Daintree CAPITAL

A Perennial Partner

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AGENDA

The Inflation Genie:

Back in the bottle?

Portfolio Implications

What does the outlook mean for fixed income and portfolios more broadly?

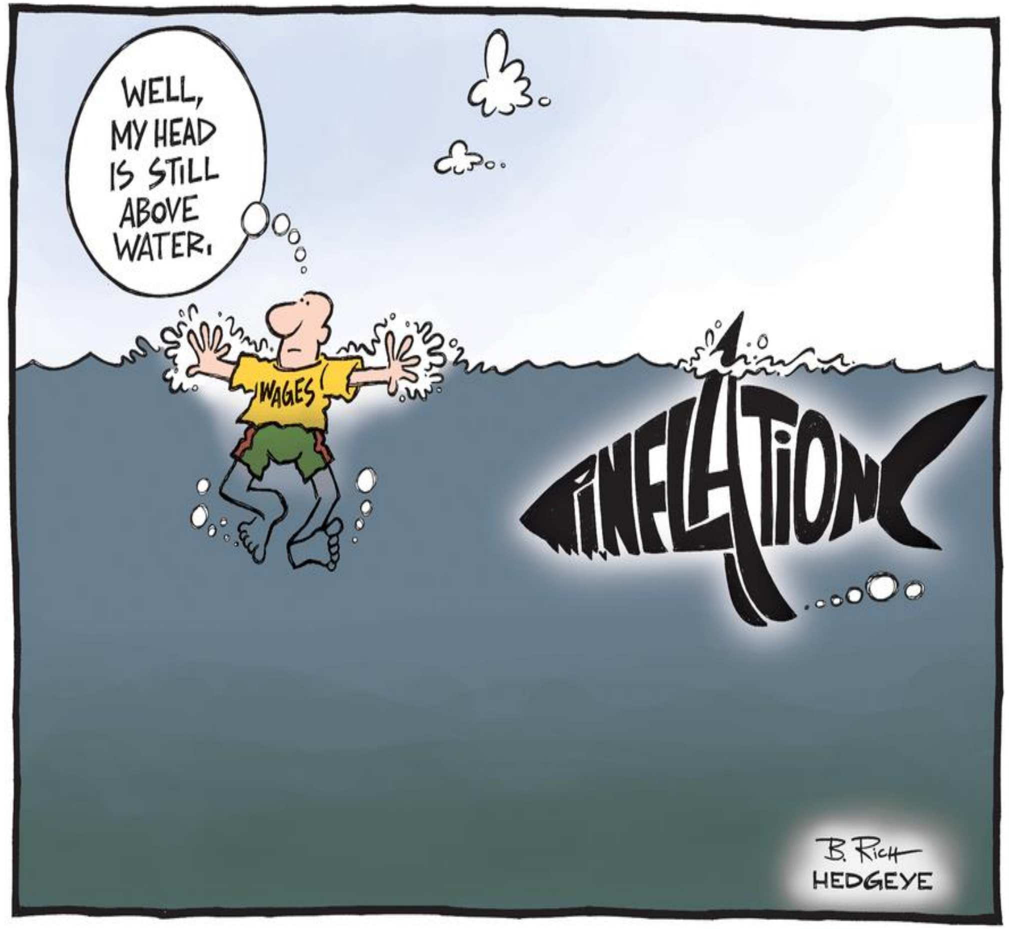
About Daintree

WHY DOES INFLATION MATTER?

Why does inflation matter?

- **Reduced purchasing power:** Inflation reduces the real purchasing power of consumers, and can distort behaviour by influencing spending and major life decisions.
- **Reduces real investment returns:** Inflation reduces the real return on investment, and particularly erodes the incomes of those (for example, the elderly) with little way of bargaining for a higher income.
- **Very high inflation impacts market performance:** Sustained high inflation has often, throughout history, been associated with particularly weak performance in financial markets due to increased economic uncertainty. It is also associated with changed relative performance which has important ramifications for portfolio diversification.
- **Very high inflation has the potential to become self-fulfilling:** Workers may seek higher wages to maintain their real purchasing power, but this increases costs for business which may lead to further price rises and a wage/price spiral. Equally, if prices cannot be easily increased firms may reduce employment.
- **Inflation increases inequality:** By reducing the real value of debt but also reducing real investment returns, inflation can cause a redistribution of wealth in the economy.

WHAT DRIVES INFLATION?

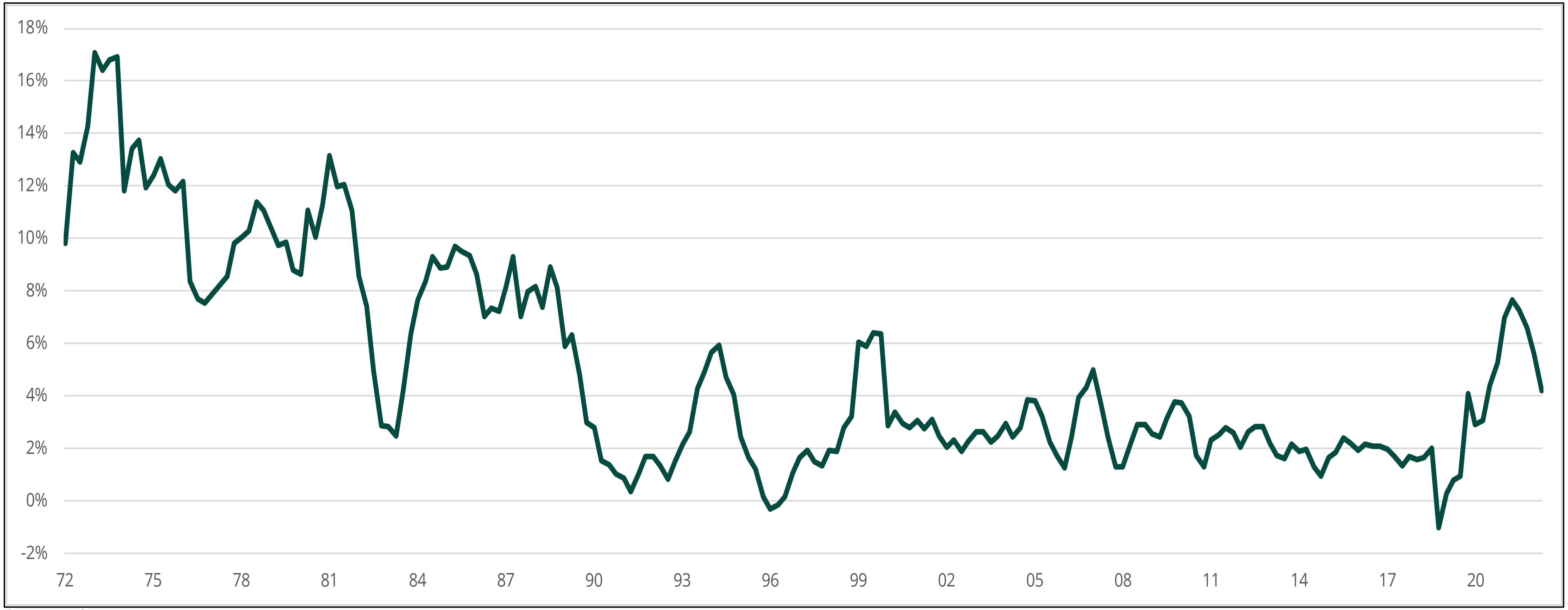


Inflation is a sustained, general rise in the prices of goods and services in the economy. Drivers include:

- **Money supply:** Various forms of post-Covid support turbocharged inflation (e.g.: fiscal stimulus aimed directly at consumers; liquidity and funding support for banks)
- **Expectations:** Inflation expectations have a longer-run impact, but are difficult to reliably measure
- **Labour market:** Clear labour market linkages; but long and variable lags between labour market and CPI changes
- **Commodity prices:** Important in the short-run, particularly oil prices and commodities that are important to a nation's export mix
- **Bottom-up composition:** Firms face costs when changing prices, thus they will likely alter prices only if the change offsets associated costs. These changes are not evenly distributed across the economy, i.e. they are skewed. This skew enhances explanations of aggregate inflation based on other factors, and measurement is a good proxy for the impact of supply shocks.

