SALT GLOBAL OUTLOOK April 2022

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Growth slowing, inflation rising

We started 2022 with a view of the macro environment which we summarised as a unique set of circumstances that would see growth slowing, headline inflation moderating but core inflation remaining problematic, and central banks bringing forward the withdrawal of monetary conditions. Uncertainty would remain high due to the known unknown of the future path of Covid-19, especially the risk of new variants of the virus. We have not been disappointed.

Vladimir Putin's war in Ukraine has "doubled down" on that already unique set of circumstances: headline inflation is now expected to move even higher; growth forecasts are being revised further downwards, and there is a new layer of uncertainty to think about in the form of the future look of the global geopolitical landscape.

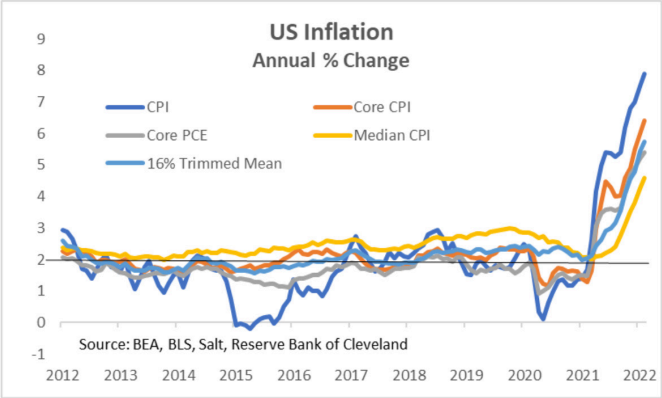
Developed world central banks have belatedly realised that they do indeed have an inflation problem. Most have now started the process of withdrawing monetary stimulus, while those who haven't are now closer to doing so than they were three months ago.

Earlier concerns from many commentators about the return of 1970s-style stagflation have, for some, morphed into rising recession risks. This has been reinforced with the recent flattening, and at times inversion, of the US yield curve. We see the greatest risk of recession being a central bank policy mistake, though there are risks in both tightening too fast, and too slowly.

Growth headwinds and tailwinds

In our last report in January, we expected growth in every country we monitor to be lower in 2022 than it was in 2021. That was mostly due to the base effects of following strong growth in 2021 that was itself mostly related to the recovery from Covid-related lockdowns in 2020.

There were other expected headwinds to growth in 2022. These included sharply higher inflation eroding real consumer incomes, ongoing supply constraints and logistical challenges, and rising interest rates.



The headwinds have certainly increased recently, following the Russian invasion of Ukraine, as growth has been revised lower. The price of oil has moved significantly higher adding to inflation, further eroding household incomes and delaying the expected moderation in headline inflation. Asset prices have fallen which may see some households pull back on some expenditure, and the conflict is adding to already challenged supply chains.

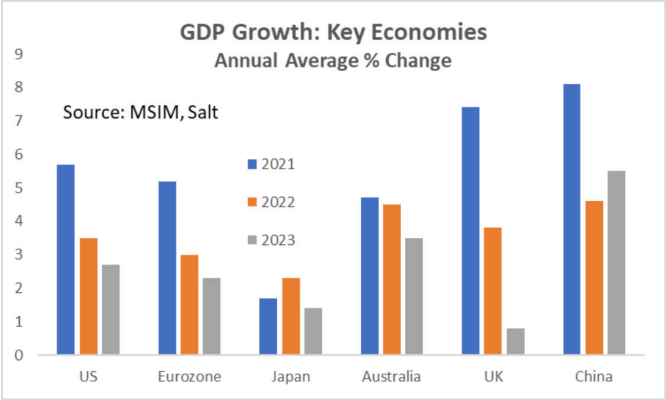
At the same time, central banks around the world have pivoted to the more hawkish, finally accepting that inflation is a problem that needs to be responded to. Some, such as the US Federal Reserve (the Fed) and the Reserve Bank of New Zealand (RBNZ) are projecting

interest rates moving above neutral and into restrictive territory.

Of the major economies, only China is going against the trend. As growth woes there intensify, especially with respect to their ongoing determination to eliminate Covid, policy makers are set to ease both monetary and fiscal policy in the weeks and months ahead.

But there are also tailwinds to growth across the developed world. Labour markets are tight and there is high demand for labour. Strong hiring combined with strong wage pressure is boosting aggregate labour income. In general, corporate earnings remain healthy and business investment in key economies such as the US is strong. Furthermore, in the US and elsewhere household sector balance sheets are in good shape and many households have significant cash balances.

Aggregate global growth is clearly slowing, but recession doesn't appear imminent anywhere we monitor. Indeed, latest major economy growth forecasts from our global partner Morgan Stanley Investment Management show a healthy buffer to recession in 2022.

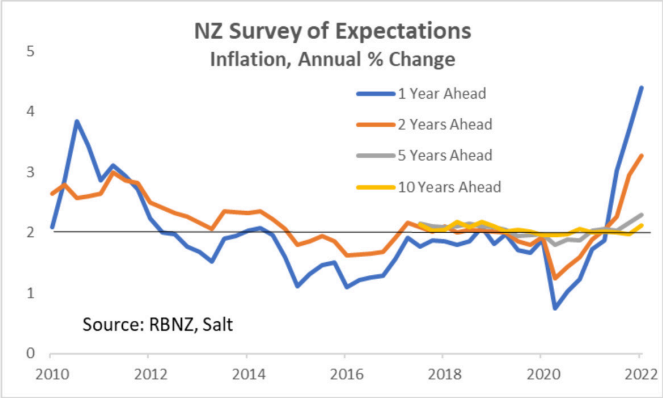


However, that buffer is at its narrowest as the monetary policy cycle peaks and as the economic cycle bottoms out in late 2023 and into 2024. It's at this point we see the greatest risk of recession, in large part because at that point will have seen a significant and synchronised (China excepted) tightening of global monetary policy,

Central Bank credibility and recession risk

The biggest recession risk is a policy mistake. Having made such a bad mistake in not recognising the seriousness of this current surge in inflation, no central bank wants to get it wrong again now by abruptly ending the post-Covid economic expansion. They are simply looking for the means to lower the inflationary side-effects of a range of extraordinary stimulatory phenomena, which have been recently compounded by the Russia-driven energy shock.

At the same time, central bank credibility has taken a bit of a knock recently. In failing for too long to recognise that rising inflation was likely to prove more persistent and would require a monetary policy response, many developed world central banks now find themselves well behind the curve and facing the possibility of a more problematic "unanchoring" of inflation expectations.

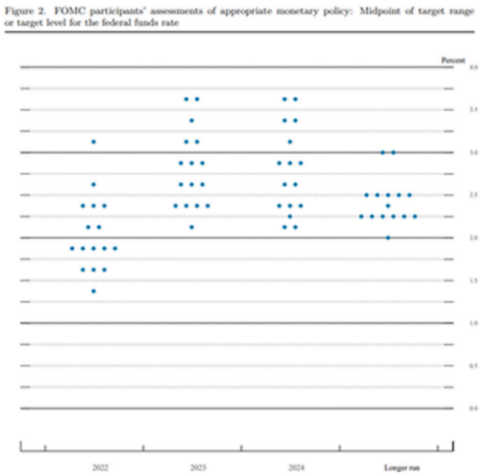


Even here in New Zealand where the RBNZ was one of the fastest to pivot and interest rates have been raised three times, the Official Cash Rate (OCR) is only halfway toward neutral at a time when there is no justification for stimulatory conditions.

Caution appears to be directed mostly at Covid and the uncertain near-term outlook for the economy. The problem with that is that Covid is a supply-side shock that is inherently inflationary. Any support for the economy needs to be through targeted fiscal measures, as has been the case.

In the United States the Chair of the Fed, Jerome Powell, appears to be starting the process of restoring credibility by promising to do everything he needs to do to control inflation. Interest rate markets are taking that as a sign that we will see a ramping up of the pace of tightening over the next few meetings, including the potential for a series of 50bp hikes in the Fed funds rate and an announcement on the start of Quantitative Tightening as early as May.

