CAN WE PROTECT AGAINST THE DUAL RISKS OF INFLATION AND RECESSION

IMAP

March 2024

e support@centricwealth.com.au p 1300 223 687 w centricwealth.com.au
Specialised Private Capital Ltd (ABN 87 095 773 390, AFS Licence No. 246744)

Disclaimer

- Specialised Private Capital Ltd (ABN 87 095 773 390, AFS Licence No. 246744) trading as Centric Capital (Centric Capital) is part of Findex Group Limited (ABN 40 128 588 714). Centric Capital is the operator of the investor directed portfolio service (IDPS) known as "Centric", and the sponsor, promoter and investment services provider for the Centric Super Fund (ABN 91 593 544 166, RSE Registration Number R1078619). Equity Trustees Superannuation Limited (ETSL) (ABN 50 055 641 757 AFSL 229757, RSE Licence Number L0001458) is the trustee of the Centric Super Fund (read more about Equity Trustees Superannuation Limited on their website). For more information about Centric Capital, including our Financial Services Guide and disclosure documents, click here.
- Any factual information or general advice in this email has been prepared without taking into account any personal objectives, financial situation or needs. Before you act on any information in this email you should seek specific advice that considers your personal circumstances. Investors should also read the relevant disclosure document before making any investment decisions, copies of which can be obtained by visiting centricwealth.com.au or by calling 1300 223 687. A copy of the target market determination for Centric and Centric Super can be located at centricwealth.com.au/ddo.

Centric

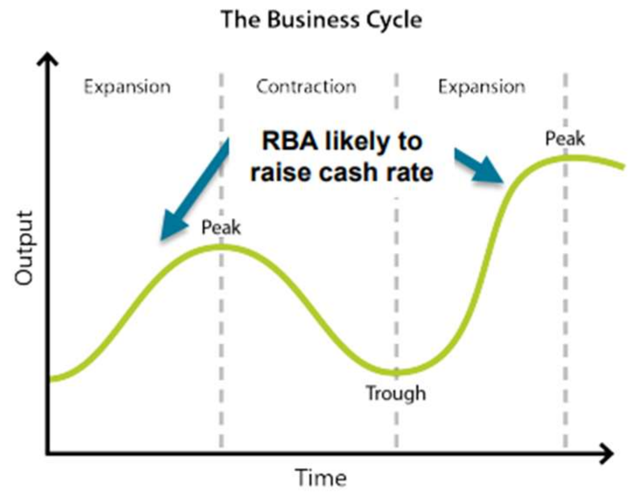
Can we protect against the dual risks of inflation and recession

In a typical business cycle inflation and **recession are often seen in succession.**

- Protecting portfolios in this scenario **is less complex**.

There are a number of more complex scenarios that complicate the ability to protect against both inflation and recession (significant slowing of growth) that **occur in tandem**.

- **Stagflation**
- Inflation remains higher for longer – **structural higher inflation** (above CB targets)
- **Inflation spike**



Source: RBA

Frequency Of Transitions To Subsequent Regime		Early Expansion	Late Expansion	Early Recession	Late Recession	Next Regime (Expected)	Most Frequent Next Regime
Initial Regime	Early Expansion	-	13 (50%)	0 (0%)	13 (50%)	Late expansion	Late expansion / Late recession
	Late Expansion	5 (38%)	-	6 (46%)	2 (15%)	Early recession	Early recession
	Early Recession	0 (0%)	0 (0%)	-	5 (100%)	Late recession	Late recession
	Late Recession	21 (100%)	0 (0%)	0 (0%)	-	Early expansion	Early expansion

NOTE: GREEN CELLS REPRESENT THE THEORETICALLY EXPECTED REGIME SHIFT FROM AN INITIAL STATE. BOLDED CELLS REPRESENT THE MODAL REGIME SHIFT FOR EACH INITIAL REGIME. DATA SHOWS THE NUMBER OF TRANSITION TO EACH SUBSEQUENT STATE. NUMBERS IN BRACKETS REPRESENT THE RELATIVE FREQUENCY, ROUNDED TO THE NEAREST INTEGER. THE SAMPLE GOES BACK TO Q4 1959.

Source: BCA

Our base case for CY 2024

	Scenario 1 Contraction/Recession	Scenario 2 Stagflation	Scenario 3 Unsustained Recovery	Scenario 4 Sustained Recovery
Economic Growth	Economic growth negative Global synchronised weakness	Economic growth is flat/weak Regional growth is mixed	Economic growth not self-sustaining Regional growth is mixed Underlying problems not solved	Economic growth positive and sustained Major economies return to growth
Inflation	Deflation	Inflation persistent & too high	Inflation persistent & too high	Inflation in target range & under control
International Trade	International trade negative Trade protectionism increases	International trade flat/negative Trade protectionism increasing	International trade flat/negative	International trade strong Trade protectionism decreases
Business Sector	Company earnings negative PMIs below 50 Increased level of defaults	Earnings neutral - some good, some bad PMIs mixed but generally below 50 Increased levels of defaults	Earnings neutral - some good, some bad PMIs mixed but generally below 50 Increased levels of defaults	Strong Earnings growth PMIs above 50 Low levels of defaults
Consumer Sector	Unemployment increases Consumer confidence negative	Unemployment weakens Consumer confidence poor	Unemployment weakens Labour markets constrained Consumer confidence poor	Unemployment low Labour markets not constrained Consumer confidence strong
Government Sector	Interest rates lowered Counter-cyclical fiscal measures enacted	Higher interest rates are impacting growth	Higher interest rates are impacting growth Central Banks & Govts supporting markets	Economy can sustain higher interest rates Budget deficits & debt burdens decline Political & Geo-political stability
Where are we now?	**55%** Toward the back half of the year	**5%** Weak growth with a second round of inflation	**30%** Growth with 2nd round of inflation	**10%** Soft landing scenario

