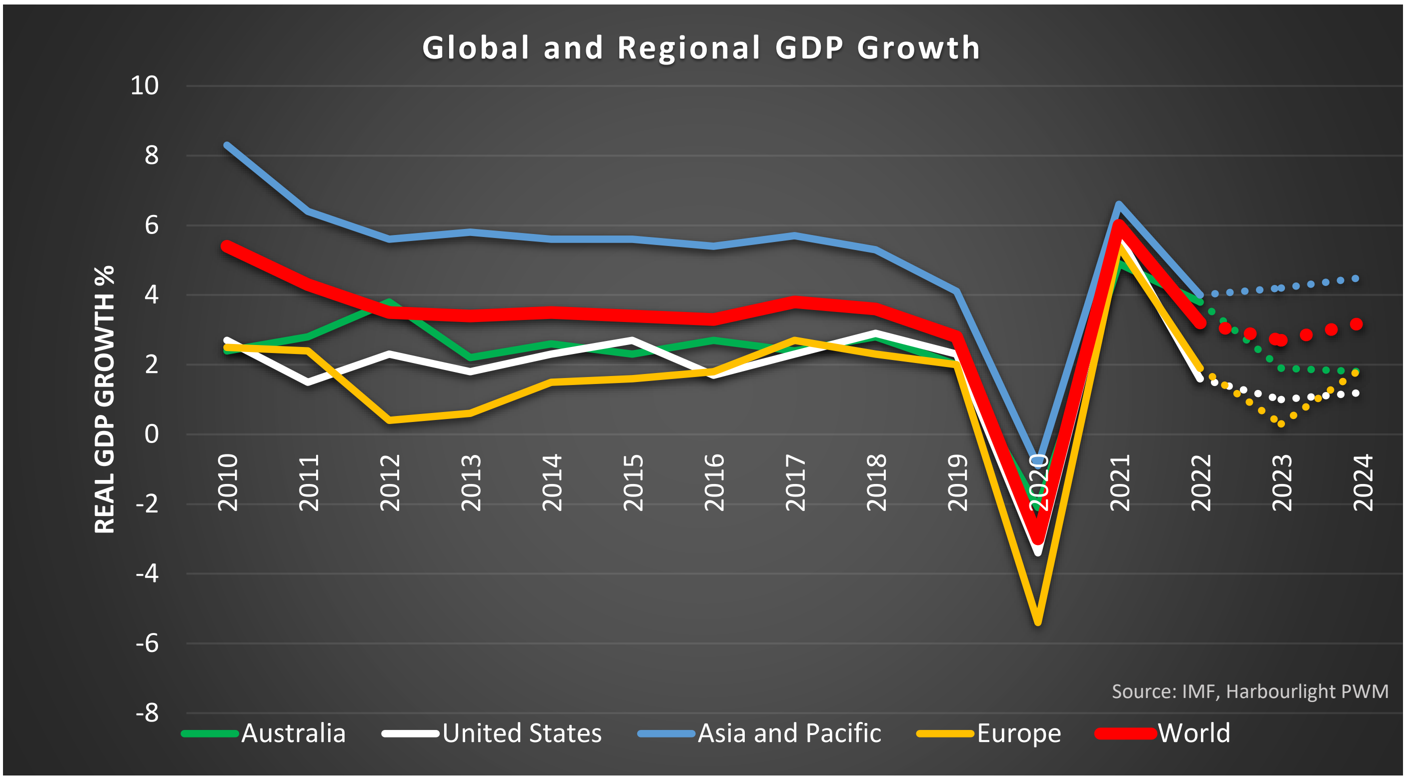
Inflation looks to be softening in the US and Europe though Australian inflation is still rising.



