THE HOPKINS GROUP
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THE HOPKINS GROUP MARKET UPDATE

22 JULY 2022

SYSTEM UNDER PRESSURE

- **ECONOMIC & MARKETS COMMENTARY**
  - **Markets wrap-up**
    - Global equity markets posted consecutive exceptionally poor returns at the end of June. Rising interest rates, historically high inflation and fears of recession continued to push equity markets lower. The broader Australian share market was down 8.97% during the month of June, while Australian small-caps, underperformed large-caps, down 13.09% for the month. Global share markets were also down, but outperformed Australian shares. Australian & International property asset classes were also hit, down 10.33% & 5.18% respectively. The infrastructure asset class was also down but fared relatively better than other assets, only down 1.69% for the month. This month caps off a poor financial year for investors, with the average Balance (70/30) portfolio generating a negative return of -8.1% to the end of June. The last time we saw a negative return such as this was during the GFC in 2009.
  - **US' Q2 22 earnings season is set to be the most important in years**
    - US Q2 earnings reporting season will take center stage this week, with investors looking for signs of how company earnings are being impacted by higher interest rates, record inflation, and higher input costs. This particular earnings update comes at a very critical time with Global share markets down 14.43% for the calendar year to date. In light of this risk-on environment, investors are expected to show no mercy to companies that miss their earnings expectations. Q2 22's earnings growth rate is expected to be approx. 5%, which is the lowest rate of growth since Q1 20. On the face of it, a 5% earnings growth rate is considered a positive; however, questions around whether earnings and margins have fully priced in rising interest rates, record inflations, and a slowing economy remain. A rising US Dollar is also expected to have a negative impact on companies generating offshore revenue.
  - **Strong labour market continues to highlight a disconnect**
    - The disconnect between the strength of the economy and recession concerns continued with US' June job payrolls data. US' unemployment rate remains at near 2-year lows of 3.6% for the fourth consecutive month, with 372,000 jobs created in June. The Australian unemployment rate fell to almost 50-year low of 3.5% for the month of June. We are beginning to see some softening in the US labour force data, with a small decrease in job openings, and an uptick in jobless claims. The cooling in the labour force could create some food for thought for the Fed and its hawkish interest rate policy stance.
  - **Not all recessions are alike**
    - Central Banks are trying to normalise interest rates through a not-so-normal front-loading of interest rate increases, even at the risk of pushing the global economy into recession. But not all recessions have behaved the same, some have been short in duration and shallow in impact, while some lasted longer and had a deeper impact. Currently, corporate and consumer balance sheets seem healthy, and if we continue to see current near full employment conditions hold up, these factors should help in weathering a short recession.
  - **Is Inflation close to the peak?**
    - US headline annual inflation rose to a new 40-year high of 9.1% for the month of June. Similarly, Australia's annual inflation rate soared to 5.1% in Q1 2022, its worst reading recorded in more than two decades. While we have yet to see any firm data to support whether inflation has peaked, we are starting to see some price pressures coming off from durable goods with slowing demand, rising inventories, and shifting demand to services. The spike in prices for durable goods is the leading contributor for the rising core inflation.

- **INVESTMENT OUTLOOK**
  - **Equity market rallies continue to be snuffed out**
    - Should CPI data cool over the next few months, there is every chance that we could see some rallies in global equity markets. However, if at all, any rally might be short lived. The lack of adjustment in earnings for impact of inflation, rising input and wages cost, is unlikely to provide solid support of equity markets rally.
  - **Equity market valuations falling but is it cheap...**
    - Broader equity markets valuations have been declining since the start of this year. The S&P 500 forward P/E has fallen 15% to 16x, just below its 10-year average of 16.9x. Similarly, the S&P/ASX 200 forward P/E is trending just above its 15.9x long-term average. It's a challenge to determine the 'cheapness' of the current valuations as there are uncertainties around earnings. This is especially important given that earnings is the denominator in the P/E ratio; therefore, it would be difficult to form a solid view on valuation if earnings have yet to be adjusted.

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- **Are we at the bottom and what do markets need to see to change direction**
  - It is very challenging to identify an equity market bottom accurately. Some say the only way to pick one is when you've passed it. Equity market bottoms tend to be where we find investor sentiment at the panic & capitulation level. Investors throwing in the towel and selling off. Back in April 2020, market valuations went as low as 12x Price Earnings (that was the bottom) vs. LT average of about 15 times. In terms of the current environment, it doesn't feel like we are at the bottom at this juncture. We aren't at that investor capitulation stage just yet. Perhaps we might be nearing a market bottom when the US Fed starts hinting that that they might be nearing the end of the rate hike cycle after getting inflation under control. You might then see equity markets rally.