Protecting against inflation and recession – retail portfolios

- Two approaches – top down and bottom up.
- ‘Top down’ tools
- Asset Allocation
  - Strategic allocation – anchor within the context of a market cycle / regime
  - Tactical allocation – allows for movement away from the strategic anchor to position portfolios for the near term expected conditions.
    - E.g. reducing weight to risk assets ahead of expected slowdown
- Portfolio Construction
  - Asset class structuring
  - Underlying investment choice
  - Blending sectors and managers
  - Focus on liquidity

Asset Allocation under different regimes

GROWTH (+)

EARLY EXPANSION
Slack
Positive Growth

COMMODITIES
- OW Commodities (GSCI)
- OW Oil

FIXED INCOME
- OW Credit vs Treasuries
- OW HY vs IG

EQUITIES
- OW Equities vs Bonds
- OW Cyclicals vs Defensives
- OW Small vs Large Caps
- OW EM vs DM
- OW ex-US vs US
- OW Europe vs US

LATE EXPANSION
Overheating
Positive Growth

COMMODITIES
- OW Commodities (GSCI)
- OW Industrial Metals
- OW Oil

FIXED INCOME
- UW Duration vs Cash
- Curve Flatteners
- OW Credit vs Treasuries
- OW HY vs IG

EQUITIES
- OW Equities vs Bonds
- OW Cyclicals vs Defensives
- OW Value vs Growth
- OW Large vs Small Caps
- OW DM vs EM

GROWTH (-)

LATE RECESSION
Slack
Negative Growth

FIXED INCOME
- OW Duration vs Cash
- Curve Steepeners
- UW Credit vs Treasuries

EQUITIES
- OW Bonds vs Equities
- OW Defensives vs Cyclicals
- OW Growth vs Value
- OW DM vs EM
- OW US vs ex-US

COMMODITIES
- OW Commodities (GSCI)
- OW Oil

EARLY RECESSION
Overheating
Negative Growth

FIXED INCOME
- OW Duration vs Cash
- UW Credit vs Treasuries

EQUITIES
- OW Bonds vs Equities
- OW Defensives vs Cyclicals
- OW Growth vs Value
- OW Large vs Small Caps
- OW DM vs EM
- OW US vs ex-US

COMMODITIES
- OW Gold

(-, SLACK) CAPACITY UTILISATION (+, OVERHEATING)

Note: OW = Overweight Allocation, UW = Underweight Allocation. Allocation pairs are colour-coded across the cycle

Various protection strategies

Inflation protection

Protecting against inflation that is higher than market

expectations **Treasury Indexed Bonds**

- If Inflation is higher than currently priced, Treasury Indexed Bond will outperform. However, if inflation is lower than expected, regular bond will outperform.

Cash - Nominal returns should keep up with inflation if accompanied by rising short term rates - best performing asset during 2022

Equities - Need to be companies that can pass on higher costs. Quality – ability to pass on price increases

REITs and Infrastructure - In an environment with rising wages, higher rents can be passed on. Many infrastructure assets have inflation linked revenue models.

- We shifted our allocation between Property & Infrastructure to be overweight infrastructure during 2022 and 2023. On a relative basis this outperformed.

Recession protection – strategies will vary depending on the severity of recession, time of recession, fiscal and monetary response to the recession.

Necessary to hedge when **equities pricing in more optimistic earnings**.

Look for **defensive assets**

- Utilities/Staples/Healthcare
- Avoid overvalued companies relative to fundamentals
- Quality