The more hawkish positioning in the US has contributed



to a significant flattening of the US yield curve as short-dated bond yields have risen faster than longer-dated bonds. At times various parts of the curve have inverted as short-term yields have moved higher than longer-term.

Conventional wisdom has it that an inversion of the yield curve is a harbinger of recession. That seems to send a warning to the Fed not to raise interest rates too fast.

But that only covers one type of recession risk. The second type derives from not tightening fast enough, allowing higher inflation to become even more entrenched and inflation expectations to become unanchored from the target rate.

That would ultimately require an even more aggressive tightening of monetary conditions that would be more damaging to economic activity, the labour market, and asset markets. Indeed, both the Fed and the RBNZ are projecting monetary conditions will need to become tight, meaning interest rates higher than the assumed neutral rate (around 2% in New Zealand and 2.4% in the US) and designed to have a restrictive impact on economic activity.

But given the combination of risks, we believe a prudent course of action for central banks right now is to tighten more aggressively in the near-term until policy rates were at their assumed neutral level, after which policy could become more cautious, considered, and nuanced. That means a series of 50bp hikes from the Fed over the next few months and the same from the RBNZ at their April and May meetings.

So, what's the US yield curve telling us?

We take the recession signal seriously but make the following points. The first is that given the huge purchases of bonds by central banks that remain on their balance sheets and have played havoc with the term premium, we're not convinced the yield curve has the information content it has in the past.

While growth forecasts around the developed world are being revised down following the start of the war in Ukraine, in most cases, including here in New Zealand and in the US, growth is still expected to be above trend in the near term. There is thus a reasonable buffer between the growth we expect and recession.

It's important not to get too negative too early. History suggests an average lag of 19-months between the inversion of the yield curve and the onset of recession. That is consistent with our view that the weakest part of the US economic cycle (and where recession risk is therefore greatest) is in the second half of next year and into 2024. This coincides with the time at which we expect New Zealand growth to be at its weakest and the risk of recession greatest.

It's also important to note that equities can rise in the early stages of an interest rate hiking cycle. It is crucial to bear in mind that the sustained upward movement in global interest rates in recent months reflects strong underlying economic activity, and price rises are only possible in countries where demand is robust enough to make them viable for vendors.

There is potentially a period of improved profitability and the defence of firm margins ahead, for agile or well-positioned businesses. The onset of the 2007 Global Financial Crisis was preceded by an inverted yield curve in 2005. Yet if you had de-risked your portfolio then, you would have missed the 14% rally in the S&P500 in 2006.

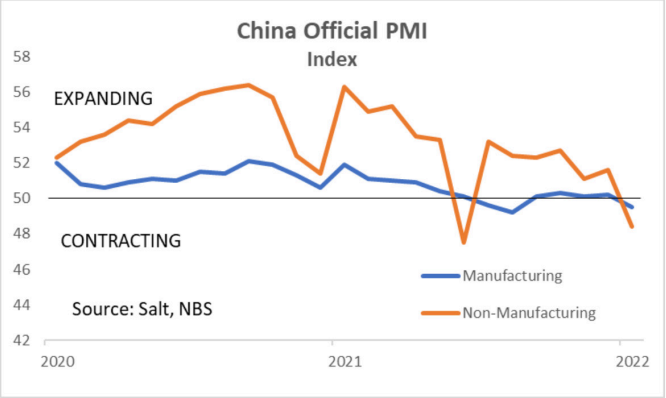
China slowing – more easing to come

The growth environment in China has deteriorated since our last report as the country persist with its Covid elimination strategy and is currently battling its most significant outbreak of Covid since it first emerged in Wuhan two years ago. Russia's invasion of Ukraine and the resultant increase in commodity prices, especially oil, is weighing on activity levels.

The downward bias to growth expectations was already in play at the end of last year given the Covid strategy, the "regulatory reset" targeted at achieving common prosperity including restrictions aimed at over-speculation and mitigation of the risk of potential asset bubbles, along with limits on the borrowing power of developers could lead to further defaults.

After starting the year with stronger than expected growth in key activity data, the Chinese economy is now facing a sharp slowdown. Recent official Purchasing Manager Index (PMI) data for both the manufacturing and service sectors have moved into contradictory territory.

This places the official GDP growth target of 5.5% in jeopardy, which will generate further easing in monetary policy. This is likely to include further cuts to the Reserve Requirement Ratio and key interest rates such as medium-term lending and loan prime rates will be cut further in an effort to support growth.



The changing geo-political landscape

Geo-political tensions have been rising steadily since the Global Financial Crisis, particularly between the US and China as both vie for global economic and political supremacy. This has its own territorial dimension through the South China Sea and Taiwan.

The pandemic has intensified political tensions and supply chain disruptions are leading to a further shift from globalisation to regionalism.

Russia's invasion of Ukraine is, however, the most fundamental breach of rules-based political orthodoxy that has prevailed since the end of World War II.

We imagine Putin has been surprised by two things since the war started: the fierce resistance of the Ukrainian people and the severity and co-ordination of the sanctions imposed by western countries. These include:

- The removal of a number of Russian banks from the SWIFT payments system;
- The freezing of the Russian central bank's hard currency denominated foreign exchange reserves held overseas;
- The imposition of sanctions against key Russian personnel including President Putin and Foreign Minister Sergey Lavrov;
- The US has banned the import of Russian oil and the UK has announced it will phase out Russian oil imports by the end of 2022;
- Several western countries have increased tariffs on Russian imports; and
- A number of multi-nationals have either scaled down or completely exited their operations in Russia.

Further sanctions appear likely.

The path of the conflict remains uncertain. A diplomatic solution is possible, but so too is a protracted and costly war.

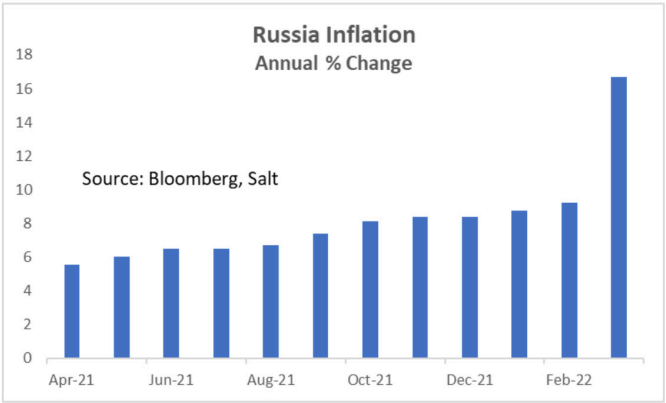
It is not hard to imagine a return to cold-war style fragmentation and factionalism. Over the last two weeks the West has discovered a new-found sense of unity, though that may come at the price of the end of the peace dividend which has been enjoyed in the 77 years since 1945. Germany has already announced an increase in defence spending and even Switzerland has jumped off its neutral fence. Higher defence spending may well come at the expense of further progress on other important fiscal initiatives such as addressing climate change and reducing inequality.

China has not yet shown its full hand by neither supporting nor condemning Russia's actions. Given China's already-global economic reach, it potentially has more to lose by a further retreat from globalisation. Much of China's wealth-generation engine relies on its integration within complex international supply chains of value-adding manufacturing.

But Putin has sent a clear message to the world that Russia is important too, and what the country lacks in economic heft, it is more than willing to make up for with aggression. At least under its present leader, Russia retains the capacity to spring surprises on an international order that was already reaching the limits of goodwill, following the two years of pandemic restrictions and associated ructions.

Impact on the Russian economy and broader implications

The Russian economy faces significant damage from the sanctions imposed thus far. Consensus forecasts anticipate a 10% contraction in Russian GDP in 2022. That is five times the contraction the economy suffered following the invasion of Crimea. Annual inflation has already surged to 16.7% and is likely to hit 20% in the next few weeks.



The sanctions that have prevented Russia from accessing its hard currency foreign exchange reserves places the Russian Government at risk of default. The Government managed to make its interest rate payment obligations,

but they seem unlikely to manage this too much longer. Putin has stated he will meet future repayment obligations in ruble's if sanctions don't allow access to dollars. Credit rating agencies have already stated that ruble payments on dollar denominated debt would constitute default.

