

## **IMAP**

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### **AMP Intro (00:17):**

AMP Capital is a boutique global private markets, investment and asset manager with a strong and established history in real estate infrastructure investing AMP Capital employs over 500 people across 15 countries and manages 42 billion in assets. Under management AMP Capital is focused on delivering long term sustainable outcomes for clients through a principled investment philosophy that considers the decisions made today will impact the world tomorrow for more information, visit [AMP Capital.com](https://AMP.Capital.com).

### **David McDonald - IMAP - IMAP (00:49):**

Welcome to this podcast in the IMAP Independent Thought series. Given current concerns about rising inflation. Our topic today is a very relevant one. We are going to be discussing whether Real Assets offer inflation protection. Joining me on the podcast to discuss is Diana Mousina who is a senior economist with AMP Capital and Angela Ashton, founder and executive director of Evergreen Consultants.

Welcome Diana and Angela. Thank you, Diana. Perhaps we can start with you and maybe you can give us a little bit of macro background, particularly on the global inflation picture and what's driving it and how you see the outlook

### **Diana Mousina - AMP Capital (01:34):**

Sure. Thank you for having me on today's podcast. We know that inflation has been rising over the past six months, quite significantly around the world, particularly in the Western developed world. What's caught everyone by surprise is how fast the increase inflation has been. And the breadth of price rises across both goods and services. Some of the increases in inflation are transitory.

I know that that's not a very sexy word that we have liked to use over the past few months because a central banks were saying that the increase in inflation would be transitory and it didn't end up being so, but there are still some strange things going on in the inflation data, which won't persist. We know that the pandemic wrecked havoc with supply chains around the world, and it still is to some extent. Consumer demand surged for goods over the pandemic.

### **Diana Mousina - AMP Capital (02:31):**

And we're still trying to normalize supply chains around the world to more normal levels of goods demand because consumers, because consumers are putting not demanding as many goods, but they're increasing their demand for services. So inflation is likely to slow from its current pace over the next six to 12 months, we're likely to see continued strong growth in inflation related to services. So there is likely to be this transition from high goods inflation towards higher services inflation.

And we can see that around the world in things like higher rents, for example, we've also of course had one off events like the war Ukraine, which has caused a further increase in commodity prices. Although commodity prices were already quite elevated, even at the end of last year, we're seeing some of those commodity prices starting to come off now, especially in metals, but energy prices still remain quite elevated because some of the disruptions around energy flows in Europe, that's related to what's happening in Ukraine and Russian flow of gas to Europe.

### **Diana Mousina - AMP Capital (03:39):**

But hopefully those price rises weren't continue at the same pace that they have been going. And in Australia, of course, we've also had our local floods in new south Wales and Queensland, which has meant very big increases in fresh food and vegetable and fruit prices. So inflation's likely to slow from its very high pace at the moment, but it doesn't mean that it will go back to its pre COVID levels. We see Australian inflation hitting about 7% on an annual basis by the end of this year and slowing to more around three to 4% on a headline basis next year

**David McDonald - IMAP** ([04:15](#)):

And Diana in locally, there's obviously been a lot of talk about real wages not rising and so on. Do you see signs of pressure on the wages front in Australia as well? Is that something we should be worried about?

**Diana Mousina - AMP Capital** ([04:30](#)):

Wages are likely to rise in Australia because we have a tight labor market. The unemployment rate is at the lowest rate that it's been at in about 48 years and probably likely to see some more downside as well under utilisation in the labor force, which is underemployment as well as the unemployment rate is also at a multi-year low because we've had this big recovery in our economy after the pandemic, thanks to all the fiscal and monetary stimulus that was done over the pandemic. It's really allowed our economy to, to boom at a pace that it wouldn't have been able to do if we, if we didn't have all that stimulus go through.

So when you have a tight labor market, naturally you expect high demand for employees and job switching, and that's likely to generate some wages growth we can already see as well that employees are demanding high wages through things like the minim wage increase that we had recently increases to the minim award wages, which were quite high in the level of about 5% per and wages before the pandemic we're running at about 2% on an annual basis. So we're likely to see some increase, we think to somewhere around three and a half to 4% on an annual basis over the next year.