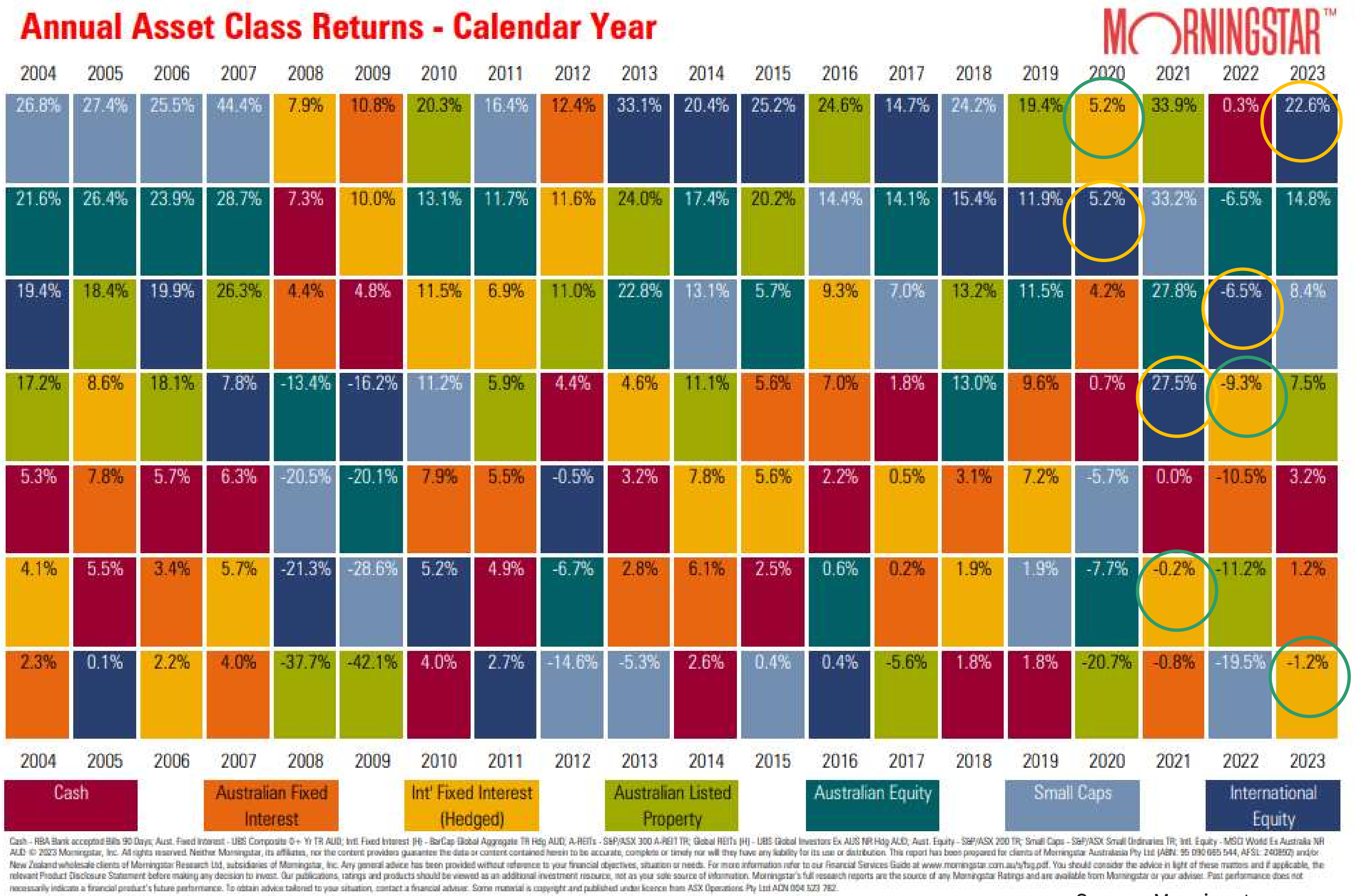
REITs with defensive characteristics

- E.g. Alceon hold properties with long leases to govt agencies.

Move up the capital stack

- Reduce equity and increase allocation to fixed income and credit. If more protection is needed, move from credit to govt bonds. In recessionary environment high quality credit.
- **Long duration once rates come off or monetary policy is clear**

Asset class returns



Source: Morningstar

Protection from simultaneous inflation and recession risks

Need to **determine key client/portfolio risk**. AA and PC risk mitigant strategies may differ on the below outcomes.

- **Conservative, income generating portfolios** will be **more impacted by inflation.**
- High **growth portfolios** with longer timeframes will be more **impacted by large drawdown** from growth declining.

Need to **consider wider conditions** – do you expect inflation to spike and then revert lower or stay higher for sustained period.

Is a s**lowdown** in growth expected to be **short lived or longer lasting.**

How are **central banks** going to **respond**? What is the **potential fiscal response**?

What are conditions like in **other regions**?

Use some combination of allocation

- Treasury Indexed Bonds
- Higher Cash allocations
- Defensive equity positioning – allocation to REITs, Infrastructure, alternative asset classes or products

Thank you

Centric

Appendix

Centric

Vinva Global Systematic Equities Fund - Style Agnostic investing

- Core Global Equity Fund
- Low tracking to benchmark
- Style agnostic means there is no material style bias e.g. value/growth tilt over a market cycle
- Systematic investing leaves aside the human behavioral biases
- Ability to rotate in/out of sectors may benefit navigating an inflationary period
- May be blended with traditional value/growth managers
- 40+ investment signals based on Fundamentals (value, quality etc)
- Coverage of 10,000 global stocks
- Final portfolio of between 400-700 stocks with tight active risk management

Source: Centric Research, Vinva, Morningstar. Fund alpha is net of PDS fees and relative to historical PDS benchmark (MSCI Index).

Centric