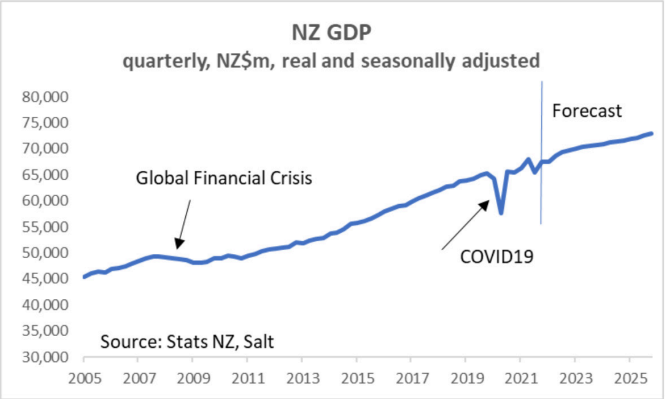
Looking beyond Russia, the primary implication of the conflict has been the rise in commodity prices and the impact on inflation. From the perspective of central banks, they were already facing into soaring headline inflation and problematic core inflation. Many had already started or were close to starting the withdrawal of monetary stimulus.

The conflict does not alter this story. Even in Europe, the region closest to and most directly impacted by the conflict, the European Central Bank surprised with its hawkishness following its March meeting. The ECB said they expected to end their asset purchase program in the third quarter of this year and would look to increase interest rates sometime later. Interest rate markets have interpreted this as an interest rate hike coming before the end of the year.

New Zealand economy at the crossroads

The New Zealand economy is at the intersection of a number of critical forces: the current Omicron wave is peaking, borders to the rest of the world are gradually reopening, and we are in the early stages of a significant increase in interest rates that is expected to take financial conditions from the exceptionally easy to restrictive over the course of 2022.

Right now, the economy is flat-lining as retail spending suffers the consequences of a virtual lockdown. The red traffic light setting under the Covid Protection Framework offers more freedoms than the prior full lockdowns, but people have been cautious. This has been particularly challenging for the hospitality sector, already suffering under the absence of the international tourist market.



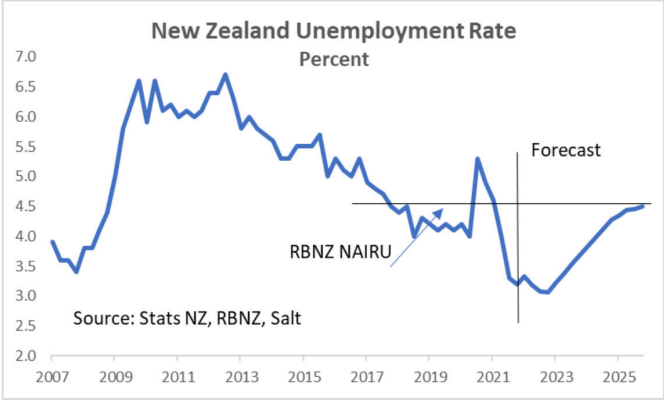
We see zero GDP growth in the March quarter of 2022, with the risk biased to the downside. This is consistent with current low levels of both business and consumer confidence. We expect the middle quarters of the year will be stronger as borders reopen and life returns to whatever normal is these days. Other factors that will support growth, at least in the near term, are high dairy prices, along with the strong pipeline of residential construction activity.

By the end of the year, we will be through the reopening bounce, but interest rates will be higher. We see calendar year growth at 2.9% in 2022. Growth slows sharply as we head into 2023 where we see annual growth falling to around 1.0%. We're not forecasting a recession, but its during 2023 that the risk is greatest as tighter monetary conditions are having the greatest impact and we reach the bottom of the cycle.

Key risks to the outlook include further waves of Covid infections, particularly from a new variant, a sharper fall in house prices than the cumulative 10% we currently expect over the next two years, and continued pessimistic confidence readings.

Labour market the tightest ever, and could get tighter

Labour supply shortages, particularly through closed borders and low net migration along with what is already the highest participation rate in the OECD, has taken the unemployment rate to 3.2%, its lowest ever level as measured by the Household Labour Force Survey.

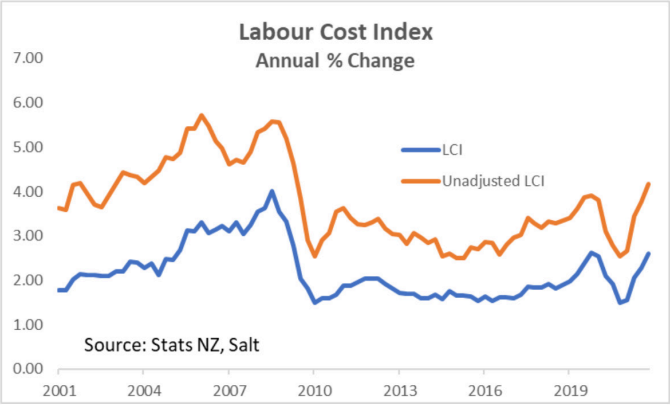


It could move lower yet. The combination of strengthening demand for labour as growth recovers through the middle part of the year and still tight, if not tighter, supply conditions could see the unemployment rate breach 3% during the course of this year.

Critical to the outlook is the near-term path of net migration. Borders reopening gives hope of a return to a degree of labour inflow. However, it also allows Kiwi's greater freedom to leave, especially young people whose OE has been delayed since 2020.

Also, many countries are facing labour shortages and

some of those jobs are in critical industries that pay higher wages than in New Zealand (think Australia). We expect the first migration wave could see a net outflow of people from New Zealand, putting even more pressure on the labour market, particularly skilled labour.

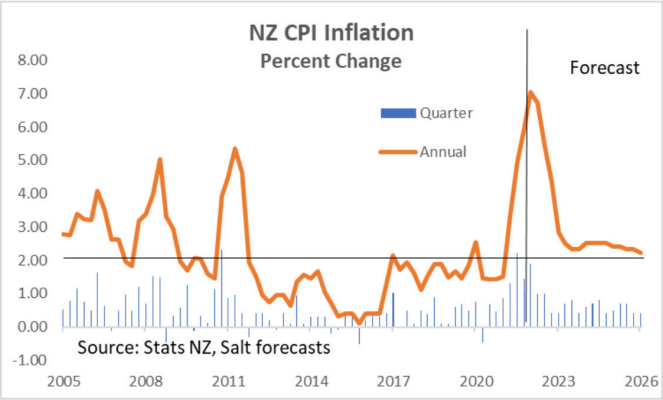


Unsurprisingly wage pressure is intense. The Labour Cost Index (LCI), a measure of unit labour costs, is currently at 2.6% and we expect it to rise to around 3.5-4.0%. This index is the wage measure that is the most consistent with core inflation.

Nominal wage growth, as measured by both the unadjusted LCI and the Quarterly Employment Survey, is running at over 4% and is expected to rise to over 5%, especially once the index captures the 6% increase in the minimum wage that was effective from 1 April.

Inflation and monetary policy

Headline inflation reached an annual rate of 5.9% at the end of 2020 and will move higher still given the significant increase in some commodity prices, particularly oil, since the Russian invasion of Ukraine. We currently have the annual rate of increase peaking at 7% in the first quarter of this year before beginning a gradual decline as large increases from last year drop out of the annual calculation.

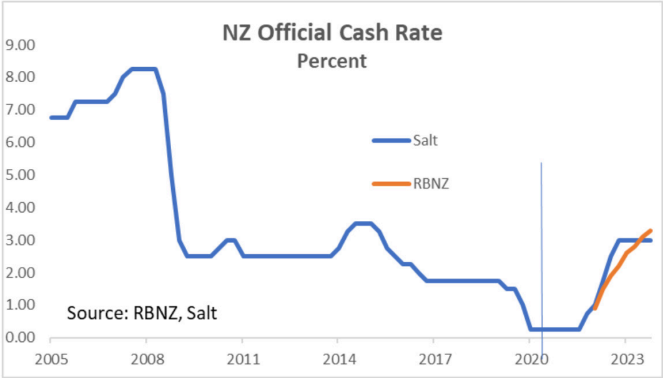


Headline inflation is still expected to be at 4.5% by the end of the year and doesn't sneak back under the top end of the RBNZ's 1-3% target range until the first half of next year. Much will depend on the price of oil. A faster decline in the headline rate is possible should commodity prices come off more quickly.