But I wouldn't call that a situation where wages growth is becoming unsustainable or we're getting into this wage price spiral in the us, for example, wages growth is much higher running it between five and 6% on, on an annual basis. If you have that continuous level of wages growth, that's when it becomes unsustainable.

**David McDonald - IMAP** ([06:01](#)):

Yeah. Yeah. Right. And if inflation comes back to three to 4% next year, locally, as you've suggested, that's still above, I guess, where the RBA would like it to be. So not going to see any relief from interest rate hikes for some time then.

**Diana Mousina - AMP Capital** ([06:19](#)):

Well, the RBA has said that they want inflation to average in their target band two to 3% over the course of a business cycle. So we've had the last eight years where inflation has been undershooting their inflation range. So we can get a period where it's overshooting their target band. The problem is that they don't want it to overshoot too much, right? So they don't want to see inflation at five or 6% on an annual basis. And if they're confident that even at three to 4% in the next little while they can get prices down, then I think that they would still be okay with that. We see further rate rises over the next six to 12 months, but ultimately we see the cash rate peaking at about 2.6% by the middle of next year. After which time we think inflation will show signs of slowing and the economy will show signs of slowing and the RBA will have to pause on its rate hike agenda. And actually we see the risk of rate cuts in the

second half of next year to support the consumer again. And as the RBA becomes more confident that inflation will start to slow. We see quite a significant deceleration in domestic economic growth next year, because of all the rate hikes that we've had so far and the ones that are still going to come in the next few months.

**David McDonald - IMAP (07:36):**

Okay. Thanks. Angela, I know that we are talking there about the growth outlook and that's something you'd mentioned is equally, if not more important than inflation in terms of the outlook for all asset classes and particularly the real assets we're going to talk about here.

**Angela Ashton - Evergreen Consultants (07:52):**

Yes so Diana I guess I'm gathering from what you're saying that you're expecting, I guess growth to remain resilient for up to 12 months and then potentially fall off. Is that true globally or just in, is that just in Australia or how, how are, how are you seeing that?

**Diana Mousina - AMP Capital (08:10):**

Well, a lot of people are talking about the risks of stagflation and what that means for investment markets. Actually, our forecasts pretty consistent with a stagflation type of environment over the next 12 to 18 months, both in Australia and, and globally, we think with Australian GDP growth to be between one to 2% on an annual basis next year, similar in the us, that's a pretty slow growth environment at the, at a same time when you have quite high price growth. So we, we do see that deceleration and growth coming because the central banks are being so aggressive with their rate hikes.

**David McDonald - IMAP (08:52):**

The other thing to your honor, I guess that's obviously stagflation something that's been in the headlines, but there's also more and more talk about recession globally and locally. I mean, is, is that going too far? Do you see a risk of a recession in Australia?

**Diana Mousina - AMP Capital (09:08):**

I think we have to be mindful that there's the big risk of a recession here. Maybe less so in Australia. I think the risk is still less in Australia than it is in the us. The us has much higher inflation. Their headline price growth is close to 9% on annual basis. Their central bank has been raising rates more than in Australia.

And I think that the us federal reserve will raise rates more than the, than our central bank will in Australia. But as, but I guess one thing that makes me nervous is that Australian households are much more leveraged to interest rates and to debt than the average US household.

So if we see the RBA being more aggressive than we expect then perhaps the risk of a recession is much higher here.

**David McDonald - IMAP (09:56):**

Yeah. Thanks. And Angela I guess talking particularly about the real assets we are going to discuss here, what do you think would be the worst outcome?

Is it inflation remaining other control or would it be if we had a recession, is that going to be something you'd be more concerned about in terms of this asset class

**Angela Ashton - Evergreen Consultants (10:16):**

Real Assets do tend to work well in inflationary environments. So in terms of what might be worse for their outlook, it's probably low growth or recession. So interestingly the US does look very weak. A lot of the "nowcasting models" actually show that it potentially is already in recession. So it, there's no doubt that the US economy is weak, but inflation has remained high. That as you know is stagflation to some degree. So that's definitely not a pleasant situation, but real assets are probably one of the few pockets that potentially can do well in that type of environment. The problem with stagflation is when growth is weak, often earnings can be weak as well. So a lot of share market can suffer in that environment.