INFLATION IN A LONG-TERM CONTEXT

Australian inflation in 2021 was the highest seen since the 1980s, bringing to an end a period of low and stable inflation that lasted more than 30 years



Source: ABS.

INFLATION OUTLOOK: MONEY & EXPECTATIONS

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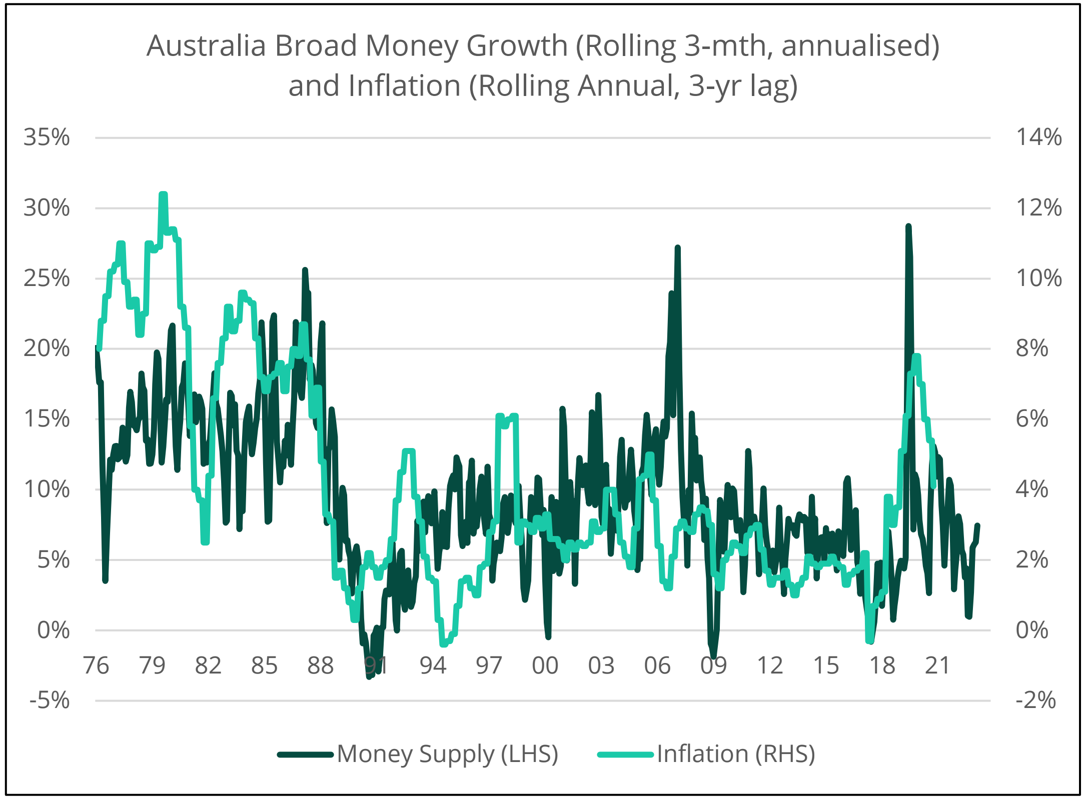
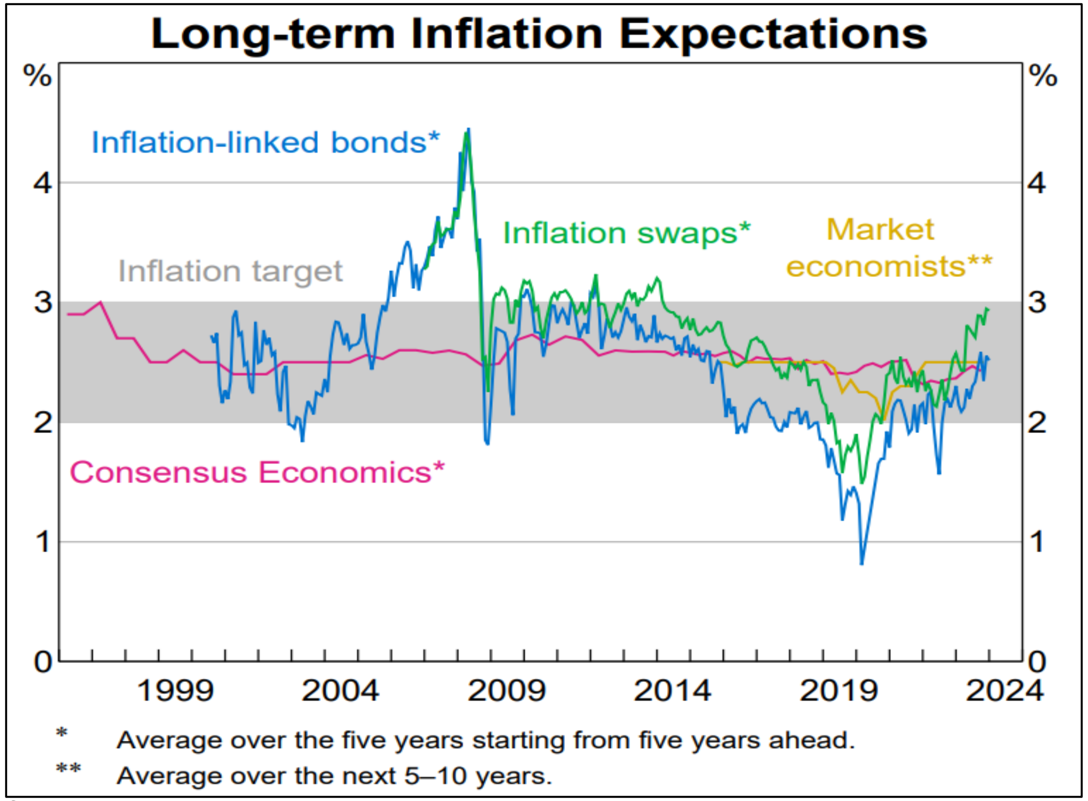
Money-supply growth leads inflation by around three years – this indicates normalisation ahead



Source: RBA, Daintree

Expectations are important though, and a commodity supply shock would be problematic