It's core inflation that is the problem. When the transitory versus durable inflation debate was playing out, it was our view that it was the tight labour market and rising wage inflation that would have central banks pivoting from the transitory to the durable and bringing forward the withdrawal of monetary stimulus. Given our outlook for the labour market, we see no let-up in core inflation pressures any time soon.

RBNZ too slow

To their credit, the RBNZ pivoted faster than any other central bank and already have three 25bp hikes under the belt. But this pace is too slow, and they remain well behind the curve. This risks a more aggressive adjustment to unanchored inflation expectations further down the track.



The Official Cash Rate (OCR) is currently at 1.0% and the RBNZ assumes neutral to be around 2%. Interest rates are thus still on the stimulatory side of neutral but there is currently, in our view, no justification for stimulatory monetary conditions.

As outlined above, we believe the most prudent course of action for the RBNZ is to get the Official Cash Rate to neutral as quickly as possible. That recommends 100bp of hikes in quick order. In reality that probably means two successive hikes of 50bp in April and May.

Taking this course of action then allows policy setting to become more nuanced as interest rates become restrictive. This reduces the risk of more aggressive hike in interest rates that would be more damaging to the economy, the labour market, and asset prices.

Outlook for New Zealand Equities

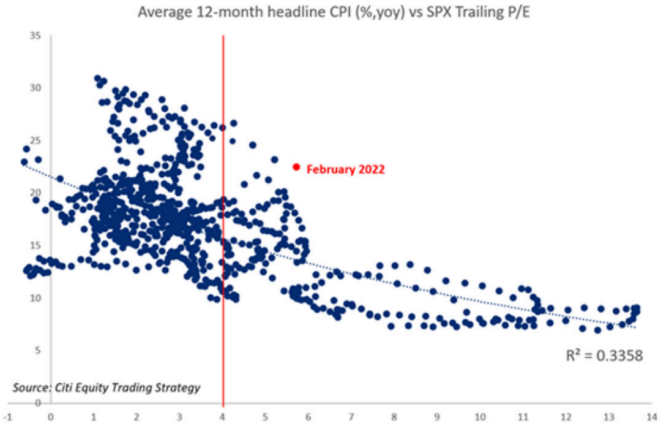
The NZ equity market declined by -7.1% in the March quarter on the back of three fundamental drivers. Business conditions became decidedly mixed as firms face a cascade of cost pressures that they are having trouble passing on; 10-year bond yields surged from 2.37% to 3.27%; and the Ukraine invasion sparked a generalised bout of risk aversion.

NZ sharply underperformed Australia which advanced by +2.2%, with this almost entirely attributable to their much greater weighting to commodity stocks. An analysis of sectoral performance in that market is telling. Energy advanced +28.6% and Materials by +15.4%, whereas the impact of higher bond yields weighed heavily on long duration growth stocks, with Information Technology falling -13.7% and Healthcare -10.1% as some of the hopium that had been priced into extended valuation multiples dissipated.

Markets are in a strange transitional phase at present. Inflation is fulfilling our long-stated warnings and is bursting out everywhere, bond yields are rising, yield curves are threatening to invert and even the most dovish of the Fed Governors is talking about having to make 50bp rate hikes and embark on sizeable QT. The Ukraine war is adding fuel to the inflationary fire.

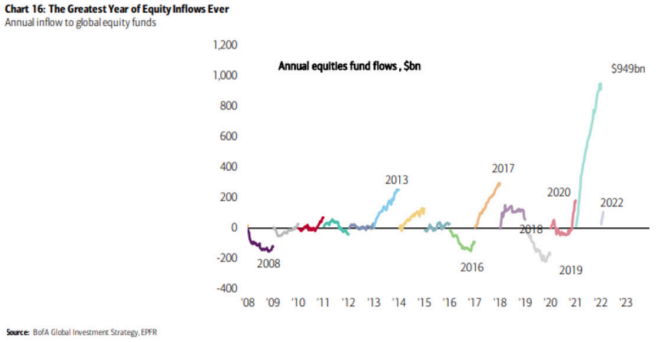
Equities are reacting to these storm-clouds in a volatile manner but generally bounced from their mid-March lows on what seems to have been a mix of short-covering, short-dated call option buying creating a gamma squeeze and a technical bounce from extremely weak sentiment levels. Goldman Sachs estimated that the week ended 18 March was the largest 5-day de-grossing event (i.e., risk reduction) in the last decade.

It is beyond question that significant inflationary pressure is upon us. The key question for equities is what flavour will it be? The jury is still out on whether it sets in above 3-4% for an extended period (bad for equities); whether some countries tip into stagflation (horrid for most equities); or whether we merely experience a bout of inflationary growth (quite good for some equities).



The chart above from Citigroup for the S&P500 shows how high PE ratios tend to decline as inflation rises above 3.5%-4.0%. Indeed, when I started in markets in the early 1990's, the "Rule Of 20" was commonly referred to, with this holding that fair value is when the forward PE and CPI inflation sum to 20x. This is simplistic and abstracts from changing earnings but it still provides a useful anchor. Right now, the median NZ PE is around 20x, so it would be rather helpful if inflation returned to its former 2% region and did not linger at 5-6%+.

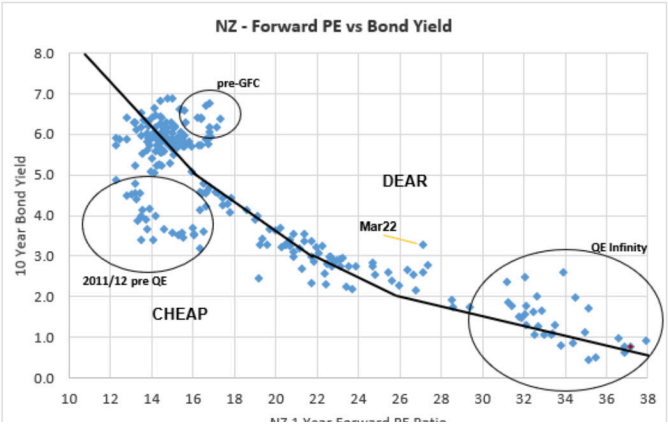
It is hard to overstate just how easy liquidity conditions have been for the last several years. This has seen hot money seep into all corners of the market, with long-dated growth stocks apparently no longer needing to discount decade-away earnings. At the same time, tourists from the term deposit department have been aggressively buying higher yielding equities. As the old saying doesn't go, buy bonds for growth and equities for yield. We are on the path to bonds being for yield once again.



The chart above from BofA Global Strategy shows just how the deluge of cheap money has found its way into risk markets. The aqua line shows $949bn of inflows into global equity funds in 2021, which exceeded the previous two decades combined. The response by investors to negative real yields has been profound but as rates rise across the curve, it would be folly to expect such flows continuing.

NZ is very much beholden to these global trends. The RBNZ has now lifted the OCR target three times from its low of 0.25% in September to 1.0% now. Our house view is that they will need to move to 3.0%. This is not perhaps hugely aggressive when inflation is running at 5-6% plus but there is a partial transitory element to current inflation. The issue is that while it is unlikely to linger at 5-6%, it looks most unlikely to fall back below the 3% top-end of the RBNZ target range.

These future moves are at least partially anticipated in current equity prices but we still see fascinating implications for NZ equities. The chart below shows the one-year forward PE multiple at month-end versus the 10-year bond yield for the last 20 years.



There are a couple of clear findings. Firstly, the NZ market tends to get stuck in certain paradigms, with three of these being highlighted. We are now well and truly out of the QE Infinity funny-money era where one could justify a 35x PE at 0.5% bond yields.

Secondly, our market does still appear expensive at current bond yields. However, this is over-stated to some degree as mindless forced buying of the largest, most expensive stocks by passive funds means the PE for the market of 27x is far higher than the PE for the median company of 20x. If bond yields can stabilise, equity prices tread water for a period, and earnings grow 10-15% thanks to high inflation, then we won't be too far away from fair value over the next year or so.