**Angela Ashton - Evergreen Consultants (11:14):**

Some companies can work their way through, but it, it's not the majority. It's a difficult environment for many companies. So real assets do, you know, offer potentially some area of protection. And that's because often a lot of the income that they generate is linked to inflation. For example, a toll road often has some sort of concession with the government whereby it can raise the amount that it charges by inflation or some or inflation. Plus the problem with the recession is you have toll numbers falling. The numbers actually going on the toll road may decrease, but compared to a lot of other companies, the comparative effect would be lower on a toll road. So, a lot of those real assets do offer a really good protection against inflation.

**David McDonald - IMAP (12:19):**

Yes. Diana what do you think?

**Diana Mousina - AMP Capital (12:20):**

What I've been surprised with is that company earnings haven't actually been downgraded that much for this year or for 2023. They've been very resilient against the bear markets that we've seen in equities. We do have the US reporting season starting around now. So maybe we'll start to see more of those downgrades. And I do expect those downgrades to start coming through, but Angela, are there any industries that you like more so in the next 12 to 18 months given the environment that we're expecting?

**Angela Ashton - Evergreen Consultants (12:52):**

You mean in listed markets? Look, I agree with you, Diana, it's really interesting that we haven't seen a lot more downgrades yet. But you know, it will be surprising if we get through this earnings season without seeing some real hits to earnings in some companies, there are companies that potentially can get through this period better than others. Apart from a lot of real assets are obviously things like quality companies, that people will continue to buy their products and can pass through inflationary increases. A good example is something like a Microsoft, if Microsoft licenses go up 5% or 7%, most people will still buy them.

**Angela Ashton - Evergreen Consultants (13:40):**

So you can see that their ability to potentially pass through inflationary increases will be pretty good. There will be a lot of companies that will suffer, that will have potentially products that aren't quite as sought after by the market. Companies that are highly levered, and they're the types of companies that potentially can be impacted. Very high growth companies that aren't earning anything are often the sorts of companies that can be affected in this period. But if you want to talk about styles, it's going to be potentially quality. Because quality really does talk to ROE and economic moats and so on. Potentially

value, whereas that full on high growth type company or style investment style is probably not going to be quite as strong going in this sort of environment.

**David McDonald - IMAP (14:31):**

Angela. I understand, you know, you've explained how real assets can offer protection in inflationary environment, the toll roads and, and so on. And one question I have is when I read a lot of commentators at the moment, it seems to be everyone's favorite. So the inflationary environment, real assets, infrastructure. Yes are great places for protection. Do you see the sector then as being potentially overvalued or is it something you're still recommending clients have exposure to?

**Angela Ashton - Evergreen Consultants (15:04):**

Yes we're still recommending it. You're right. It has done really well over the past year. It's one of the few asset classes that have had positive returns. But we are still seeing consistently you know, private investors like super funds and so on continuing to try and take out these assets, that listed assets and, and the reality is that there are other groups out there that value them more highly than the market is currently valuing them. In our view, infrastructure is still a good place to be. I think it probably isn't go, it's not as quite the outstanding asset class. It might have been a year ago because as Diana said, you know, inflation is expected at some point over the next 12 to 18 months to start to moderate and how that might affect in infrastructure as an asset class is something that we need to turn our minds to. So it's not potentially quite the glowing beacon that it was, but it's still definitely something that's very worthwhile considering.

**David McDonald - IMAP (16:08):**

Okay. I, I think you've that one interesting issue you've raised there, you've mentioned the super funds and we've seen them buying Sydney airport, for example. And the question, I guess, is for those running a managed account. How can they access these sort of assets, a toll road and airport? Is it something that's easy to access for smaller investors?

**Angela Ashton - Evergreen Consultants (16:32):**

Yes, if you want to access the assets directly, it's not a managed account product, and it's not liquid. These are real assets. And one of the issues with all real assets, not just infrastructure, but property and agriculture and so on is that they're not liquid. That is one of the features of them. And that is part of the attraction during these sorts of periods. But it's also one of the major disadvantages.