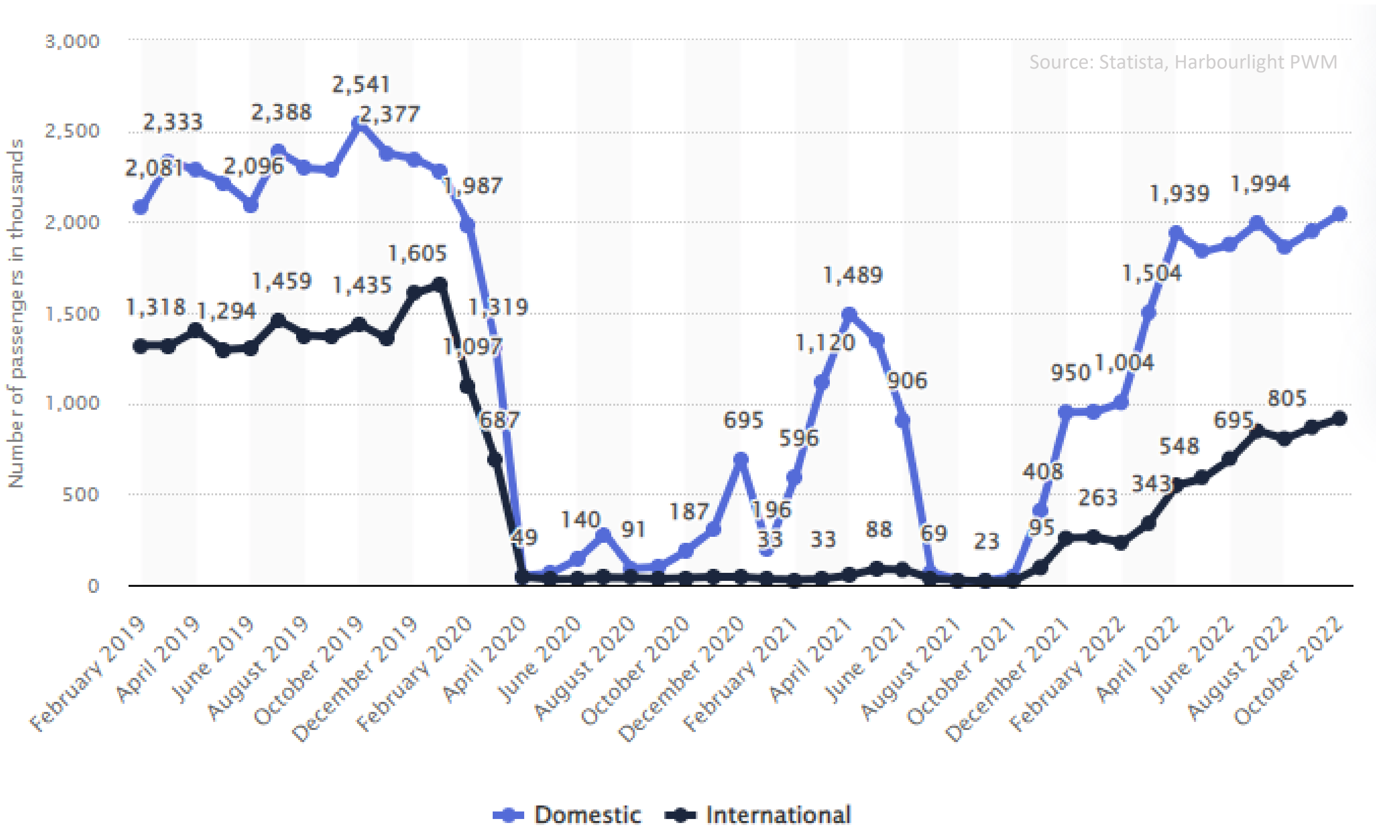
Employment remains strong globally.



GDP data looks to weaken without a hard landing.