In terms of stock-specific NZ equity market movements over the March quarter, it is clear that the headwind for growth stocks from higher bond yields was blowing hard. Key under-performers included Serko (SKO, -33.4%), Pacific Edge (PEB, -27.8%), Fisher & Paykel Healthcare (FPH, -25.7%) and Vista (VGL, -22.2%).

The retirement village sector weakened sharply despite feedback from most companies that unit sales have been tracking strongly. Investors are concerned about care cost pressures, future development cost pressures and potentially difficulties in re-selling units due to a weakening housing market. Ryman Healthcare (-23.4%) and Oceania Healthcare (OCA, -21.6%) were stand-outs on the downside.

Stocks that did well tended to be names that investors viewed as being relatively resilient to inflationary pressures due to having a degree of pricing power. Examples included Westpac Bank (WBC, +15.2%), Chorus (CNU, +6.0%), Meridian Energy (MEL, +5.7%) and Spark (SPK, +5.2%).

The property sector performed largely in line with general equities as the headwind from higher discount rates was offset by the prospect of higher rental inflation for some names.

The sector where investors faced a real quandary was the broad group of cyclical stocks. These had generally been very strong performers in 2020 and delivered excellent results in the February reporting season. The key question that investors are vacillating over is how much longer this may continue and what has been temporarily boosted by Covid-19 versus what is repeatable. Flattening yield curves were also a potential warning sign. Examples of such names included Fletcher Building (FBU, -9.5%), Mainfreight (MFT, -10.8%) and Freightways (FRE, -1.9%).

Implications for Investors

Churning market, challenging times

In our previous editions of "Strategy Outlook" we highlighted the degree of expensiveness that was prevailing in many asset classes and market segments at the end of last year. Barely had 2022 got underway, when the combination of a faster and more extended prospective rise in global interest rates, and the energy price and securities shocks unleashed by Russia's invasion of Ukraine, set off a sharp re-pricing in assets. It has been vital not to interpret the re-pricing of many assets over the last three months as a "death-knell" for a positive investment environment, however. Rather, what has occurred (and is still occurring) is a re-orientation of global portfolios to better suit the inflation-prone and risk-laden world that we now expect to persist for several years. For that reason, expensive bond markets remain risky.

An example can be drawn from the long-maturity bond markets, where Q1 2022 total returns from US 30 Year Treasury securities were an eye-catching -10.6% while the equivalent German Bund lost -9.0% in Q1.

The first quarter saw negative returns across all global asset classes except commodities. All major equity regions saw negative total returns, with Emerging Markets recording the lowest First Quarter return, at -6.1% in local currency terms. However, the returns from key global bond market were as weak, or even weaker, than returns from shares – a very unusual combination, because when equities correct historically, fixed interest assets have in recent years performed better and provided diversification value.

Quarterly Market Performance Barometer

	Performance %				Performance %		
	Q1 2022	Q4 2021	1Y		Q1 2022	Q4 2021	1Y
Equities				**Fixed Income**			
U.S. Market	-5.33	8.27	12.33	U.S. Core Plus Bond	-5.92	0.08	-4.05
Value	2.35	5.66	12.80	U.S. Treasury Bond	-5.50	0.32	-3.46
Growth	-11.97	6.99	9.19	U.S. High Yield Bond	-4.53	0.65	-0.37
Developed Markets ex-US	-5.17	2.75	2.61	TIPS	-2.44	2.51	4.60
Emerging Markets	-5.90	-0.63	-8.27	10+ Year Treasury Bond	-10.49	3.32	-0.86

Source: Morningstar US Equity Sector Indices (USD) Fixed Income – Total Returns to 31 March 2022

Not this time. The three months to March delivered the first negative quarterly returns from equities and bonds in four years, since Q1 2018 when the Trump Administration was ramping up its trade war with China. On that occasion, inflation remained dormant and the "war" in question deployed tariffs, not tanks.

Despite widespread concern about the investment-unfriendliness of the last US Presidential administration, the environment today is arguably more fragile for capital growth and preservation. The luxury that years of below-target inflation gave to central banks, that of counterbalancing periodic contradictory forces by interest rate suppression, is not presently within their reach. Thus, a re-set is needed, so that portfolios are not hamstrung for the next several years by retaining structures built for (and successful during) the low-inflation, moderate growth, globalized international order of 1995-2020.

Threats and opportunity sets have changed

Equity market weakness triggered by inflation and interest rate concerns cannot be expected to automatically trigger compensatory gains in fixed interest holdings. The years since the GFC have preconditioned some investors to rely upon a causal chain of events running thus: exogenous shock – equity weakness – forecasts of economic slowdown – responsive global monetary and fiscal policy – rapid asset price rebounds – sentiment recovery –back to normal. The pattern favours dip-buying and short-termism, as while it has guaranteed new "higher highs" each mini-cycle, taking profits on a market trend has been prudent, as extra-strong equity runs have several times been followed by "ghost bears."

Those episodes are not bear markets in the sense of persistent, wealth-eroding multi-year market malaises. The "ghost bears," of which there are examples in late-2011, 2015 and 2018, were subsequently shown to be false alarms for enduring equity value loss and proved to be buying opportunities.

The main new factor this time around, which has stymied that familiar, re-assuring pathway out of market weakness is inflation. Now that it is clear that inflation will persist,

market participants are split on the consequences of the embedded cost- and price increases currently washing through the global economy. The more pessimistic school of thought believes that mounting inflation will require such a degree of monetary tightening, over an extended period, that corporate profitability growth cannot remain elevated, and that valuations (using newly-elevated discount rates) must consequently come down markedly for stocks.

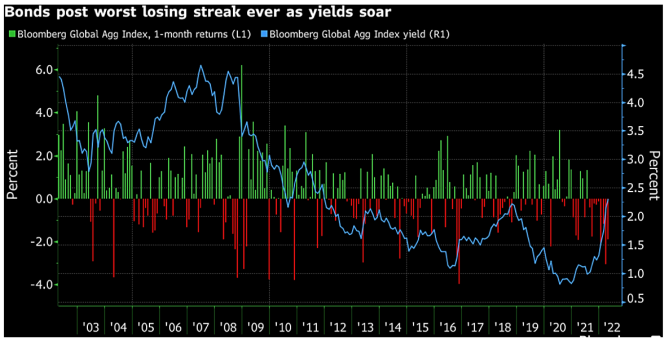
The optimistic interpretation is that companies with pricing power can protect their margins, use inflation to pull off price increases, rely on their robust current balance sheets and re-finance their operations at historically low corporate bond rates only as needed, given the long maturity profiles of corporate debt. Another factor still supporting equities from the investors' viewpoint is a pervasive agreement that credible and liquid capital growth alternatives to shares remain in short supply. The situation is not so much a "TINA – there is no alternative"(because there are always alternatives) as a "LOCO – lack of compelling options."

Bonds buffeted: "No Time to Buy?"

We began this year with the warning that Bonds risked substantial further negative returns, even following the impact of rising interest rates beginning to bite in later 2021. Even so, the scale of investor flight from Fixed Interest in the First Quarter of 2022 has been remarkable, with substantial negative impact on traditional Diversified Fund models which allocate substantial strategic (long-term benchmark) weightings to both international and domestic bond securities. Break-out inflation and newly stern central bank rhetoric has led US bonds to experience their worst quarter of performance in 20 years, with the longer-maturity bonds being worst hit. The total return of US 10 Year Treasuries fell by -6.6% in the quarter, while US Investment Grade (IG) Corporate Bonds lost -7.7% and the Global IG equivalents, -7.4%. These losses erase years of coupon income and render transitory the mark-to-market capital gains the Fixed Interest sector achieved in 2020. Bond ballast in portfolios has now shown a capacity to drag multi-sector returns sharply and swiftly downwards.

In New Zealand, the Fixed Interest market has also weakened markedly. As is also the case for international government bonds, the recent sharp rises in bond yields have more than erased the returns earned during the Covid shock in 2020. It is remarkable to note that the NZ 10 Year benchmark yield, which reached a historical low of 0.5% in May 2020, is now yielding 3.4% less than two years later. Hindsight is wonderful, but funds which trumpeted their own "conservative" merits due to strong bond out-performance when a totally unanticipated public health shock struck, must now face a dilemma of when to exit or lower such allocations. Are they to be retained, in case another unforeseeable nightmare scenario breaks upon the world, or reduced, due to their continuing drag on total rolling portfolio returns?

