

April 2023 Quarterly Market Update for NFPs: ESG evolving, bond returns recovering

By Perpetual Private

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In the **April 2023 Perpetual Private Quarterly Market Update**, we look at recent market moves, discuss the evolution of ESG investing and outline a major shift in our fixed income strategy. You can download our full report – or read our concise review below.

Please note: except where otherwise noted or quoted, the views in this article are those of Perpetual Private and its staff.

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March 2023 quarter: What happened?

- 2023 got off to a good start with the Australian market rising on positive inflation news and the possibility rates could ease at year end. Later in the first quarter some nasty but quickly contained bank failures shut down the rally. However, Australian shares still generated a 3% quarterly return.
- Major global markets also had a strong start to 2023. In local currency terms, French and German markets were up well over 10% for the quarter. Globally, tech stocks rallied while energy companies fell. That reversed last year's trend.

- Bond markets emerged from their slump. Global bonds rose 2.4% for the quarter and local fixed income did even better, posting a return of 4.6%, partly in recognition of the strength of Australia's banking sector.
- The most recent data point in the great 'investment style' debate saw local Growth shares beat Value in the March quarter. However, Value now outpaces Growth over all other time periods out to five years.

Indices referenced: S&P/ASX 300 Index, German DAX Index, French CAC 40 Index, MSCI Australia Value Index, MSCI Australia Growth Index, Bloomberg Global Aggregate Index, Bloomberg AusBond Composite (0+Y) Index. All performance numbers for March 2023 quarter unless otherwise stated.

According to Perpetual Private Investment Director, Emily Barlow, the first three months of 2023 were "a quarter of two halves." With some evidence that inflation was easing, share markets rose handily, reflecting the potential for rate cuts in late 2023 or early 2024. As we moved into March, the narrative changed, with bank failures in the US and Switzerland eroding confidence.

It's easy to blame some rogue banks for the sudden reversal. Silicon Valley Bank (SVB) – the self-styled 'financial partner of the innovation economy' was under-hedged and over-exposed to start-ups and technology companies that were hammered by rising rates. Credit Suisse had struggled for years with risk controls and finding the right business model.

Central banks stepped in quickly to reduce the risk these local flare-ups would damage the global banking system. Stability has returned to the system and the Reserve Bank Governor recently wrote, "Australian banks are well regulated, well capitalised, profitable and highly liquid; they are in a strong position to continue lending to domestic households and businesses."¹

Where to from here?

While commentators and investment markets are obsessively reading the tea leaves on future rates rises, the higher rates *already* in the system are reshaping the investment environment. They're having an effect on companies that relied on benign economic condition and cheap money.

On a more positive note, a higher interest rate regime is rebalancing the profile of fixed income investing. And that could be good news for NFP investors who have typically relied on income from their bond investments to help fund operations.

From corporate credit to government bonds

The reshaped economic environment, one where interest rates are higher for longer, is driving changes in the fixed income part of Perpetual Private portfolios.

We invest in both government bonds and corporate debt (debt issued by companies including banks and corporates like BHP).

Over the past few years Perpetual Private investors benefited from our overweight position in corporate debt (sometimes called credit). With government bond rates so low, our credit holdings helped generate better returns.

Credit securities also have a shorter time horizon and floating rates, which meant that as interest rates started to rise, they provided some downside protection. By contrast, when rates rise, government bonds typically fall in value because their **fixed** rates become less attractive. “In the environment we lived through over the past few years, credit investing was good for returns and helped reduce downside risk,” say Emily Barlow.

Now the plates have shifted. Perpetual Private has been moving money from credit into bonds, a decision we think works on a number of levels.

- As interest rates stabilise at higher levels, longer-dated government bonds are more attractive sources of income.
- Because these bonds are backed by governments (and their unlimited taxing powers) they’re more defensive than shorter-term credit securities issued by companies. That helps protect the portfolio if we fall into a recession.
- Corporate credit securities are affected by the same forces that affect company shares while government bonds are less correlated to equity markets. So investing in government bonds improves diversification and reduces risk.

A broader strategy to manage volatility

The first quarter of 2023 was full of ups and down and we expect volatility to persist as central bankers seek to rein in inflation without cratering their economies. In this uncertain environment and with interest rate rises still working through the system, Perpetual Private expects greater dispersion within asset classes and within sectors. In equities for example, stock-specific factors like how easily a company can pass on higher costs and fund higher debt costs will be increasingly important.

“When times are tough, you get less of the averaging-up effect of a low-rate environment,” says Emily Barlow. “There’ll be winners and losers, and fundamental analysis and bottom-up security selection will become increasingly important. In our view, it’s a time when active management can add more value. While we take a long-term strategic approach to investing, we can and do make decisive changes – such as the switch from credit to bonds – to manage risk and capture upside.”

Ever-evolving ESG

The evolution of ESG-focused investing (Environment, Social and Governance) is always of interest to NFPs and their stakeholders. For many investors, NFPs and individuals – it’s no

longer seen as a 'nice to have' but more of what marketers call a 'hygiene factor' – a basic attribute that customers expect.

Excluding problematic sectors has historically been the main tool to achieve a more responsible portfolio. However, this approach is increasingly being supplemented with other approaches that can be equally, if not more, effective in promoting a more sustainable global economy.

“By investing with managers that engage with companies on important issues such as carbon emissions, working conditions and human rights, we believe you can enable more positive change,” says Emily Barlow. “By simply divesting or excluding companies, you forego influence; they can continue to cause harm.”

This more engaged approach is becoming more relevant as investors weigh up how to handle so-called transition minerals.

Whilst many ESG-focused investors are reluctant to support mining companies, the minerals needed to power the transition to a net-zero economy – including lithium, copper and rare earths – are essential to real change and can offer an attractive investment opportunity. “By investing in the most environmentally-aware producers of these minerals you can reduce overall environmental damage **and** generate a healthy return,” says Emily.

Perpetual Private is committed to engaging with NFP clients on these issues and focused on improving our reporting so they have a clearer view of the impact their investments are having.

Perpetual Private's Quarterly Market Update for April 2023 covers how the past year's rate rises are reshaping markets and what that means for NFP portfolios. It details the outlook for equities, fixed income, real estate, currency and alternatives.

[Download the report](#)

Sources:

[1] RBA, *Financial Stability Review* April 2023.

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