WATERSHED

FUNDS MANAGEMENT

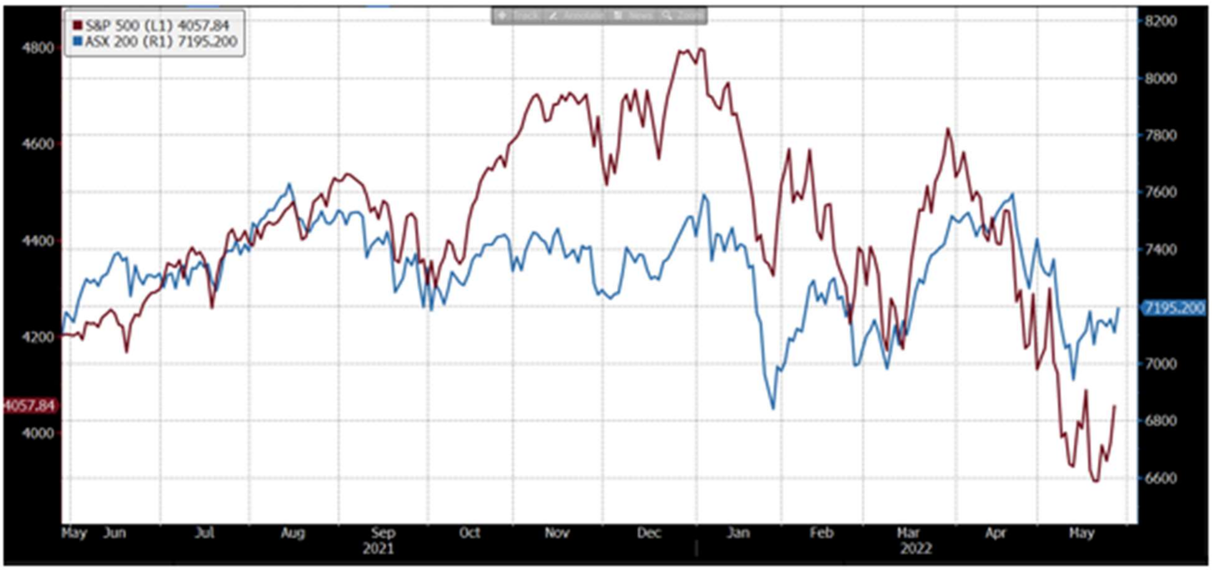
The time to be cautious was at the start of the year. After a sharp market sell-off we are now constructive on equities for the remainder of 2022 and have increased exposure across our portfolios

Peak Pessimism?

Despite stretched equity valuations, market optimism was buoyant at the beginning of the year given global economic growth remained above trend, global interest rates remained at or near zero, and the consensus view was that emerging inflationary pressures would prove transitory. Fast forward five months and recession risk is dominating headlines, a war in Europe has erupted, inflation is at multi-decade highs, central banks are rapidly hiking rates, global growth is faltering and large parts of China are in Covid Lockdown, precipitating global supply chain havoc (once again).

This rapid deterioration in the economic backdrop has given rise to extreme volatility and a sharp sell-off in global equity markets. It has also seen the biggest sell-off *ever* in fixed income (bond) markets as investors quickly priced in sharp rate hikes from both the Federal Reserve in America and Reserve Bank of Australia (RBA).

Broader market sentiment remains pessimistic, however we believe the sell-off has provided an opportunity to take a more constructive view on equities. The risk aversion has been caused by the aforementioned economic headwinds and the fact there remains uncertainty with respect to the speed with which these issues will be resolved. However, we always focus on how the world will look in six months as opposed to the status quo, and believe inflation and rate fears have reached their crescendo and will abate in the latter half of this year. As such we are of the view that the time for caution was at the outset of the year and given the extent of the market sell-off, have recently begun to deploy cash into equities.