Fixed Interest yield increases persist

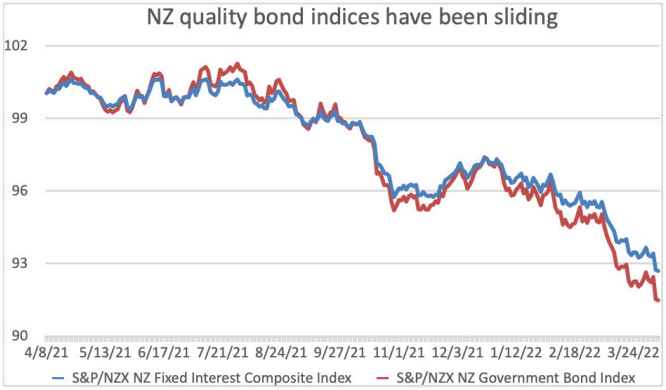


Source: Bloomberg

2020 Bond rally becomes a statistical artefact

The domestic bond indices used to track performance across a range of maturities and high-quality debt issuers are now back at their late-2018 level. The annualized return over the last 5 years from such bonds as the NZ Fixed Interest Composite and the NZ Government Bond Index is in a range of 1.2% - 1.5% per annum, whilst over shorter periods such as 3 years, the annualized return has turned negative. These returns are stated in nominal terms, so once inflation is considered, bonds have not preserved purchasing power for investors in recent quarters (even if they have diluted overall portfolio volatility.)

Security in Fixed Interest can come at a price



Source: S&P Dow Jones Indices, Salt

Total returns were negative from all developed bond markets in the March Quarter of 2022. Longer maturity bonds have been hardest-hit on rising inflation concern, while corporate credit spreads in the US and Europe widened to more than 1% above equivalent-maturity sovereign yields (+1.16% in the US and +1.28% in Europe.) Investors in High Yield (non-investment grade)

bonds were less sanguine than they had been in recent years, with the result that the US High Yield credit spread moved up from historical lows, at +2.8% at the end of 2021, to +3.3% on 31 March 2022. However, this spread remains very narrow by historical standards, reflecting still inadequate compensation for taking on material credit risk as an investor.

We will watch the corporate credit spreads closely, as they can function as an early-warning signal for the emergence of more fundamental threats or issues with the capacity to ultimately end a bull equity market.

Inadequate yield and term premia from Fixed Interest

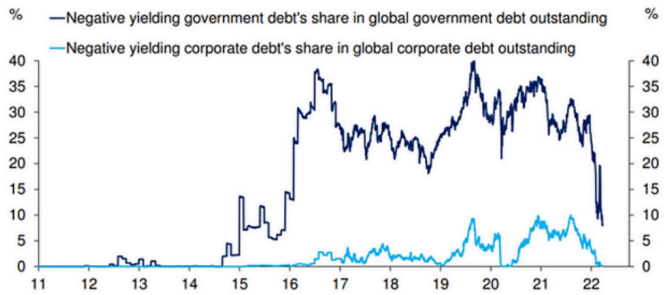
2021-2022's sizable declines in the value of key Government debt securities are sobering and make manifest the long-discussed asymmetric risks in buying bonds at very low (or negative) nominal yields. New diversifiers, less reliant on Fixed Income assets, are needed. For portfolios where bond exposure is still a requisite, active selection is critical to performance now – a fact exemplified by noting that the 2021-Q1 2022 performance of Asian region Investment Grade dollar bonds was a solid +7.2%, whereas the Global Investment Grade bond index is down by -10% over the same 15-month period: an out-sized performance difference. Note that these are all "Investment Grade" bonds being compared, so there is no element of additional riskiness being accessed on conventional credit rating metrics, to generate that superior return.

The extent of yield increases differed across markets. The US Treasury market remains in the midst of one of its worst declines on record, but upward yield moves were less pronounced in core Europe and in the UK. The US 10-year Treasury yield increased from 1.51% to 2.35%, with the 2-year yield rising from 0.73% to 2.33%. As the beginning of April, these upward moves in yield accelerated further, with the 10-year Treasury reaching 2.72% on April 10th. If the "next stop" for this key yield is 3%, there may begin to be a basis for allocating very selectively into thematically-advantaged bond and credit strategies. However, a very flat yield curve which in parts readily dips into inversion shows that the term premium on bonds -the compensation investors should expect for taking on a range of risks over a longer time period until the bond matures, can only be described as woeful and unappealing at present.

The First Quarter saw the UK 10-year yield rose from 0.97% to 1.61%, the 2-year from 0.68% to 1.36%. The Bank of England (BoE) raised rates a second time in February to 0.75%, in spite of concerns about the UK outlook and particularly cost of living pressures on households. The European Central Bank (ECB) unexpectedly pivoted to a more hawkish stance in February. Comments from President Lagarde indicated rate rises were no longer ruled out for 2022 and the ECB confirmed a faster reduction in asset purchases. The German 10-year yield increased from -0.18% to 0.55% and the 2-year yield from -0.64% to -0.07%.

This repricing has led to a plunge in the proportion of international fixed interest securities offering a yield below zero, and in time that does argue for better value building in the bond asset class. However, the extremity to which yields had been lowered in the last six years means that there is no compelling reason to add to government debt exposure until greater clarity emerges on central banks' balance sheet adjustment plans.

Shrinking share of world bonds have yields below 0%



Source: Deutsche Bank

We believe than in years to come, investors will still wish (or need) to purchase both government and corporate bonds and debt securities. However, having learned in 2021-22 that rising yields hit undifferentiated or index-bound Fixed Interest portfolios rapidly, their appetite is likely to become much more selective. One area that we anticipate will see greater interest from both institutional and retail investors is the "sustainable fixed income" domain. For many years, bonds have been a blind spot in otherwise nominally ESG-focused portfolios, with little attention paid to the activities of debt issuers compared to the scrutiny directed at the equity market components. This is now changing, and we will be reflecting this positive and overdue development in our recommendations from later this year onward.

Interest rate-sensitive exposure still risky

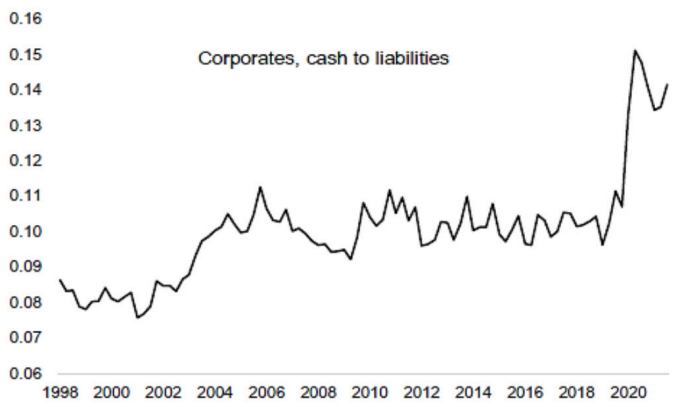
In terms of the outlook for global yields, we do not see a comparable upward surge later in 2022 as was experienced over the last nine months or so. Nevertheless, there are unusual supply dynamics coming into play this year. Bloomberg has estimated that global government treasuries will issue less bonds by value, but that QE purchasing dynamics will still ensure a rising supply in the market for private investors to absorb. Other things being equal, that implies higher sovereign bond interest rates will be consistent this year and that the tendency will be

reinforced by investors seeking yield compensation for inflation risk.

In the absence of sustained central bank bond buying on the scale established in 2020, there is little reason to expect global sovereign yields to remain on average less than 2%. A return to the 2018 yield levels (e.g. in the US, 2.7%- 2.9%) has, as of early April set in once again, implying another risky year ahead for the asset class. Global interest rate dynamics will continue to be led by the US market, which retains its predominance at around 40% of total global debt.