- **INVESTMENT STRATEGY**
  - **De-risking portfolios**
    - We continue to maintain a more defensive portfolios position considering growing market volatility and uncertainty. We had positioned portfolios to lose less relative to the average multi-asset portfolio. In this period of market volatility and macro adjustment, it is sensible to remain well diversified within asset classes. Given the current market uncertainty, the potential for varied returns outcomes is high.
  - **The importance of staying nimble and move when opportunities & risk present themselves**
    - In this highly volatile market environment, it is important to remain active and nimble in asset allocation strategy so that we can take advantage of opportunities and mitigate risks when they arise in a timely manner. At this point in time, we prefer to hold ample cash reserve in most portfolios to take advantage of real & attractive opportunities when they arise.
  - **Still prefer value over growth stocks, but will this value continue to outperform?**
    - Value stocks have been found to perform better in an environment with rising prices and interest as compared to growth stocks. Also, high-quality companies with pricing power will be able to pass on the inflationary price pressure to their customers as they typically have higher cash flows and high cash on their balance sheets.
  - **Keeping exposure to Emerging Markets at near neutral levels**
    - Emerging Market valuations are attractive, and while they should continue to benefit from above trend economic growth, rising interest rates, inflation & geo-political risks along with China's economic slowdown could create headwinds for returns.
  - **Maintaining an underweight exposure to small-caps**
    - Increased volatility following the recent correction is a sign that we could be entering the later stages of a bull market. During this time, exposure to smaller companies should be kept at a minimum. Given that this sector and the underlying companies are illiquid in nature, they can be very volatile and can significantly underperform large-cap stocks.
  - **Holding a nominal exposure to the Global infrastructure asset class**
    - Exposure to the listed infrastructure asset class continues to provide the important element of diversification within a diversified portfolio. Infrastructure assets can have attractive investment characteristics, including long-life assets, inflation-linked returns, lower risk of capital loss relative to other equity investments, and have low correlation to other asset classes. Infrastructure has also proven to provide downside protection to multi-asset portfolios.
  - **Prefer a material exposure to uncorrelated assets**
    - Uncorrelated asset classes, such as private equity, have provided some downside protection over the past month whilst producing attractive returns in up markets over the medium to long term.
  - **Retaining gold exposure in defensive alternatives**
    - Having some exposure to gold is beneficial because it can be used as an inflation hedge and is proven to provide downside protection when equity market returns fall, as it has in recent months. We observed that the price of gold has been trending upwards following recent inflationary concerns, and increased probability of slowing global economic growth.
  - **Reduced hedging of international equities exposure**
    - Over the past two months, the Australian dollar has experienced a period of softness and choppiness with the Australian dollar drifting from 70 US cents to around 67 US cents, its weakest level since July 2020. Factors, such as concerns around slowing Global GDP Growth, commodity prices coming off from an exceptionally strong rally, the effects of the current lockdowns in China on Australia's economic growth, and interest rate differentials between Australia and the US, are expected to place downward pressure on the Australian dollar relative to the US. Also, the US dollar tends to perform well when investors become more risk averse as shown in the current environment as they seek shelter in assets that they perceive as more secure. Its status as the world reserve currency continues to make the US dollar a particularly attractive and proven safe haven for investors.

- **MARKET INDICES PERFORMANCE**

INDEX Period ending 30 June 2022	Mth %	Qtr %	1 Yr %	3 Yrs p.a. %	5 Yrs p.a. %	10 Yrs p.a. %
Australian Shares						
S&P/ASX 300	-8.97	-12.22	-6.78	3.44	6.90	9.24
S&P/ASX Midcap 50	-10.34	-14.71	-8.60	7.61	8.13	12.21
S&P/ASX Small Ordinaries	-13.09	-20.39	-19.52	0.38	5.07	5.37
International Shares						
MSCI World ex-Australia	-4.64	-8.42	-6.52	7.83	10.12	14.11
MSCI World ex-Australia Hedged	-8.10	-15.10	-12.51	6.36	7.33	11.29
MSCI World ex-Australia Small Cap	-5.82	-9.19	-14.86	4.91	7.10	13.38
MSCI Emerging Markets	-2.61	-3.30	-18.43	1.25	4.44	7.26
Listed Property & Infrastructure						
S&P/ASX 200 A-REIT	-10.33	-17.68	-12.26	-2.75	4.41	9.17
Global Real Estate Index: FTSE EPRA/NAREIT Developed	-5.18	-10.84	-5.54	0.28	4.51	9.35
Global Real Estate Index: FTSE EPRA/NAREIT Dev Hedged	-8.51	-17.05	-11.20	-0.98	1.96	6.43
Infrastructure Index: FTSE Developed Core Infrastructure	-1.69	-0.50	12.56	6.25	9.74	12.15
Infrastructure Index: FTSE Developed Core Infrastructure Hedged	-5.23	-7.85	4.33	4.87	7.05	9.50
Australian Bonds						
Bloomberg AusBond Composite 0+ Years	-1.48	-3.81	-10.51	-2.58	0.87	2.58
International Bonds						
Bloomberg Global Aggregate Hedged	-1.64	-4.66	-9.33	-1.62	0.78	3.12
Australian Cash						
Bloomberg AusBond Bank Bill	0.05	0.07	0.10	0.33	0.95	1.73

RELATIVE PERFORMANCE – June 2022