Our view is predicated on the following assumptions:

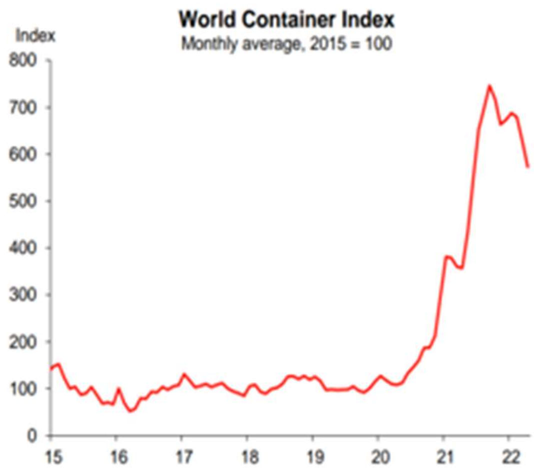
- We believe global inflation has likely peaked and will decline over the remainder of 2022.
- Supply bottlenecks are beginning to show signs of improvement
- Global PMIs may have recently dipped but are still in expansionary territory
- Global earnings growth remains robust with a solid recent US reporting season despite several prominent stumbles (mainly in tech and retail)
- We believe we have seen the worst of the global bond sell-off and that the US 10-year Treasury yield will be far more stable for the remainder of 2022
- The combination of falling inflation and supply-side led growth will provide a springboard for equities.

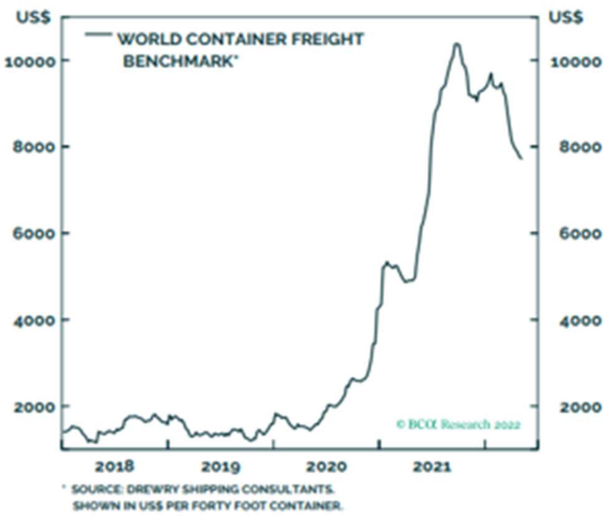
We are still concerned about the longer-term outlook, but note that it takes some time for tighter financial conditions to impact economic activity and believe that it is too early to position portfolios for recession.

Peak Inflation?

Global inflation prints have recently pushed to multi-decade highs due largely to a spike in food and energy prices and supply chain disruptions. These issues have been exacerbated by the most recent Covid outbreak in China and the war in the Ukraine. Whilst a near-term détente being reached in the Ukraine looks remote, the conflict no longer seems likely to devolve into a broader regional conflict. China's situation is far more encouraging as their latest protracted period of harsh lockdowns has seen their Covid infection rates fall sharply. Just this week, lockdown restrictions were eased in the financial hub of Shanghai. Whilst further outbreaks can't be ruled out entirely, the country's recent approval of the use of antiviral pills manufactured by Pfizer engenders confidence that the nation will be more effectively inoculated and able to deal with subsequent infections.

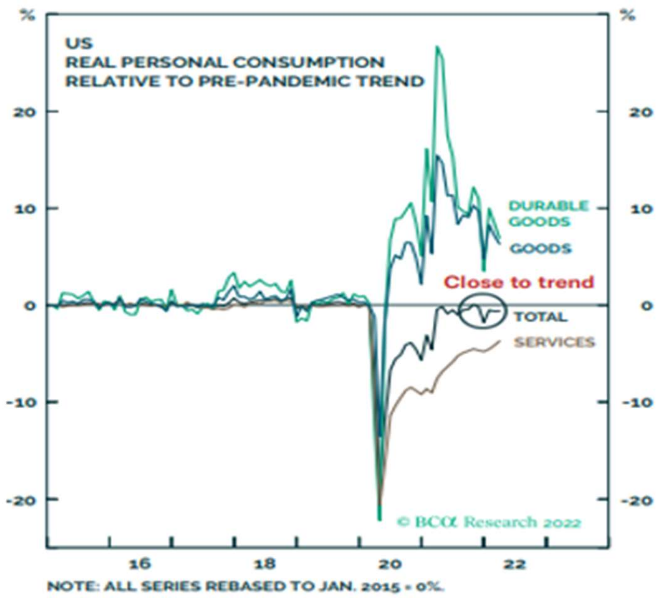
Encouragingly there are signs that supply-chain bottlenecks are already abating as evidenced by the charts below showing global container rates:





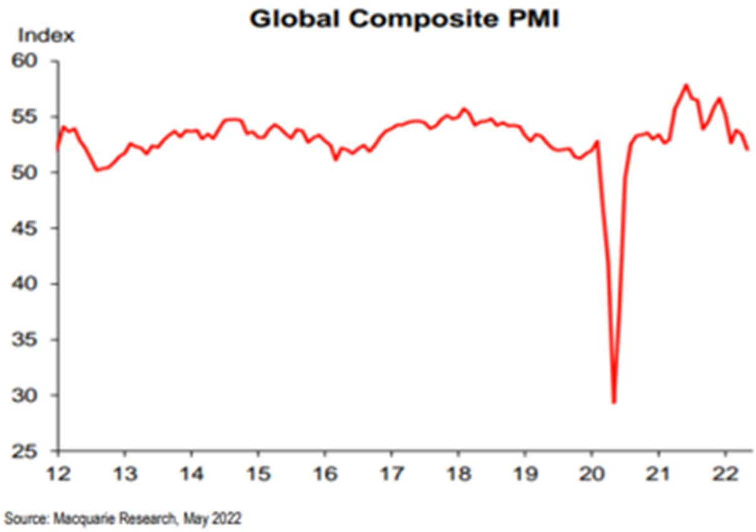
Spending will shift from Goods to Services

Another factor that has driven inflation in the US has been the asymmetry between spending on goods and services. Overall spending has reverted back to its pre-pandemic trend however spending on goods remains well above long-term trends while spending on services is below long-term trends. This is of particular relevance because service prices tend to be stickier, or far less susceptible to inflationary forces, than those of goods. The shift in spending patterns during the pandemic caused goods inflation to rise markedly with little offsetting decline in services inflation. This distortion would usually be mitigated with a supply-side response that wasn't forthcoming during the pandemic. Recent spending patterns (in the chart below) suggest as the world opens up that the consumption of durable goods will fall and spending on services will increase which will have a positive effect on curbing inflation. The key driver of services inflation is wages growth, which is now also showing early signs of normalising.

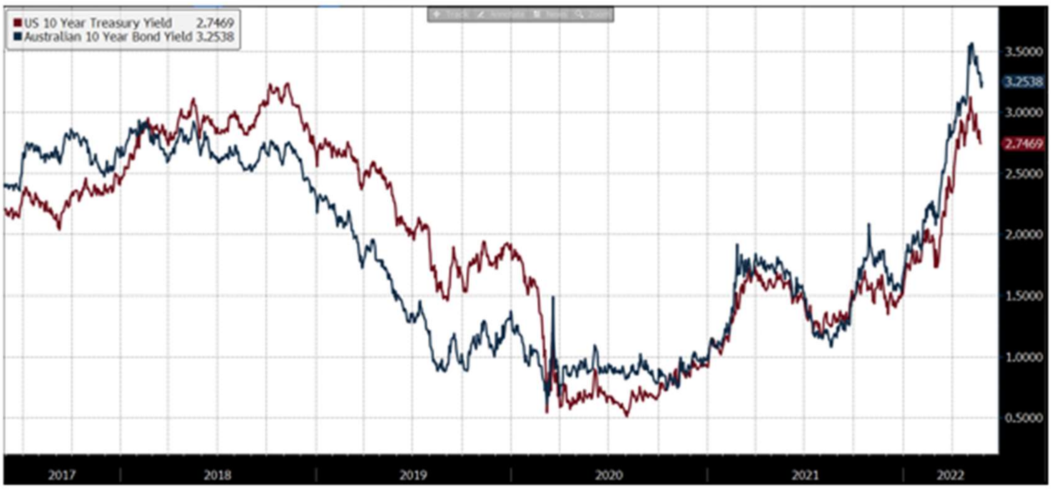


We expect inflation to remain high for quite some time yet but believe that we are at or near the peak and that a gradual decline over the second half of 2022 will be supportive for equities.