Source: RBA

INFLATION OUTLOOK: LABOUR MARKET

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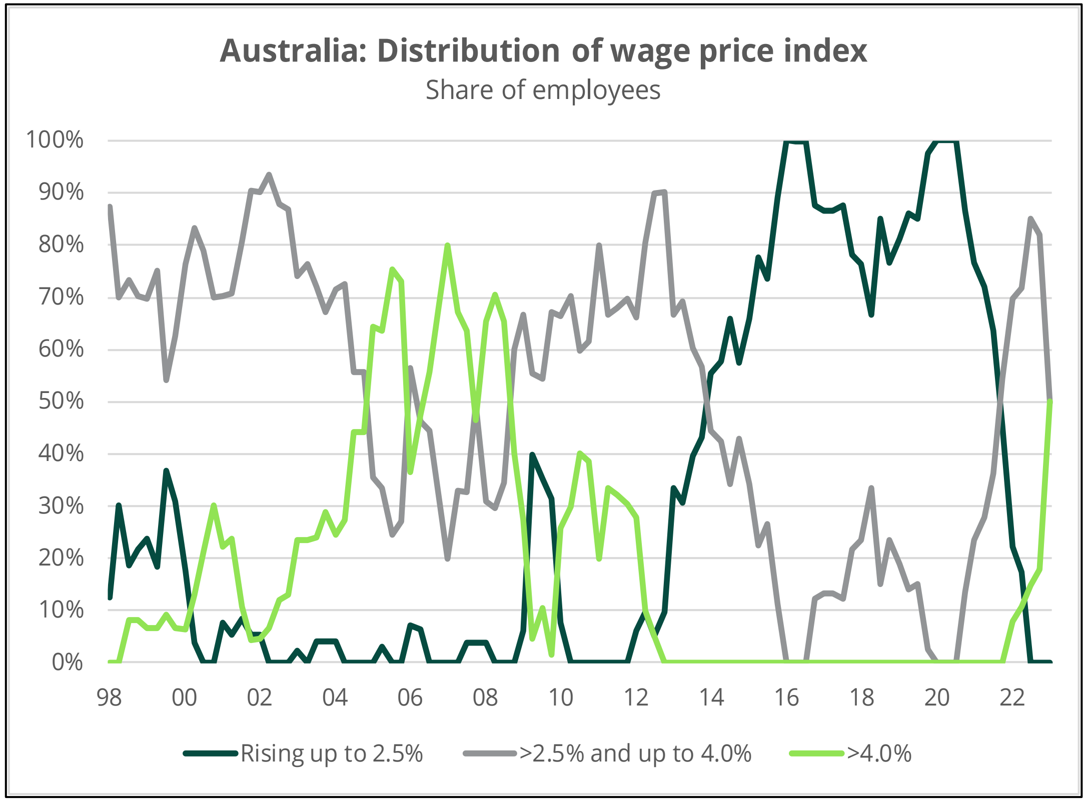
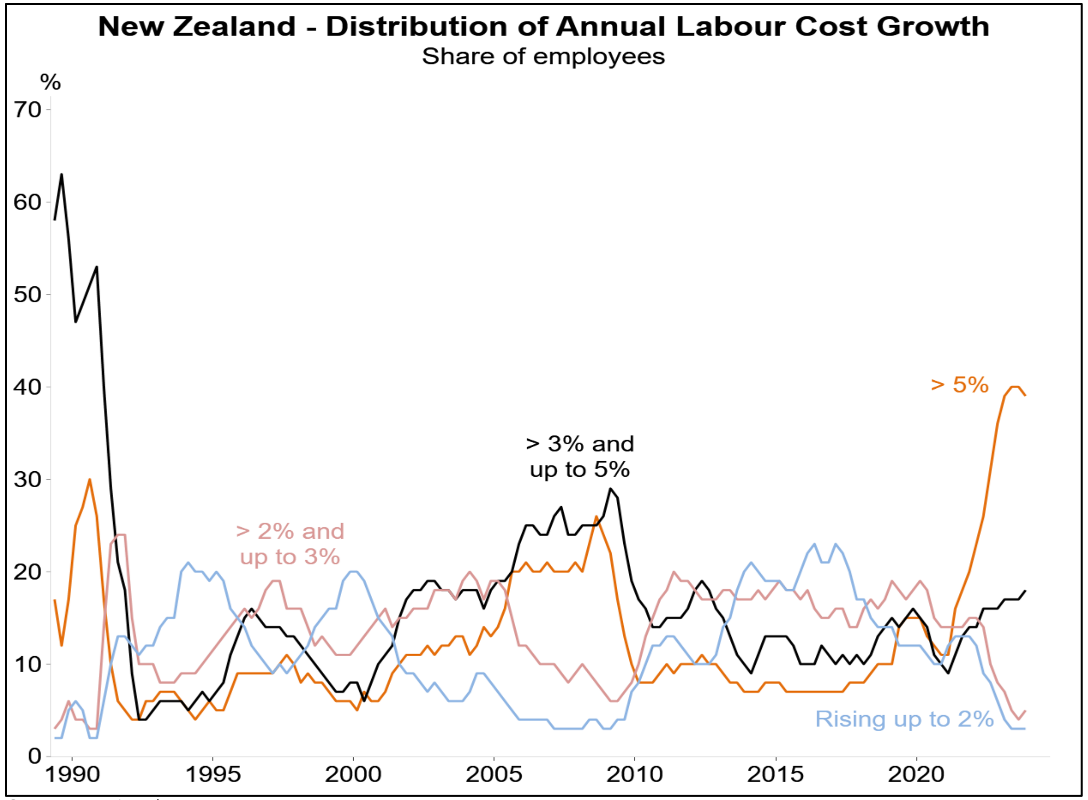
Distribution of wages in Australia back to early 2000s levels, although unit labour costs are high



Source: ABS, Daintree

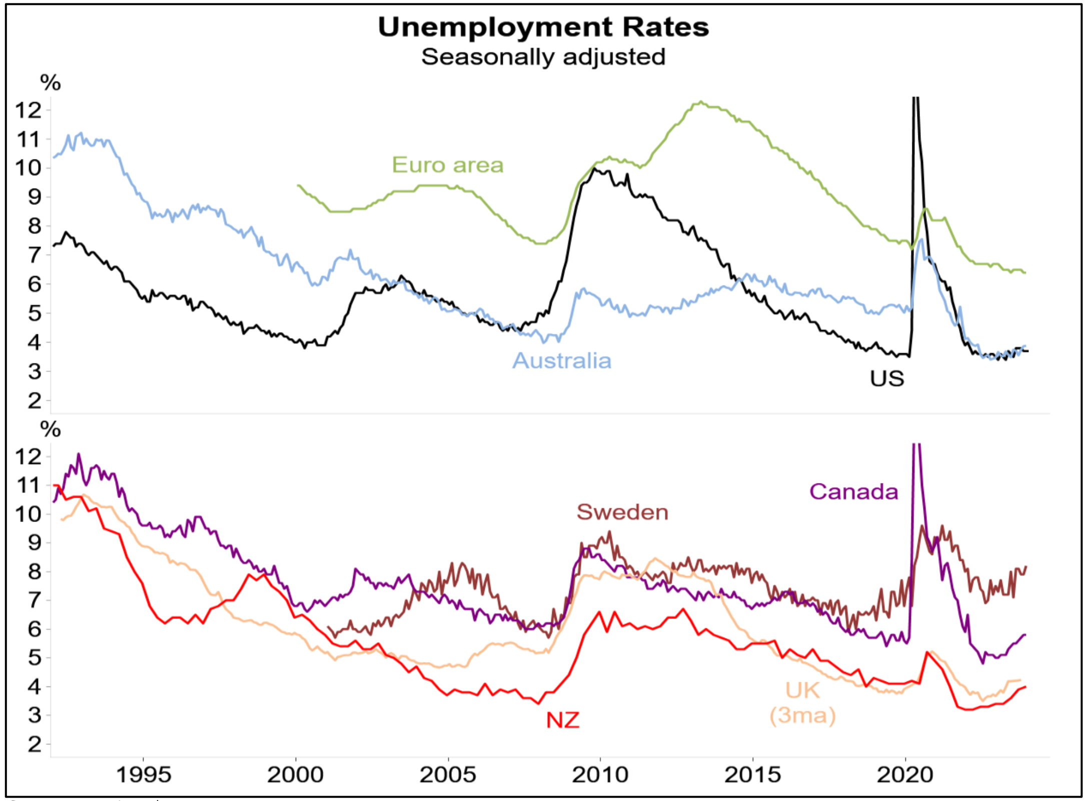
Distribution of wages in New Zealand is more skewed compared to history



