INNOVA
ASSET MANAGEMENT

DECEMBER QUARTER 2021
MARKET OUTLOOK REPORT

MARKETS REMAIN STRONG DESPITE RISING INFLATION AND CHINA'S EVERGRANDE PROBLEM

Most major asset classes posted positive returns over the September quarter until concerns surrounding Chinese property developer Evergrande and the US Federal Reserve's tapering plans caused increased volatility.

Equity markets peaked in August with small caps and Growth stocks outperforming, as well as high-yield credit, although Value equities, small caps and credit were the top performers over the 12 months. The Japanese Nikkei also put in a good showing.

While returns have remained healthy, it would be hard to argue that markets aren't at an inflection point.

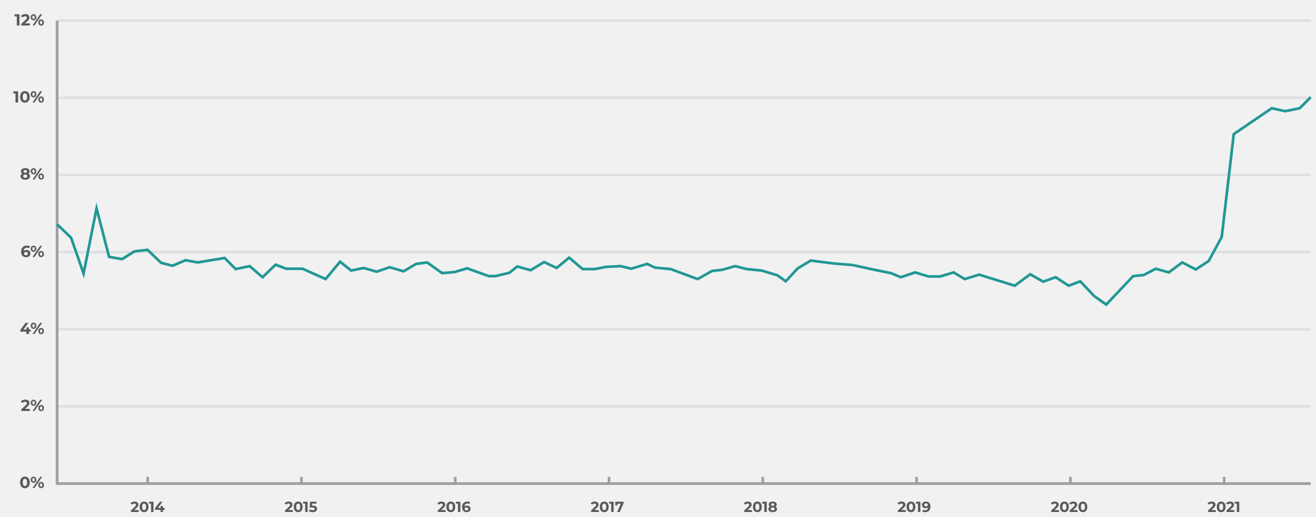
In early-November, the US Fed confirmed it would begin tapering the pace of its asset purchases as the data increasingly suggests higher inflation may be here to stay.

However, it's not a sure thing as supply bottlenecks, material shortages and poor pricing power at either the producer or consumer level mean we are still in transition.

Nonetheless, inflation expectations – which change behaviour – are still rising.