Finally, the Fixed Interest returns cycle is not simply defined by bond yields rising, plateauing and then gradually falling as inflation begins to decline. The secondary phase of a negative returns period in bond markets is frequently a late credit cycle ratings shock. This is the phase when international ratings agencies begin to estimate and incorporate the rising risks of default on behalf of over-indebted enterprises and to reflect their assessment in the issuer's credit rating. While lowering a rating does not automatically cause value loss to bond investors, many bond holders are constrained by minimum ratings criteria in their bond mandates. If a bond issuer's rating is taken out of the acceptable band for a particular pension fund, for instance, there will be forced selling which active Fixed Interest investors must be agile to avoid.

US corporates have healthy balance sheets at present



Source: Refinitiv, Credit Suisse Research

In the current atmosphere of negativity on debt, debt sustainability given higher interest rates, and an engineered economic slowdown that may stall growth to barely positive levels later next year, it is important not to become unduly hostile to all-and-any forms of debt security. One positive factor likely to persist is the healthy cash levels on US corporate balance sheets. This helps ensure that companies are well place to absorb some additional cost and interest pressure while they navigate the more inflationary terrain ahead, but that their fragility in the face of interest rate rises per se may be overstated, for now.

The key consideration is that identifying the companies with robust balance sheets, good interest cover, and stable or improving credit metrics requires active analyst engagement. Indexed bond investment funds where the largest weightings are automatically given to the borrowers with the highest debt levels by value, are probably sleepwalking into several years of poor returns and purchasing power erosion.

Equities: a sideways-trending market?

There is no doubt that investors have, for some time, been willing to pay far larger sums in present currency-terms to access presumed future gains in many asset types and rationalizing and justifying historically extreme valuation levels (see the extended discussion in "**Salt Investment Outlook Q1 2022**").

As has been apparent over the last two years in the New Zealand equity market, any asset class which had performed more strongly than fundamentals should reasonably support, for several successive years, can easily be susceptible to a subsequent multi-quarter period of flat- or negative returns, regardless of other macroeconomic variables (which may remain supportive and / or superior to those in competing capital markets.) A period of anaemic returns for recently expensive segments of the international equity markets potentially lies ahead, and active sector and security selection will become even more crucial in achieving superior after-inflation returns.

In New Zealand, the benchmark NZX-50 Index is trading at the time of writing (10 April) within 0.1% of the February 2020 pre-Covid peak value. Although NZ equity investors have benefited from the dividend yield paid by the more defensive domestic stocks over the last two years. New Zealand shares' recent performance might be used to provide a preview of some future features of how a market may behave after reaching unsustainable valuation multiples while not being pushed there by a single "moon-shot" sector. In New Zealand, improved governance, globalization and deeply suppressed interest rates pushed the pre-Covid domestic market to among the most overvalued in the world. However, after topping in late-2020, the market has gradually lowered the valuations of many of the previous leaders and moved on a sideways pattern for the last 15 months. Some domestic property enterprises and heath are providers have emerged in that period as less vulnerable (at least in many investors' eyes.) We might expect global sectors with stable yield and companies with customer loyalty and pricing power to likewise be advantaged. In contrast, the bar to credibility for "single product growth stocks" is likely to become progressively much higher. Overall, though, a post-rotation market can retain high average valuation multiples. It is simply a transfer of optimistic

valuation assumptions from one group of companies to a different group, whose value proposition has become more credible at the expense of the former leaders'.

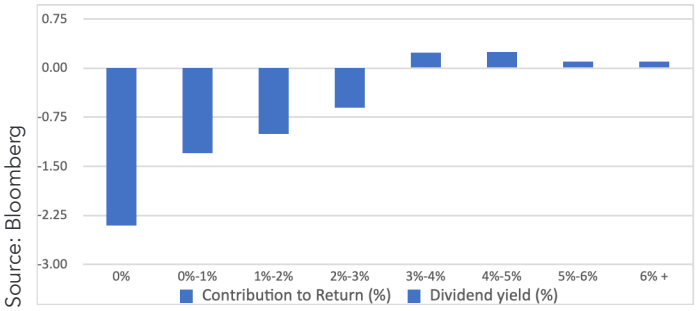
Another way of stating this observation is that not all expensive investment markets necessarily "crash." There are many instances, like New Zealand, where there is simply a medium-term sideways consolidation trend. When a headline market index moves sideways for an extended period, then "under the bonnet" there intractable shifts in investor preference will often be occurring. Interestingly, while some such grinding rotations will favour undervalued companies and sectors which may have lagged the formerly winning capital gains stars, at times the preferred stocks in a sideways market will be the most reliable and mature ones, supplemented by a small number of idiosyncratic companies who have a compelling exposure to a globally emerging narrative. Food price inflation is one such narrative that could become reflected in NZ companies in the next 1-3 years, as is the shift toward renewable energy and carbon capture and sequestration. On the other hand, mass-tourism seems unlikely to return soon as a differentiated investment theme, so companies reliant on travel-related retail may well continue to lag.

Sustainable dividend yield becoming indicative of favoured sectors

Internationally, the sharp increase in US Treasury yields placed an even greater focus on dividends, profitability, and valuations – favouring value rather than growth companies while also supporting larger, more well-established companies. Higher yields have placed greater focus on solid cash-flows and dividends, favouring equity income solutions. During Q1 2022, there was a strong relationship between dividend yield and return. The chart below indicates that S&P 500 companies that did not pay a dividend or provided a low dividend yield drove the overall market decline during the quarter. Conversely, higher-yielding segments held up reasonably well. The strong performance from the Energy sector was particularly supportive to the 3% - 5% dividend yield region.

It is crucial, though, that superior dividends are financially and socially sustainable. Active management is required, to ensure that investors are not drawn purely by gross dividend level into undesirable industries.

S&P 500: Q1 2022 Contribution to Return by level of Dividend Yield (%)



Source: Bloomberg

Real Estate: a showcase of opposing market forces

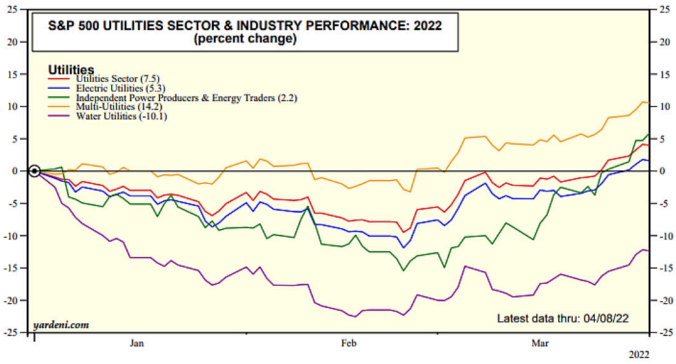
The Real Estate sector is an interesting case study of conflicting forces affecting many investment types at present. Recall that US Real Estate was the second-best performing sector in 2021, with a full-year return of 43%, narrowly lagging Energy's 47% gain. On the one hand, listed property benefits from the increased focus on yields and provides a business model that can pass through inflation pressures to end-customers. The sector has a strong historical track record in hedging investors' wealth during periods of unexpected, elevated inflation. Finally, the tangible nature of "bricks-and-mortar" assets will always attract support when investors face uncertain economic times, enabling this sector to ride out difficult periods and gain in value steadily over the medium-term. One useful characteristic of Real Estate investments is that under normal market circumstances (i.e. not GFC-style default levels) the underlying asset pool provides good, widely accepted collateral for financing other projects or acquisitions.

However, Real Estate is sensitive to rising yields due to its reliance on debt funding, as well as to yields being a factor in property valuations. At present, many large Real Estate enterprises have secured long-term debt funding at the highly advantageous interest rates that prevailed during 2019-2020. As a result, there is limited near-term pressure for such entities to obtain new financing, for which higher interest rates would apply. Eventually, however, it will become necessary for large, listed property enterprises to secure new funding, which could cap their performance upside.

There is little doubt that some segments of property around the world are indeed expensive once again. However, we believe that when securities are selected with sufficient active differentiation, the sector offers purchasing-power and income-protection features that are less vulnerable to current global challenges and can hold its own against companies reliant on more sentiment-dependent expenditures holding up in years to come.