Global Purchasing Managers Index (PMI): composite of manufacturing and services, may have recently dipped but is still in expansionary territory, and leading indicators –whether they be manufacturing or services - still point towards a global economy that is growing despite the litany of headwinds it is currently facing. Additionally, across the developed world labour markets and corporate balance sheets remain strong, as do households with record high savings rates that should help offset rising borrowing costs as central banks normalise rates.



We believe we have seen the worst of the global bond sell-off and while we do expect global bond yields to eventually rise above current levels, yields are likely to decline modestly over the next 6 months as inflation temporarily falls. This will bode both positively for equity markets, consumer and business confidence and growth assets that have been marked down severely in recent months.



Valuations are now Reasonable

Finally, the global market sell-off has seen equity valuations cheapen significantly with the S&P500 now trading at 16.3 times next year's earnings and the ASX200 trading at 14.14 times FY23 earnings.

While valuations have declined, we do still expect earnings expectations to come back slightly, which will see continued volatility. Earnings growth has been strong so far this year, but analysts' expectations will likely have to be trimmed slightly from here.

Earnings in Australia remain robust, thanks to strong commodity prices.

Buying the correction in Equities and Bonds

Against this backdrop of abating inflation, slower but still positive economic growth, improving supply chains and attractive valuations we are now tactically positive on the outlook for equities for the remainder of the year favouring quality stocks with high earnings visibility and regional exposures of Australia and the US over Europe, where the Ukraine conflict will weigh far more heavily on economic growth.

Portfolio Changes

As such we have recently sold the short position (BBOZ) on the domestic market and increased our exposure to BHP given its attractive valuation and the strong outlook for commodity prices. We have also added to a number of existing exposures that we felt had been oversold. We also last week introduced a geared exposure to the US market (GGUS), after an almost 20% decline.

Finally, we introduced an index Australian Government Bond exposure in Income SMA (AGVT). With a yield of almost 3%, this exposure is now providing a reasonable income and will provide some downside protection if there is a growth shock.

Watershed Funds Management

Our APRIL reports can be viewed [here.]

If you would like to speak to us and how Watershed can help drive your client's investment returns please contact our BDM Shantelle Lay:

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Watershed Funds Management

Watershed Funds Management is a specialist Managed Account provider and has been a pioneer in the delivery of Managed Account (MDA & SMA) solutions to financial advisers.

Watershed leverages the expertise of a highly credentialed investment team to form a global thematic view that determines asset class and sector allocations.

Our investment committee structure differs for each Managed Account (SMA) and is chaired by an individual with niche expertise and a proven track record for managing portfolios within that asset class. With a research process that is both rigorous and thorough we have been able to deliver strong historical returns across our full suite of SMA's.

An investment in a Watershed SMA provides professional and active investment management with full transparency of holdings, transactions and structure. Watershed seeks to form a collaborative relationship with advisers, actively communicating portfolio strategy in the current market environment so that advisers are better equipped to communicate with their clients.

Performance Fee Disclosure

All figures & tables stating investment performance returns (AFTER investment management fees, but BEFORE administration fees and taxes) for the Portfolio. The performance returns have been calculated on a daily basis taking into account brokerage costs, and are accumulated for the period shown. Returns are shown as annualised if the period is over 1 year, or as total returns otherwise.

FE Analytics Index

The FE Peer Group Multi-Index Indices offer average returns across circa 150 funds with a similar risk mandate, i.e Balanced.