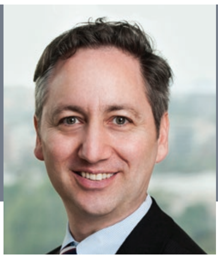

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From free money to free fall – don't lose sight of the long term

Well, what a difference six months can make. Throughout 2021 there were concerns building around valuations, the large swell of unintended consequences or distortions of near-free money that led to record loss-making companies in the Australian market. Not to mention record valuations for growth stocks, low pricing of risk, high levels of corporate activity and a sense that this couldn't last.

Now there is growing concern about stagflation or recessions, particularly in Europe, and lockdowns in China will continue to cause supply chain issues for some time to come. At home, Australia is faced with a cooling housing market after some very strong asset price growth years and the equity market has become acutely focused on valuations, with much lower tolerance for risk.

An investor's focus should be shifting towards free cash flows, profitability sustainability, earnings duration and visibility, the market structures companies operate in, the ability to maintain operating margins in the face of higher costs (higher labour wages, commodity prices, energy prices, rising capital and debt costs) and supply chain issues.

While the Australian consumer has been resilient and confident, this is expected to soften as we move through 2022, especially as the positive tailwind of a strong Australian housing market is now slowing. These emerging trends were confirmed at recent Australian company presentation conferences and the pressures are building across a spectrum of industries.

Equity markets have been trending down in the last few months after pricing in a sharp economic recovery over the last two years. Valuations rightfully have taken centre stage after asset prices in Australian housing, equities, bonds and cash all reached territories that were deemed unsustainable. In times like these, it is important to stay focused on the long term. Cash flows will continue to drive earnings, and earnings will drive share prices.

Recently, the very low cost of capital created some significant valuation distortions, especially in quality and momentum natured companies, and these are now adjusting. Momentum will likely face far greater scrutiny as this has already in groups such as e-commerce, COVID-19 winners, loss makers, home meal delivery, 'buy now, pay later', housing, online gaming, early stage software and concept stocks.

Quality will receive a significant valuation check as investor duration moves in closer, interest rates rise and discount rates are lifted. For those quality companies that generate strong cash generation, and are in strong market positions to manage through inflation and costs, this current market dislocation is likely to present a buying opportunity. However, exuberant valuations of over 100x price-to-earnings ratios are unlikely to return in the short term. Growth at a reasonable price will be the mainstay of a portfolio focused on quality rather than growth at any price.

Also, remember that there are still structural themes that will continue to drive change, innovation and leadership in markets and products:

- Cleaner and green technology
- Changing consumer habits
- Wealth management
- Virtual cloud, network infrastructure, e-commerce, platform entertainment and automation
- Increasing medical needs and medical innovation
- Resources scarcity

Value as a style and defensives are exhibiting strong price performances in current market conditions. Valuations here should also be kept in mind as these asset classes will also have their own limitations due to rising inflation, labour rates, higher debt costs as equity markets may take these stocks to peak sentiment, peak valuation and high expected returns as a safe haven from volatility as well as uncertainty. Low quality earnings, weak market structures, competitive market places, high financial leverage and poor sustainability would be the areas where investors would be wise to be more cautious.

The Australian Future Leaders Fund is remaining balanced with a blend of quality at reasonable price companies (healthcare and technology), defensives (real estate, airports, petrol stations), industrials (chemicals, engineering services) as well as resources (lithium, nickel, copper, gold).

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