Infrastructure: steady story for multi-utilities

Looking at 2022 year-to-date (ytd) US market returns, broken down by Industry, it is striking that notwithstanding a rise of 1.2% so far this year in US 10-year bond yields from 1.5% to 2.7% as at 10 April, the second-best performing sector has been Utilities. This has assisted diversified global infrastructure vehicles such as our own Salt Sustainable Global Infrastructure Fund, to log moderate positive returns of up to 4% ytd. That is set against a -6% decline in the S&P 500 Index over the same time frame, resulting in up to 10% of out-performance of the headline US Index by the most diversified Utility enterprises.



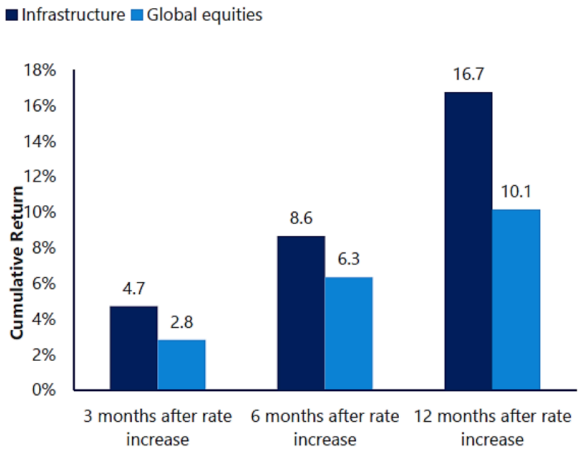
Source: Yardeni Research, Standard & Poor's

Even more pleasing is that the performance of listed infrastructure over the 12-month period is very robust, with the Salt fund having gained 15% and the global peer group average, around 13%. To assess a real asset such as Infrastructure's portfolio value, though, a longer time frame is required (to more closely reflect the operational time frame of infrastructure assets.) We find that our favoured Infrastructure strategy is accruing annualized returns in excess of 9% per annum, which makes it an excellent source of medium-term expected return planning.

Rising rates not always inimical to Infrastructure

While there are sound theoretical bases for predicting subdued infrastructure stocks' performance during an epoch of rising bond interest rates (based on their "bond-proxy" characteristics) empirical data does not clearly support that, and we are cautious not to expect a mechanistic relationship between interest rates and asset returns, given the complexities of global infrastructure investment, which captures extensive upgrading, improving efficiency and environmental transformation. These three objectives are central to the US President's "Build Back Better" economic policy package, and are widely shared by both governments and industry leaders.

2000-21 given increases above 0.5% in US 10Y yield



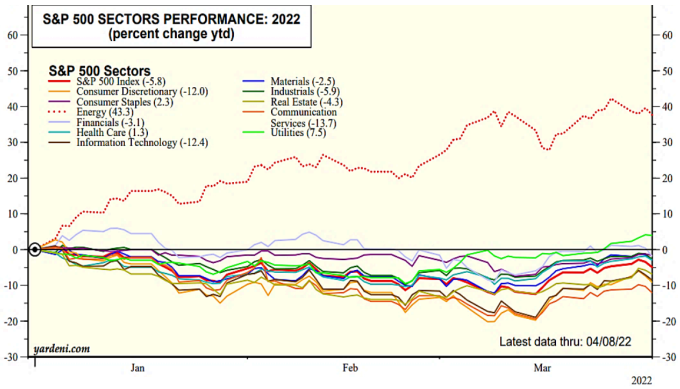
Source: Cohen & Steers, Salt. Returns shown during subsequent periods are calculated as an average cumulative return from the ending dates of the 12 rising-rate periods from Q2 2000-Q1 2021, over the subsequent three, six and 12 months.

While data covering periods of rising US interest rates since 2000 suggests that listed infrastructure often lags the performance of global equities during the central months of a tightening cycle, analysis reveals that in subsequent multi-month periods, listed infrastructure companies are frequently able to recoup the lag and extend a positive performance differential.

For the broader equity market, as we noted at the outset of this year, the "excess liquidity" element of the late-2021 rally may introduce equity conditions more akin to 2011-2012, when markets continued their "bull" up-trend, but at a significantly reduced rate-of-gain than had applied during their stimulus-enabled initial rebound. However, it cannot be denied that the Russian assault on Ukraine has introduced a wildcard into forecasts, and as that situation is still rapidly evolving, we consider maintaining current positioning intact is the prudent course at present. In International Equities, this means a quality mix of reliable companies in industries such as IT Software as a Service (SaaS), Health Care, Consumer Staples and select Financials.

As can be seen below, these sectors have not exhausted potential for recovery upside as 2022 progresses, with a particular positive prospect for Health Care and for selected Insurers, Payments Technology firms and Exchange Operators, within the very diverse Financials industry group.

Energy and Utilities led, IT and Comms Services lagged in Q1 2022



Source: Yardeni Research, Salt

Choppy markets continue, due to inflation and geopolitical risks

Overall, there remains scope for further corrective re-pricing, particularly in the more speculative parts of the international equity markets. Until the January-February near-bear episode, there had been an atypically small number of mini-corrections (down-moves of 5%) in the last two years, and these have all been treated as "dips to buy" and swiftly resolved positively. We believe that while the entry-opportunity antennae of agile investors will remain alert this year, the periods of market softness

may well last somewhat longer, potentially for blocks of 2-3 months. It is possible that markets will stabilize toward mid-2022 at the earliest.

This is due to the altered backdrop of monetary authorities, led by the US Federal Reserve, progressively draining the extraordinary stimulus level that has prevailed for the last two years. However, as explained in the Economic outlook section of this report, the scope for tightening is constrained Our global equity partner Morgan Stanley notes "Ultimately, the implication for investors of higher-than-expected terminal rates is lower stock valuations, with a somewhat steeper yield curve. This means equity-market leadership is likely to rotate from high-flying tech names toward value-style and cyclical stocks, which we believe are best accessed through active stock-picking."

Three key supports for global equity performance remain in place for now: overall monetary conditions remain stimulatory; the equity risk premium remains elevated (note that 80% of bull markets end with below-average ERPs); and the stage of the global cycle remains expansionary. Current revenue estimates for 2022 appear too low, though US profit margins are at all-time highs, so companies need to maintain their pricing power; in turn, if prices are lifted to compensate for rising costs, inflation expectations will increase further. Much depends on information to be revealed in the upcoming Q1 2022 Earnings Season.

Legitimate concerns about inflation and the prospect of tightening monetary conditions world-wide have triggered phases of "choppy market conditions" both in September and in January-February, and these can continue for the rest of 2022. Persistent weakness in bond markets, as interest rates across the yield curve increasingly reflect both enduring inflation and more active central banks, is eroding a support for the high valuations that US equities have achieved. However, a critical point is that equity vulnerability does not equal bond desirability. Bonds may well be the catalyst of erratic equity market returns, but equity markets have the capacity to recover value more quickly and to a greater quantum, than do bonds.

Strategy conclusions

We retain our central market views for the current year, and these are reprised below:

- Even though Equities (as a whole) will potentially see returns close to their long-term average of 8%, with interim weaker periods; selected Equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks that have lagged in recent years.
- For instance, listed real assets have superior, defensible yields and cyclical tailwinds, in a fraught political phase. Real Asset's historical sensitivity to rising bond yields may be counterbalanced by their cash flow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown
- De-rating in very overvalued equities (specific companies, rather than sectors) is likely as interest rates move up. A "hot stock" mentality will persist due to internet, but this is short-term only

Despite anticipating volatility as market leadership changes continue, we still prefer equity to fixed income or cash exposure. The negative real (after-inflation) yields dogging fixed income will persist for at least two years and makes higher Fixed Income asset class holdings inopportune.

After the recent and severe global bond sell-off, we do now see a somewhat better compensation for duration risk, but it remains inadequate. Within fixed income, thematic support is ready to be a prime differentiator. We acknowledge sustainable or "green" bonds as a valuable emerging theme in this regard. Default risk and Credit Quality are likely to become a focus in late-2022 and set off portfolio re-allocations within and beyond bonds. This will set the stage for a potential global slowdown in 2023 as the tightening of policy around the world begins to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities. Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, endogenous phase of economic growth.