Source: Antipodean Macro

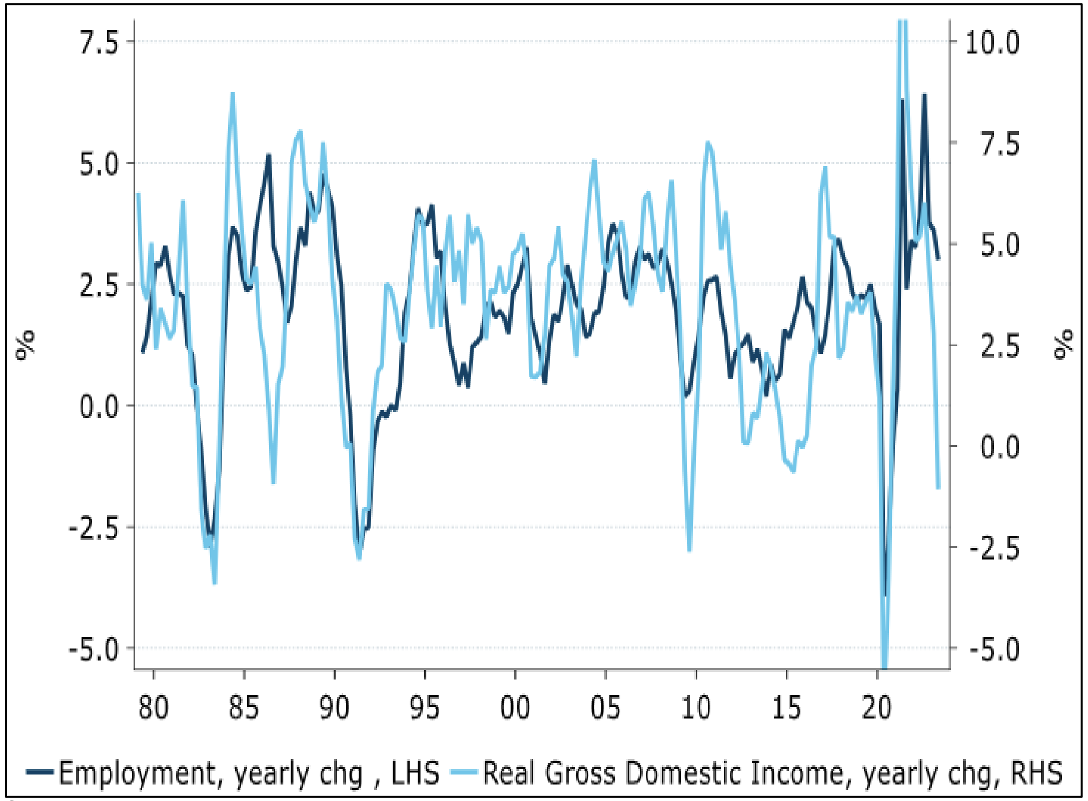
INFLATION OUTLOOK: LABOUR MARKET

Labour market weakness more advanced in New Zealand than Australia…



Source: Antipodean Macro

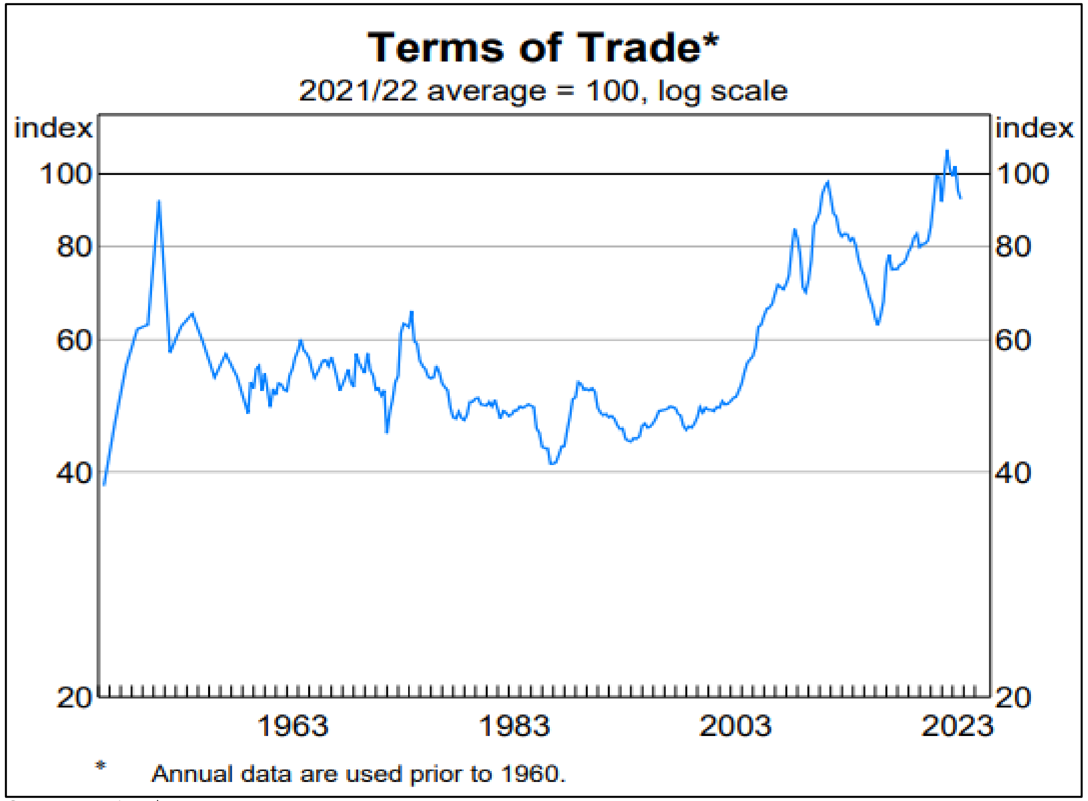
…though layoffs are increasing in Australia, portending greater weakness to come



Source: RBNZ

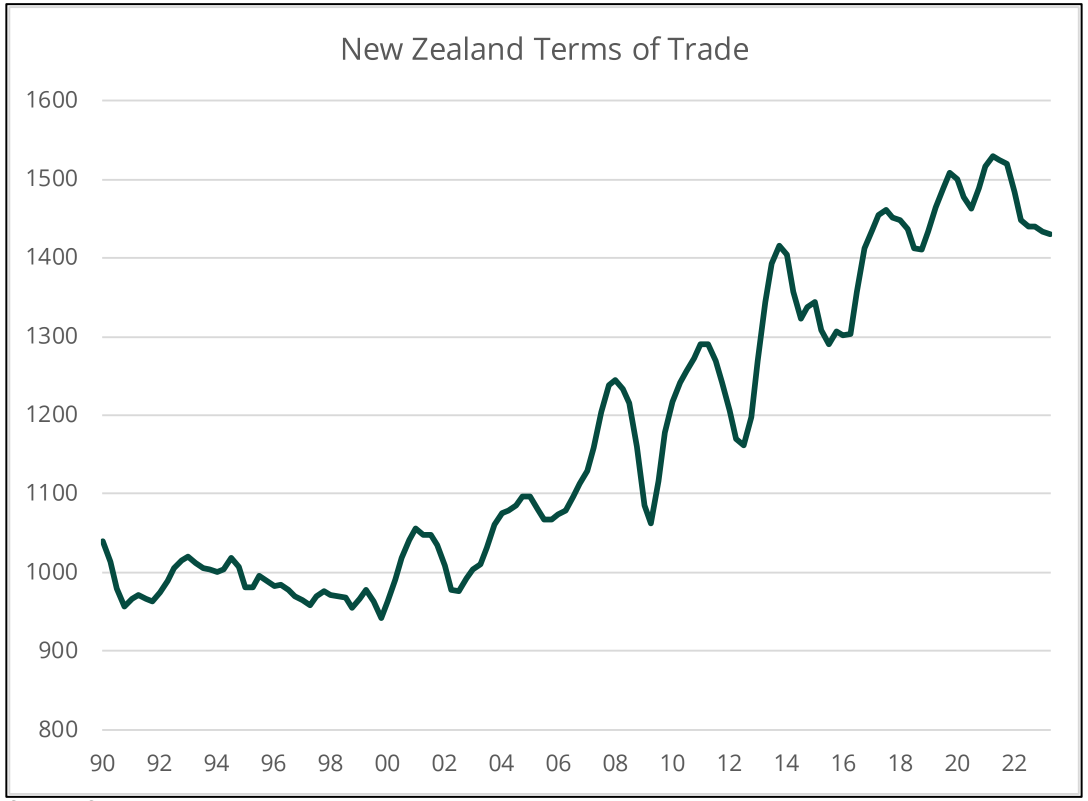
INFLATION OUTLOOK: COMMODITIES

Commodity prices have seen Australia's terms of trade peak; GDI likely to fall further