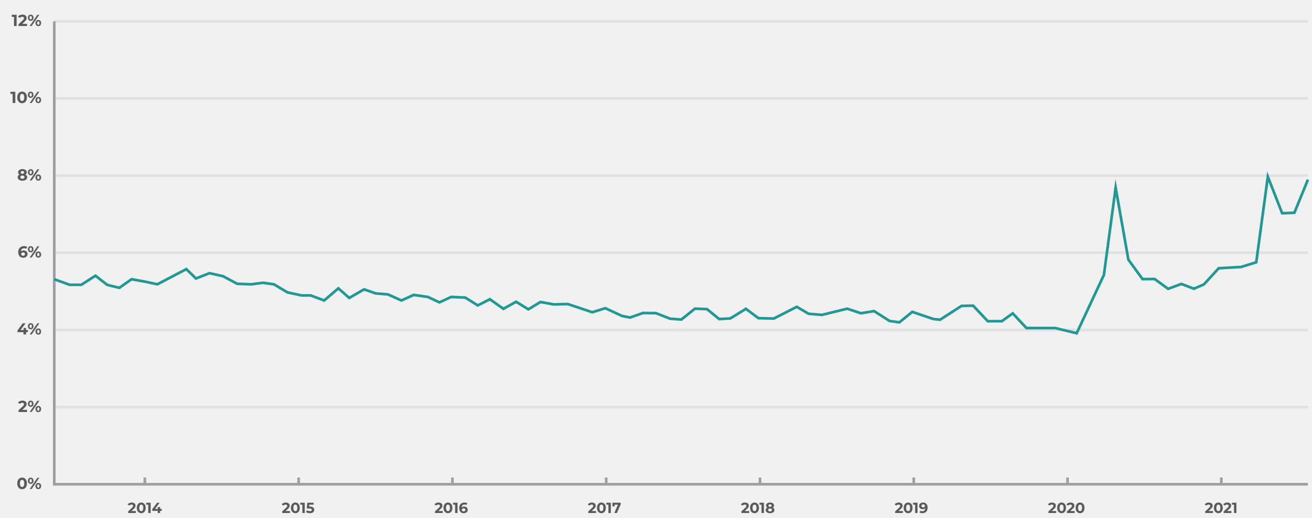
Housing and shelter costs make up about 42% and food about 15% of the US Consumer Price Index (CPI). The two graphs below show how inflation expectations for both have skyrocketed this year.

ONE-YEAR AHEAD COMMODITY PRICE CHANGE EXPECTATIONS - RENT



Source: New York Fed Survey of Consumer Expectations

ONE-YEAR AHEAD COMMODITY PRICE CHANGE EXPECTATIONS - FOOD



Source: New York Fed Survey of Consumer Expectations

Companies trading on higher valuations tend to get hurt badly when consumers, producers and investors think the value of a dollar's earnings next year will be worth less than today.

Choppy waters are ahead with uncertainty lingering around the fate of Chinese property developer Evergrande.

EVERGRANDE: A POSSIBLE RESTRUCTURING AND STATE CONTROL

Evergrande is currently the world's most indebted property developer owing 1.9 trillion RMB ($300B USD), which is roughly half the amount owed by US investment bank Lehman before its collapse in 2008.

Some believe Evergrande will default and become China's "Lehman" moment. We think a restructuring and some form of state control is the more likely outcome.

Evergrande's underlying assets are not drastically overpriced low quality, sub-prime mortgages but very valuable land and property in prime locations. Its debt is large but spread across roughly 300 banks – the impaired value of their exposure seems more than factored in by the market.

A government bailout would create a moral hazard by encouraging less-than-ideal behaviour from the other large and indebted developers such as Country Garden China (1.7 trillion RMB debt); Vanke (1.5 trillion RMB debt) and Greenland China (1.3 trillion RMB debt).

However, simply allowing Evergrande to fail wouldn't achieve the CCP's "common prosperity" goal, with the wealth of middle-class citizens highly leveraged to property.

We believe the CCP may attempt to walk the middle ground: save the property values, but not the company.

Another institution may eventually take over Evergrande while the CCP retains control over property sales to ensure their values are maintained.

The CCP may even force senior management to repay their bonuses as they have grown exceptionally wealthy during the property boom but perhaps acted irresponsibly.

However, this is just one possible scenario and significant uncertainty remains around the outcome.