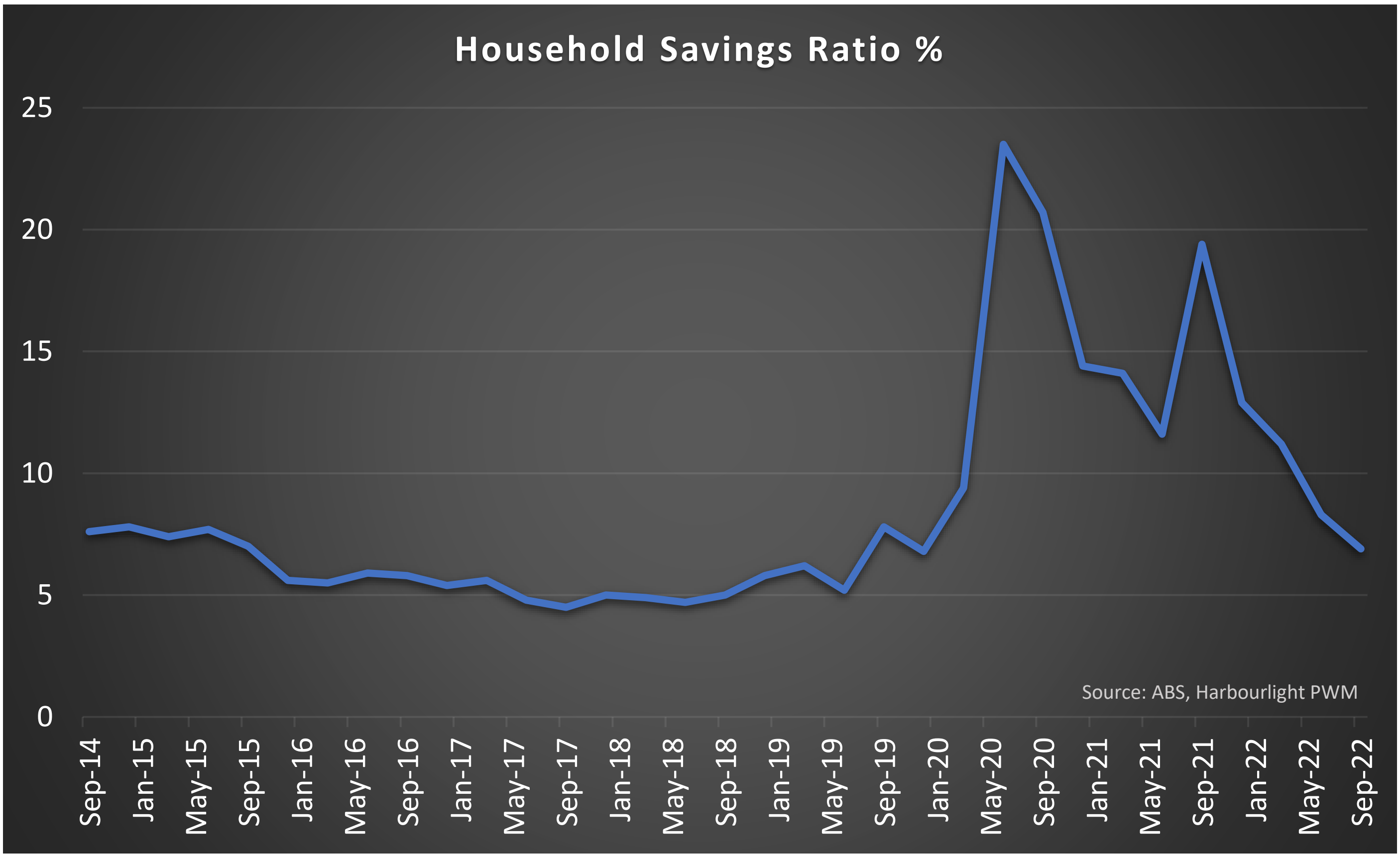


People are travelling again with flight numbers at airports recovering but remaining below their Covid peak (circa 80% domestically and 50% internationally in Australia).



Wage growth is normalising but certain sectors seem to be feeling more supply demand imbalances.

Household savings are also returning to more normal levels post government and interest rate stimulus.



Our views for the next 12 months.

As asset prices have become broadly more attractive, we become more constructive on investing in general.

We continue to prefer a neutral to more aggressive asset allocation for investment portfolios, with gradual implementation, cognisant of the fact that we may be part way through a more protracted downturn than the ones we've seen recently.

We welcome fixed income back as a valid investment option, post the exit of government stimulus and normalisation of interest rates. High grade bonds now provide more attractive yields of between 3% and 5% and high yield/ EM bonds push this out to 7-9%.

Equities are more sectorally bifurcated than before, facilitating some investments that should have better outcomes over the mid to long term.

We continue to prefer partial to more full hedging of offshore assets.

Other Regulative Matters

- The work test has been abolished on non-concessional contributions for those aged between 67 and 75 from July 2022 making contributing to super easier for those in this age group.
- The age restriction for downsizer contributions has been reduced to 55+ from the first of January 2023.
- Compulsory super contributions will increase to 11.00% from July 2023.
- Superannuation contribution caps are expected to remain at $27,500 for concessional contributions and $110,000 for non-concessional contributions.
- Temporary Covid-19 legislation relating to the halving of minimum pension payments will continue to the 30th of June 2023.
- The transfer balance cap applying to commencing retirement income streams is expected to increase to circa $1.8m on the first of July 2023.

Please feel free to contact us if you wish to discuss any of these matters.

Harbourlight Private Wealth Management

hlcs@harbourlight.com.au

https://harbourlightwealth.com.au