The only way a managed account client can access these types of opportunities is through a listed environment. Now that obviously means that some of the benefits don't accrue to the investor, but broadly speaking in the medium term that they should, but there definitely will be more volatility in unit prices than you might expect if you were investing directly in the asset class.

**David McDonald - IMAP (17:26):**

Yes pricing, I guess is another question, Angela, and there's been discussion particularly with the big industry funds and so on as to how these assets are priced or how often they're valued, as opposed to the situation if you're buying a listed product which is going to have daily pricing generally. How do you see these sort of assets in terms of price, how opaque is the pricing of some of these assets.

**Angela Ashton - Evergreen Consultants (17:53):**

Yes that's a great question. And it's really difficult to know, but if the asset is held directly, if it's in a trust or in a Superfund those valuation policies are going to mean that they look much less volatile than if they were listed.

So again, that's part of the advantage of some of these assets, but it's also potentially negative. But yes it's just one of the things that is characteristic of those sorts of assets?

**David McDonald - IMAP (18:30):**

Well, we've talked about roads, airports infrastructure, and so on, but we haven't talked much about property own. Is that an a sub-asset class, I guess you call it that offers any inflation protection or is property more of a sort of growth focus? Should we be more concerned about the economic outlook?

**Angela Ashton - Evergreen Consultants (18:50):**

Yeah. With Property the dependency on the structure of the leases is really important. And, how they're set up. So a lot of commercial property leases are CPI adjusted, and therefore can provide you with CPI or inflation hedging. So in many cases, property can be a good asset to hide in during inflationary periods. You do have to be a little bit careful often at the end of a lease or you the, the, the price or the lease price may be readjusted for market. So you might may find that you get inflation hedging for a number of years, and then all of a sudden the amount of income changes significantly. So those are the sorts of things you need to be careful about in property, but look, it's a comparatively resilient asset class. And in terms of inflationary periods, it's often one that can perform better than many others.

**David McDonald - IMAP (19:53):**

Right. I think the other question with property across all aspects of property really is what we've seen with COVID is work from home and online shopping and so on. So, you know, wonder how much those trends are affecting the asset class. I don't know if either of, you've got a view on retail, for instance, whether, you know, a retail shopping centers returning to normal turnover levels, and, or is it an asset class that maybe won't perform as well in the long term because everyone's shopping on Amazon these days?

**Diana Mousina - AMP Capital (20:30):**

I think that a lot of the fear around online shopping taking over, and shopping centers not being of value. I think that that whole trend has pretty much passed now and going to what Angela was saying, people still look to quality assets and quality shopping centers. I think that there's still value in that it, despite there being a pandemic in the past two years, that made mobility completely collapse and demand at that time for shopping centers go to zero because we were locked down, we're still seeing very strong growth across consumer spending for all these types of discretionary goods.

So I think that there is still potential growth for quality assets in retail. Although the next two years will be challenging for many retailers because we do expect consumer spending growth to slow. But if you are looking for those quality assets, I think that there is still some value in that.

**Angela Ashton - Evergreen Consultants (21:36):**

And I think you have got to remember that a lot of these shopping operators are actually very smart and are changing the mix of the sorts of things that are in their shopping centers to potentially be more in line with what consumers want to spend money on and need to actually go to in person to do... such as medical center centers and so on.

So we're seeing the mix of the retailers change in order to be more appealing. So I do think retail is fine. I think what we've seen after the pandemic as we've opened back up, is that a movement back into shopping centers, people did move back so that they do want to go and see things that they do want to go to in those sorts of centers.

**Angela Ashton - Evergreen Consultants (22:24):**

The mix has to change to suit changing tastes, but a good retail asset for example is a convenience center where you go and buy your groceries, go and see the doctor, go to the pharmacy and so on are going to be strong going forward in commercial. I think what we're seeing is although people are working from home more, there is a movement to the better quality assets. So rather than being in a C grade building, people will take a lease in a B grade or even a grade building. And they're moving up the spectrum. So you're seeing quality assets remain quite strong and as well as I guess the way that offices are presented now has changed a lot as well. There's more space. There's more amenities that I guess speak to employees and to come in more. So that might be "end of trip facilities" or, you know, a yoga class in the middle of the day or whatever it is. But still a change in use and presentation of those assets to make them more suitable for people to actually come to.