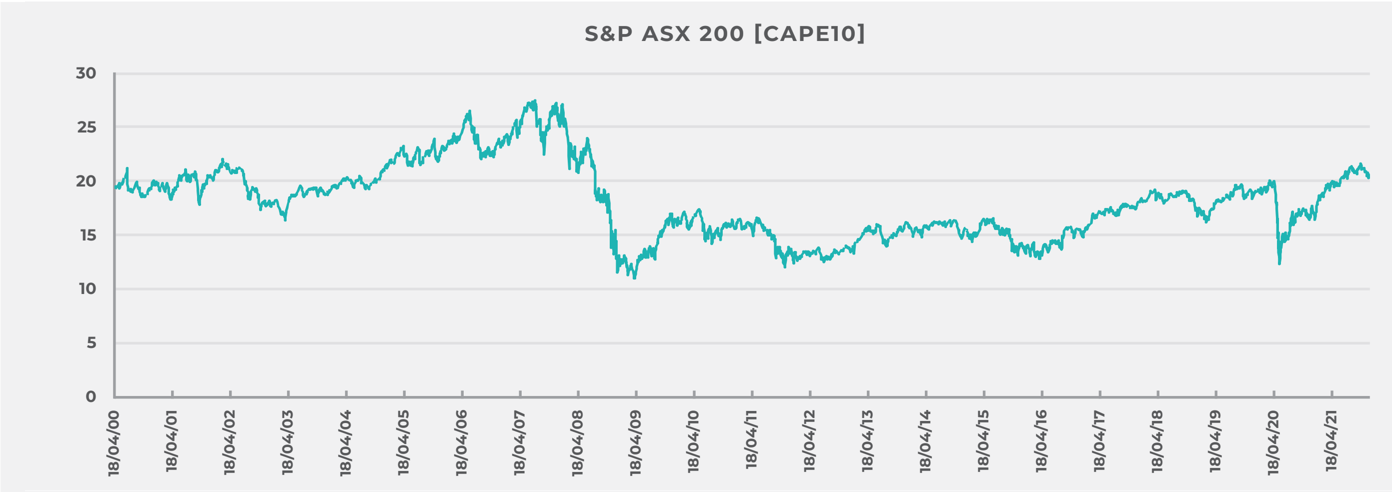
HOW WE'RE INVESTING OUR PORTFOLIOS

ASSET CLASS	FORECAST	CHANGE ON QUARTER
Australian Shares	Neutral to mildly expensive	Downgrade
Global Shares	Mildly expensive	Downgrade
US Shares	Expensive	No Change
Asia ex Japan Shares	Neutral	Mild Upgrade
European Shares	Neutral	No Change
Australian Government Bonds	Expensive long term	No Change
Australian High-Grade Credit	Neutral	Mild Downgrade
Global Sovereign Bonds	Expensive long term	No Change
Global High-Grade Credit	Mildly Expensive	No Change
High Yield Bonds	Expensive	No Change
Emerging Market Debt	Mildly Expensive	Mild Upgrade
A-REITs	Neutral	No Change
G-REITs	Neutral	No Change
Global Listed Infrastructure	Neutral to Mildly positive	No Change
AUD	Neutral to expensive	No Change
USD	Neutral	Mild Downgrade
Gold	Neutral, but becoming more attractive	No Change
Cash and Term Deposits	Mildly Expensive (no real yield)	No Change

Cyclical companies, value equities, emerging markets (ex-China), are our preferred equity allocations.

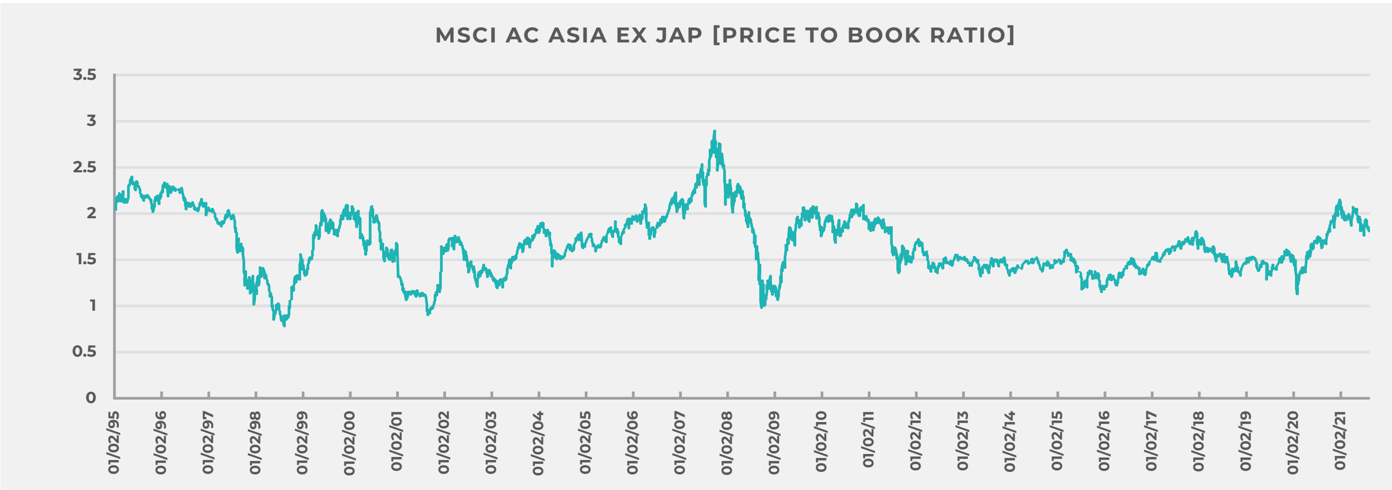
We continue to have concerns around the US market, trading at valuation ranges only ever seen before in the tech bubble, but pockets within the US look fine. We have little exposure to Growth style equities given their stretched valuations.