Source: Antipodean Macro

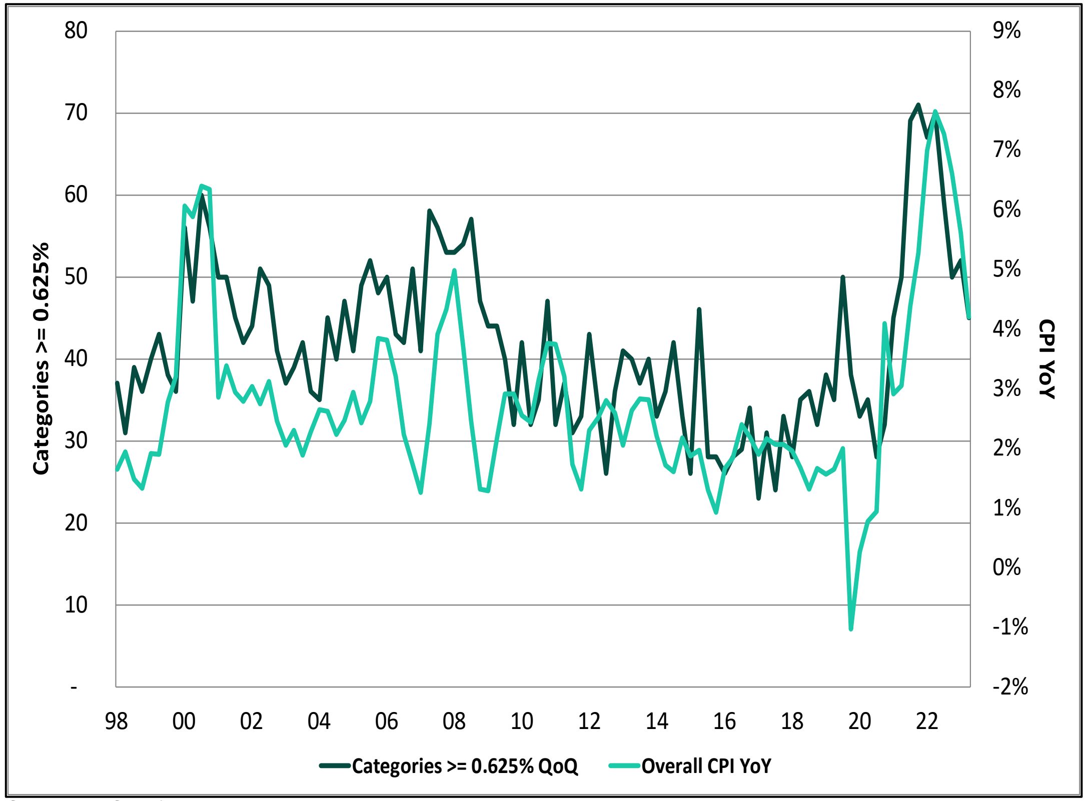
...in New Zealand the story is the same



Source: Stats NZ

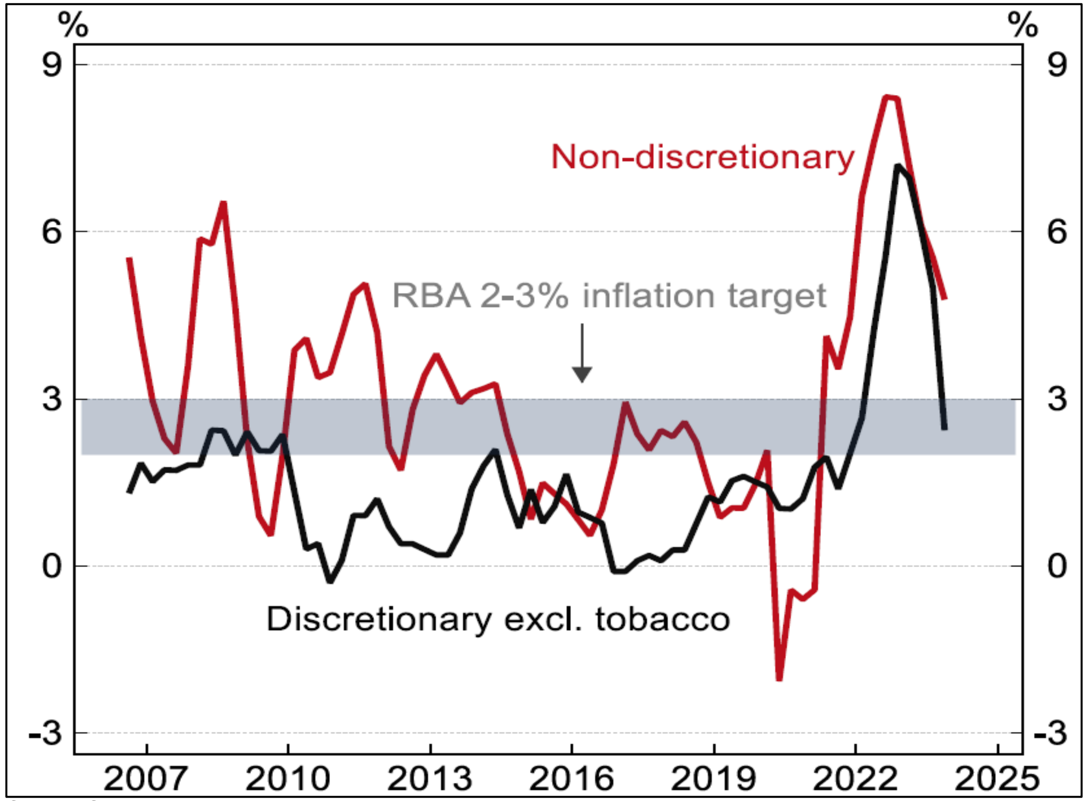
INFLATION OUTLOOK: BOTTOM-UP

The number of categories annualizing above 2.5% has led Australian inflation lower



Source: ABS, Daintree

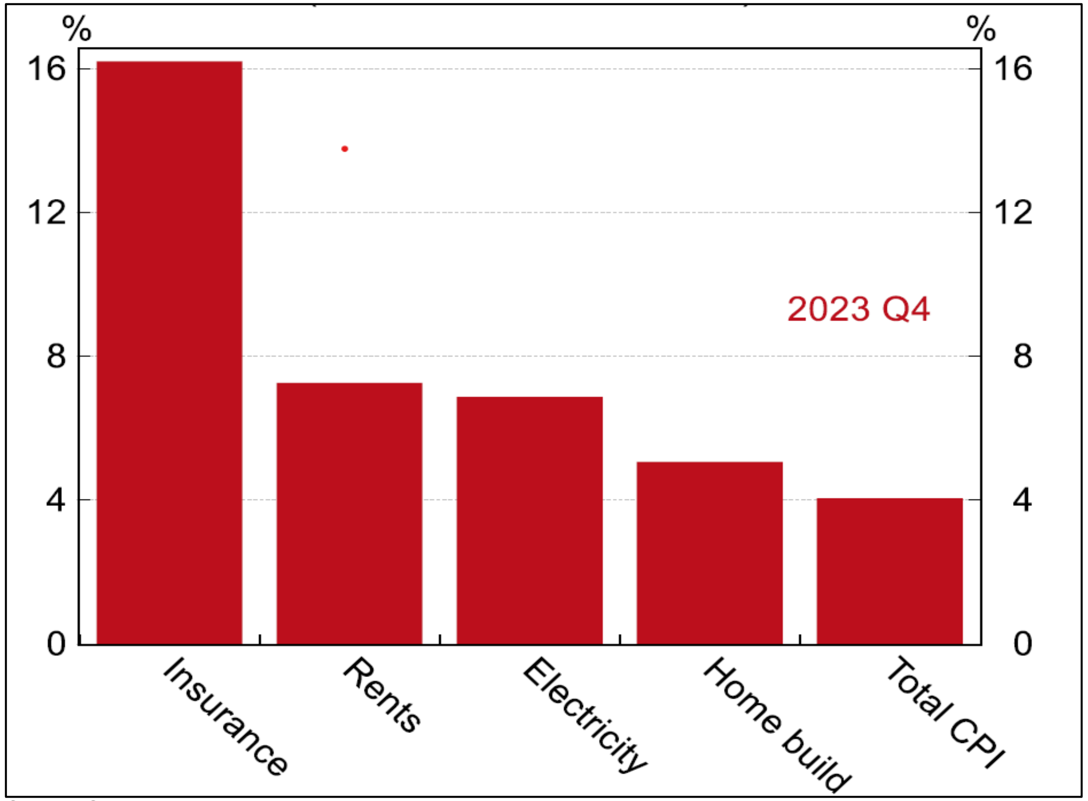
Inflation of discretionary items has normalised