**Diana Mousina - AMP Capital (23:36):**

I think there's also this idea now that working from home will be seen as a benefit. I know that it's been what everyone's been doing for the past year, so it seems like it should just be normal, but a lot of companies are now saying you need to be in the office X number of days a week or month or whatever it is. I think that the working from home permanently idea is not sustainable, and a lot of businesses have seen this. So if you can work from home three days a week, if not even more, that could actually be seen as a big benefit to employees which could just underline what Angela was saying. It will push demand for those quality types of buildings up because employees, when they do go into the office, they want to be in a nice building and have all those amenities in facilities.

**David McDonald - IMAP (24:29):**

Yes

**Angela Ashton - Evergreen Consultants (24:30):**

I think we're seeing that in the market. I think a lot of the very quality buildings aren't having problems filling space, and in some cases have actually been able to have rent increases.

**David McDonald - IMAP (24:43):**

We've talked about the inflation outlook and there's some encouragement that maybe at least by next year, we are going to see things ease off and slower growth, but hopefully not recession at least locally. Definitely as Angela highlighted, you still see that real assets are something that people should have exposure to. And we talked about equities quality, particularly the importance of certainty of earnings, but we haven't yet touched on fixed income. Can I ask either of you briefly comment on whether bond yields have gone too far, is it something people should be looking at again or there?

**Diana Mousina - AMP Capital (25:33):**

I think that are differences between the short and the long end at the moment in one yields, the short end, I think the pricing has gone a little bit too far, for example, in Australia the market expects the cash rate to be between 3.5% to 4% in a year's time. That looks too high in our opinion, because on our estimates, after you get to a cash rate of above two and a half percent, you do get some serious issues

with consumers potentially being able to service their debt, (which is the main concern with higher interest rates). It will take debt servicing costs as a share of income back to very high levels around 8 or 9% of income, which could become unsustainable for consumers, as well as that.

**Diana Mousina - AMP Capital (26:30):**

You've had a huge share of the market about 30% of the housing book, which has been fixing their mortgage over the past two to three years. And they'll have to be rolling off onto these much higher rates, more than two times what they're fixed at. I'm one of those people, so I can definitely feel the potential pain that's going to be inflicted on me next year, but in the long end pricing of bond yields, I do think that bond yields have a little bit further to go in the longer end as we start to, well, if we're correct in our view that over the next five to 10 years, inflation's going to be at a higher rate than where it was before COVID and in that environment, I think bond yields can still increase.

**David McDonald - IMAP (27:06):**

OK.

**Angela Ashton - Evergreen Consultants (27:07):**

As you know, Australian bond yields have actually been fairly volatile recently, and they're down around 1% from the highs that they reached. So they reached around 4.5% and they're now 3.5%.

We think it's clearly better than it was in terms of being an investment opportunity. We still see volatility occurring. But we are starting to allocate a little bit more, as the yields to maturity is starting to look better.

But it's really just a very slow allocation back into a little bit of duration versus having virtually none. Before credit could be a little volatile going forward. Particularly if a recession does occur or if the economy does slow quite a lot, clearly some companies will start to come under some pressure.

There's a lot of levered companies out there. I think people refer to them as zombie companies and we will definitely see some issues with those sorts of companies and credit spreads could be impacted. So credit is something we're watching closely.

And I think duration is something that we will begin to allocate to, and in a semi-regular fashion, but we do expect it to remain volatile.

**David McDonald - IMAP (28:29):**

Okay. Thank you. Well, we've great discussion across a broad range about the very topical issue of inflation and real assets, but touching on a lot of other important things too.

I wish to thank Diana from AMP Capital and Angela Ashton from Evergreen for what's been a wonderful discussion today. Thank you very much. And finally, a reminder that coming up in September 2022 in Sydney and October 2022 in Melbourne, we are having our IMAP Independent Thought conferences. These will give you a chance to hear from leading portfolio managers and consultants on how they're dealing with current environment and looking at their portfolios. You can find more details can register now for Sydney's Independent Thought on IMAP's website

Thank you very much.

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