The recent dip in the ASX 200 has pulled valuations closer to average based on a price-to-cashflow basis. However, the outlook for the overall economy isn't particularly rosy, with our main commodity exports under pricing pressure and massive rises in house prices potentially subduing future growth.



We have tilted to equity markets that have more attractive valuations – European equities, emerging markets and Asia (including Japan).

The recent selloff in Asia off the back of Evergrande contagion fears has made the fastest growing region in the world look more interesting. We believe investing directly in China is not a great idea, but a basket of Asian countries at these prices looks attractive, especially if we enter a period of higher growth-higher inflation.



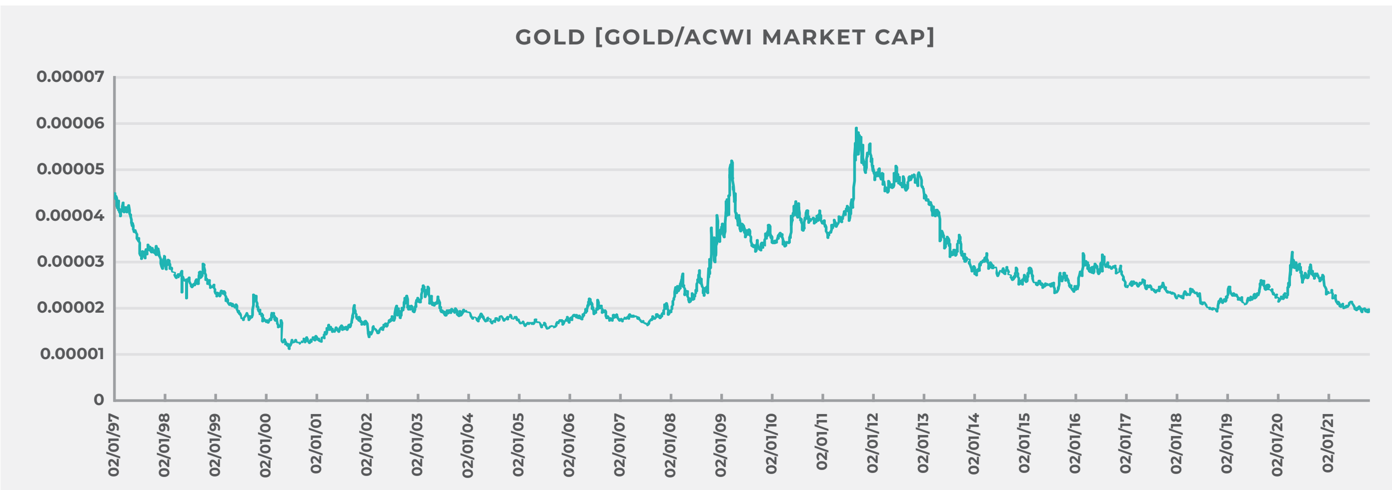
Our preference for robust and sustainable earnings growth may become easier with global growth accelerating as economies open again, yet supply-chain bottlenecks remain a problem.

Among credit, we prefer short duration debt (which is less interest rate sensitive) and are maintaining a bias to high-grade credit and loans.

The highest-grade credit is still not offering sufficient return or yield for the risk although the investment grade just below the A rating level is reasonable.