Source: CBA

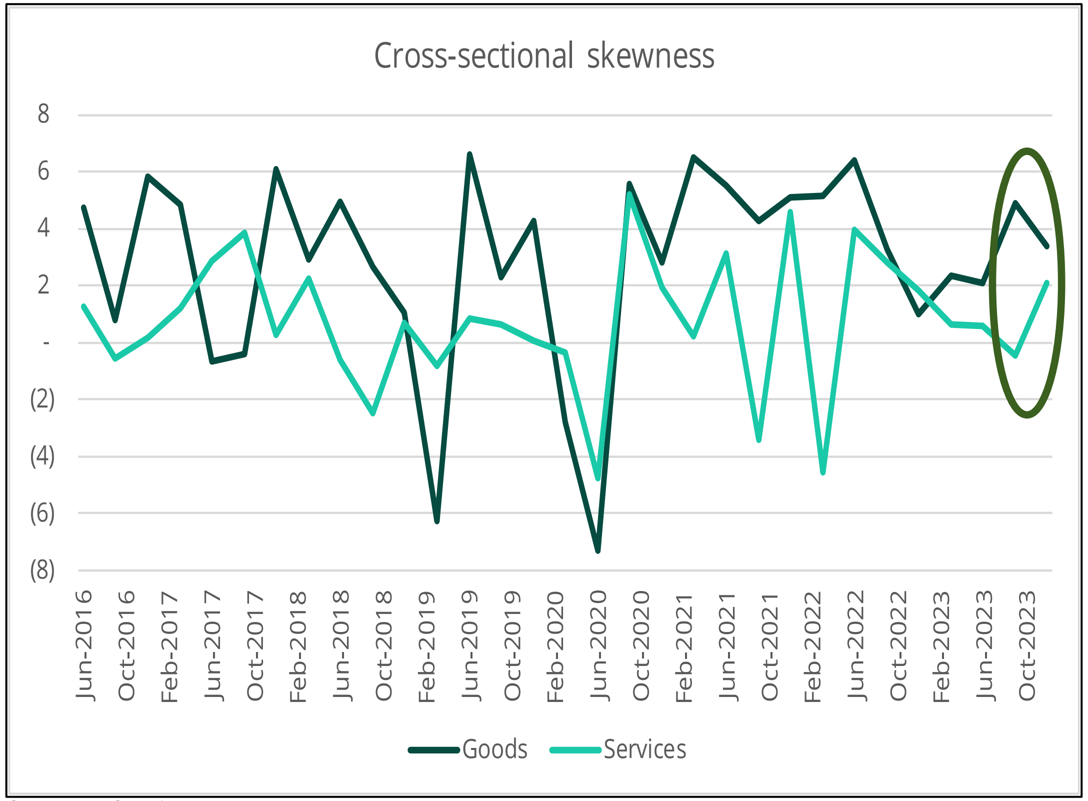
INFLATION OUTLOOK: BOTTOM-UP

Non-discretionary price growth is narrowly based



Source: CBA

Caution warranted: Skew of prices across CPI basket trended lower only from 2020-2023



Source: ABS, Daintree

INFLATION SCENARIOS

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Daintree's base case is for inflation to fall, but this is a finely-balanced view, with credible upside risks

Driver	Upside scenario	Downside scenario
Money Supply	Money supply continues to normalise, pulling inflation lower before waning as a driver later this year	Money supply continues to normalise, pulling inflation lower before waning as a driver of inflation in 2025/6
Expectations	Supply normalisation is completed, downward goods price inflation momentum is moderating, and a tight labour market is supporting services inflation. Markets are slow to re-price easing cycles, keeping inflation expectations elevated	Expectations continue to fall to levels seen in the latter part of the last decade as growth accelerates while inflation remains under control
Labour Market	Unit labour costs remain high amid stubborn services inflation	Broad labour market weakness sees unit labour costs fall as the economy slows and layoffs accelerate
Commodity Prices	Commodity prices remain resilient , with geopolitical pressures pushing oil prices higher and feeding back to upward stickiness in inflation expectations	Sharp falls in commodity prices ultimately lead terms-of-trade and gross domestic income lower
Bottom-up Composition	A persistent positive skew to prices across the CPI basket amid higher commodity prices and stubborn unit labour costs	Price baskets normalise as disinflation becomes entrenched again
Overall	**40% likely**	**60% likely**

INFLATION AND BOND YIELDS

Bond yields are a function of inflation expectations, which themselves are largely explained by a weighted average of long-term and short-term historical rolling inflation. Smoothing this inflation series and adding term premium estimates yield an accurate fair value measure

Source: Bloomberg, Daintree

PORTFOLIO CONSTRUCTION IMPLICATIONS

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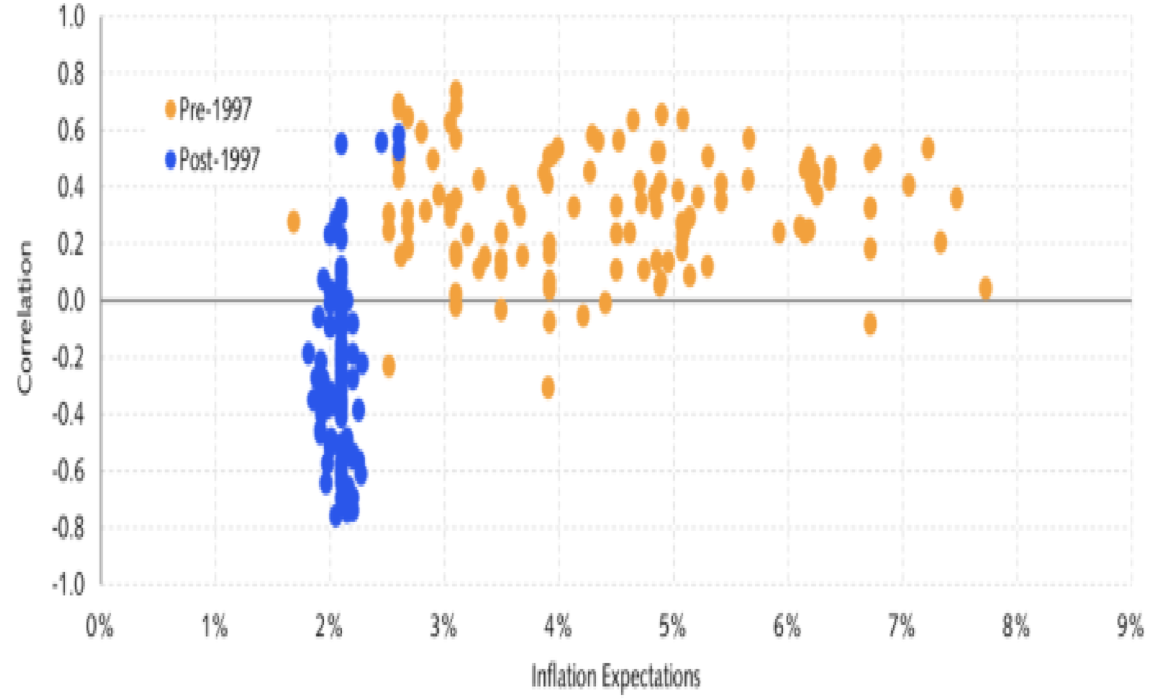
The movement of inflation expectations from here is crucial for multi-asset portfolio construction



Quarterly correlations based on daily returns of the S&P 500® and 10-year U.S. Treasury note. Inflation expectations refer to the 10-year expected PCE inflation measure from the Federal Reserve Board's FRB/US model, which we splice (beginning in 2014) to 5- to 10-year inflation expectations from the Consensus Economics survey. Source: Bloomberg; Consensus Economics.