Given the unprecedented fiscal and monetary stimulus from governments and central banks around the world, we believe gold continues to be a likely beneficiary.

While inflation fears shake bond markets, the value of gold has remained static, making it attractive relative to equities. If negative real rates persist, this is a positive tailwind for gold to act as a hedge.



We also continue to hold a tactical allocation to cash to take advantage of any pricing opportunities, although we would prefer not to since it isn't offering a real yield. We are looking to alternative forms of cash to enhance return without taking undue risk.

TRADITIONAL PERFORMANCE AT SEPTEMBER 2021

	3 MONTH	6 MONTH	1 YEAR	3 YEAR	5 YEAR	7 YEAR	9 YEAR	INCEPTION
Conservative	0.69%	2.81%	6.68%	4.25%	3.93%	4.07%	4.53%	4.79%
Morningstar benchmark	0.29%	2.62%	4.23%	3.51%	3.15%	3.43%	3.86%	4.07%
Difference	0.40%	0.19%	2.45%	0.74%	0.78%	0.64%	0.67%	0.72%
Moderately Conservative	1.21%	4.44%	11.90%	5.66%	5.24%	5.28%	6.03%	6.25%
Morningstar benchmark	0.84%	4.01%	8.37%	4.71%	4.32%	4.34%	4.97%	5.10%
Difference	0.37%	0.43%	3.53%	0.95%	0.92%	0.94%	1.06%	1.15%
Balanced	1.76%	6.28%	17.05%	7.02%	6.52%	6.52%	7.56%	7.74%
Morningstar benchmark	1.21%	5.82%	14.88%	6.27%	6.21%	5.96%	6.88%	6.85%
Difference	0.55%	0.46%	2.17%	0.75%	0.31%	0.56%	0.68%	0.89%
Growth	2.38%	8.17%	23.47%	8.47%	8.02%	7.94%	9.35%	9.46%
Morningstar benchmark	1.54%	7.67%	19.99%	7.61%	7.87%	7.21%	8.38%	8.23%
Difference	0.84%	0.50%	3.48%	0.86%	0.15%	0.73%	0.97%	1.23%
High Growth	2.71%	9.32%	27.04%	9.47%	9.02%	9.11%	10.78%	10.85%
Morningstar benchmark	1.91%	9.30%	25.96%	8.63%	9.64%	8.86%	10.34%	9.96%
Difference	0.80%	0.02%	1.08%	0.84%	-0.62%	0.25%	0.44%	0.89%

RISK DEFINED PERFORMANCE AT SEPTEMBER 2021

	1 MONTH	3 MONTH	6 MONTH	1 YEAR	3 YEAR	INCEPTION
Lifestyle Preservation Flagship	-0.75%	0.69%	2.47%	5.74%	2.50%	2.76%
Lifestyle Preservation Fundamental	-0.78%	0.57%	2.64%	4.80%	3.26%	3.12%
Target Cash Rate +1.5%	0.13%	0.40%	0.80%	1.61%	2.15%	2.38%
Difference Flagship	-0.89%	0.29%	1.67%	4.13%	0.35%	0.38%
Difference Fundamental	-0.91%	0.17%	1.84%	3.18%	1.11%	0.74%
Wealth Creation Flagship	-1.10%	2.11%	6.82%	18.44%	6.30%	6.43%
Wealth Creation Fundamental	-1.51%	1.62%	6.46%	14.31%	7.78%	6.51%
Target Cash Rate +3%	0.25%	0.77%	1.54%	3.11%	3.66%	3.89%
Difference Flagship	-1.36%	1.34%	5.28%	15.32%	2.64%	2.54%
Difference Fundamental	-1.76%	0.85%	4.91%	11.19%	4.12%	2.62%
Aspiration Flagship	-1.33%	2.74%	8.90%	24.83%	8.34%	8.55%
Aspiration Fundamental	-1.81%	2.14%	8.59%	20.22%	10.71%	8.80%
Target Cash Rate +5%	0.41%	1.26%	2.53%	5.11%	5.67%	5.91%
Difference Flagship	-1.74%	1.48%	6.38%	19.71%	2.66%	2.64%
Difference Fundamental	-2.22%	0.88%	6.07%	15.10%	5.04%	2.89%