Source: Bank of America

- **Low and stable inflation expectations allow government bonds to diversify**
- **Stubborn inflation severely limits the diversifying potential of government bonds**
- **Will 2024 see a resumption of the behaviour seen over the last 30 years? Or will the better analogue be the long period of history prior to this when inflation remained unsettled?**
- **Daintree feels the risk is that the diversification potential of government bonds remains hampered for some time to come**

PORTFOLIO CONSTRUCTION IMPLICATIONS

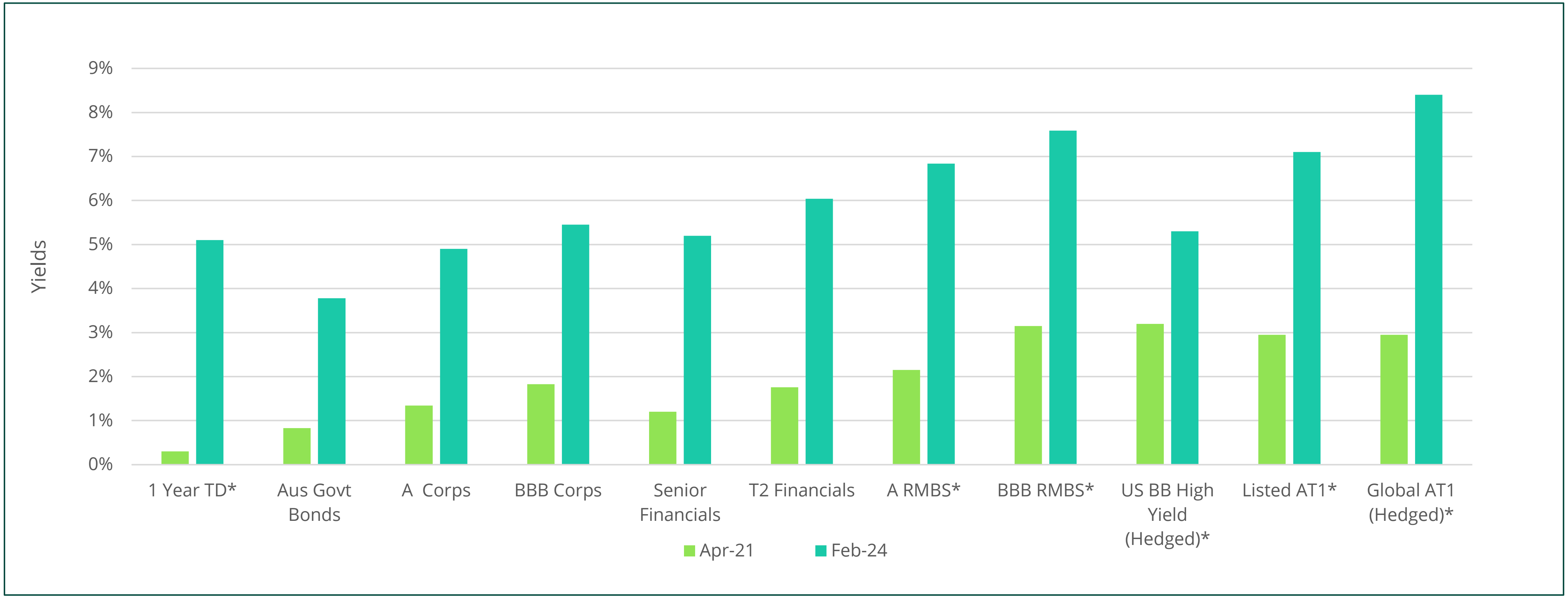
Margin of safety in high quality credit is up almost 12x from late 2020

Source: Bloomberg

- **In late 2020, a 3-year A rated bond was yielding approximately 0.42%**
- **So, with 3 years of spread duration, you only needed 14bps of spread widening to completely wipe out one year of carry**
- **Now that same bond is yielding 4.9%**
- **So, with 3 years of spread duration, you would need almost 163bps of spread widening to wipe out a year of carry**
- **In effect you have just under 12x the cushion versus 3 years ago**

PORTFOLIO CONSTRUCTION IMPLICATIONS

The 2021/22 back up in yields significantly changed the risk/return trade-off. Now getting roughly the same yield on A rated Australian corporate paper versus BB rated US High Yield hedged



* Yields are estimates based on the five-year part of the curve unless specified
Source: Bloomberg, Daintree

PORTFOLIO CONSTRUCTION IMPLICATIONS

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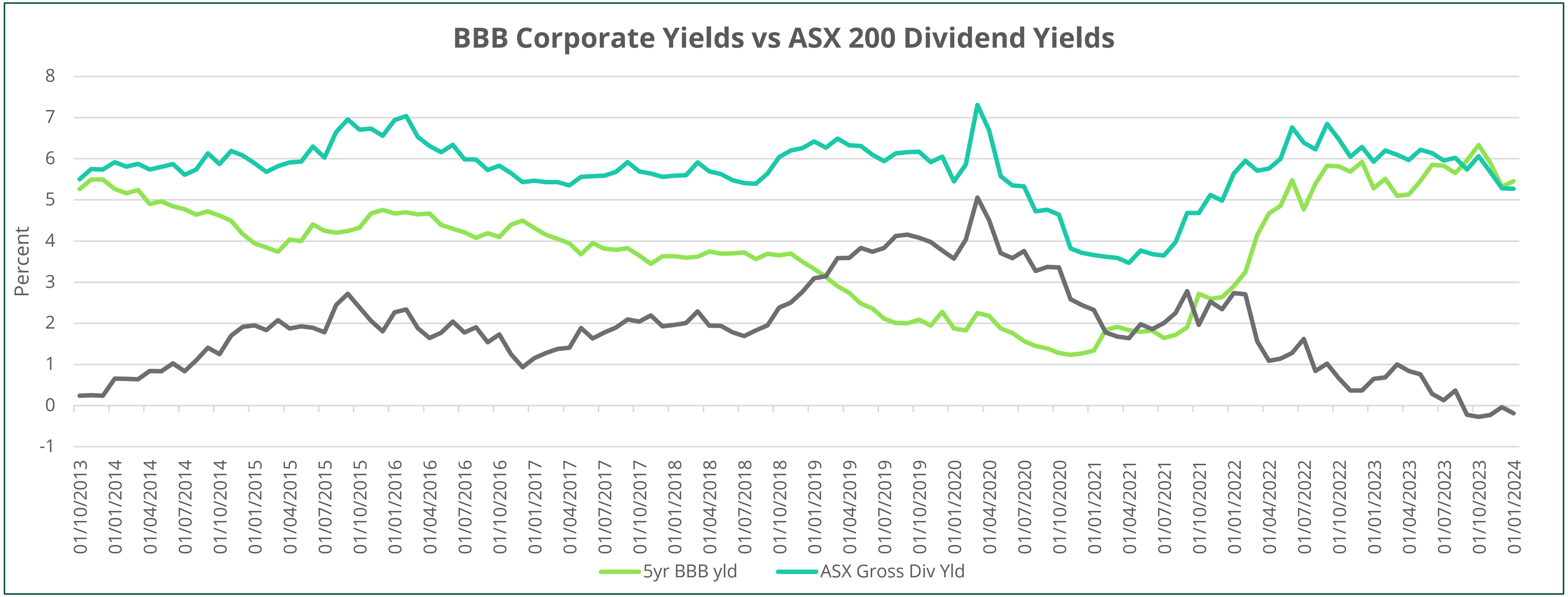
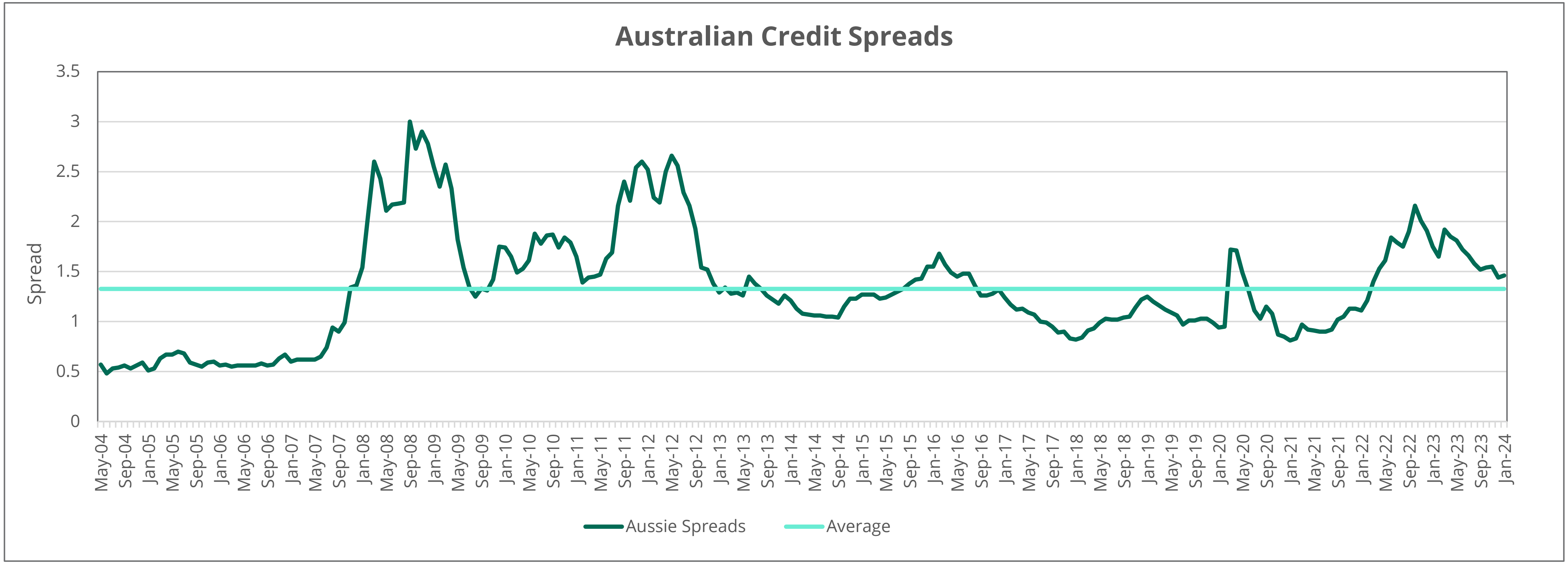
BBB Corporate bond yields now offering more income than ASX 200 equities



Source: Bloomberg, Daintree

CREDIT SPREADS

Australian credit spreads have had a good rally over the last twelve months but are still trading above their long-term averages unlike USD and EUR spreads which are now below long-term averages



Source: Bloomberg. Spread used is the BAUCOAS Index.

PORTFOLIO TAKEAWAYS

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So, what does all this mean for your client portfolios? In our view:

- **Perhaps be somewhat cautious on higher risk assets** for now as there are very limited risk premiums available in equities and high yield
- **Inflation may prove to be stickier** than the market has been pricing, and despite risk-asset resilience a recession is not out of the question
- **Risks to easing cycles** around both timing of first hike and length of cycle, but tightening likely concluded
- Might be a more volatile period with **lower-than-average equity returns for multiple years**
- **Fixed income offers a compelling alternative to equities** in this environment with much higher yields on offer

INVESTMENT PHILOSOPHY

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Fixed income markets have fundamentally changed.

The days of buying fixed rate bonds and generating a good return by benefitting from interest rates moving lower have come to an end. The approach for the next decade will need to be much more sophisticated and focus on the following:

CAPITAL PRESERVATION

Fixed income is there to play defence in your portfolio. Funds should have an obsession with capital preservation and downside protection.

INCOME GENERATION

Funds should be able to deliver reliable income streams through market cycles independent of market volatility

BENCHMARK UNAWARE

Fixed income benchmarks are flawed and arbitrary. We believe they should largely be ignored to construct optimal portfolios.

ACTIVE MANAGEMENT

Given that benchmarks are so limited and often poorly diversified, we believe passive management makes little sense in fixed income management.

GLOBAL FLEXIBILITY

Australia is less than 2% of the global bond market. If you don't look offshore, you are severely limiting your investment opportunity set.

DAINTREE FUM

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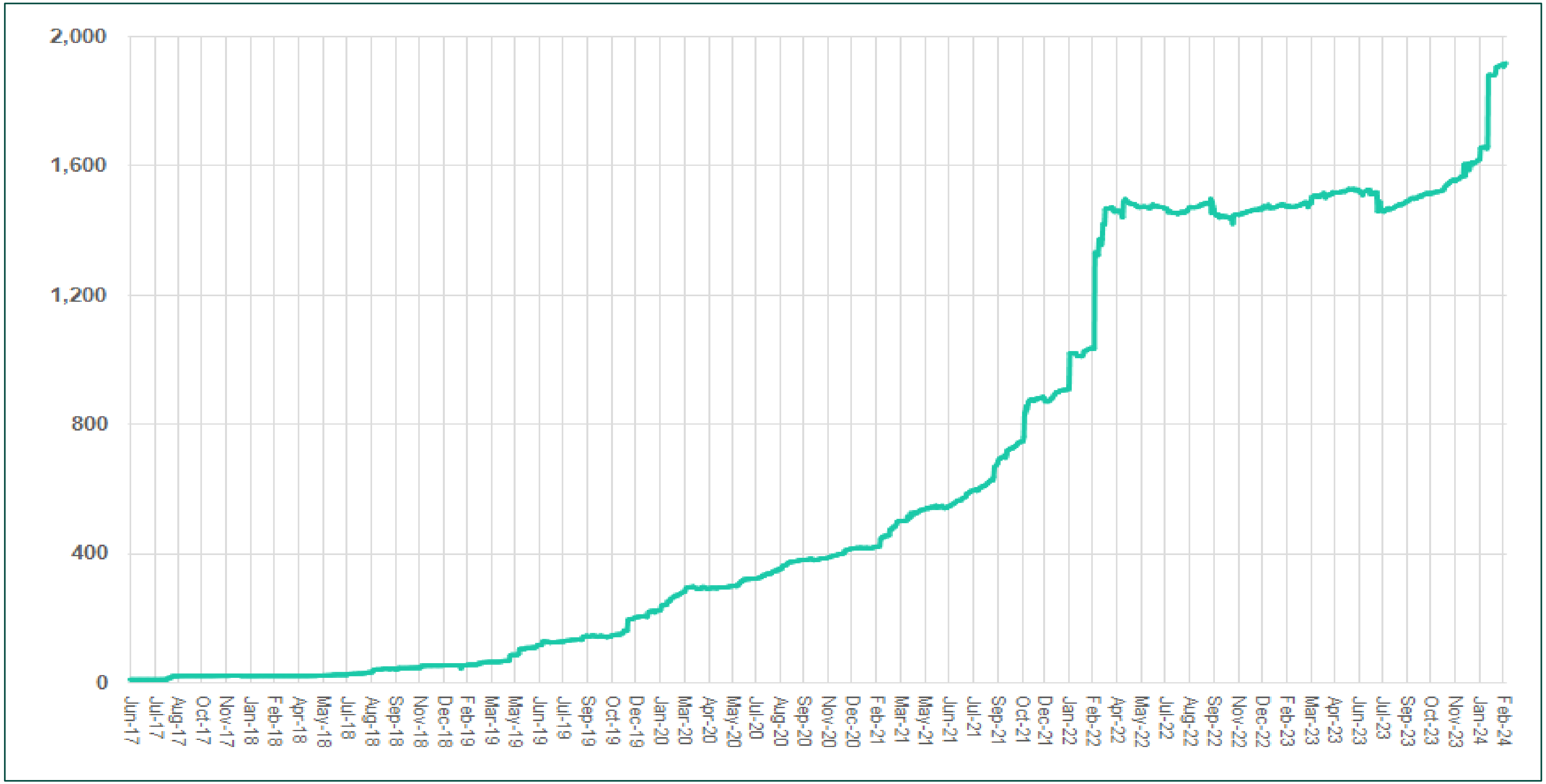
FUM AS AT 29 FEB 2024:

AUD $1.91 billion

→



DAINTREE PRODUCT SUITE

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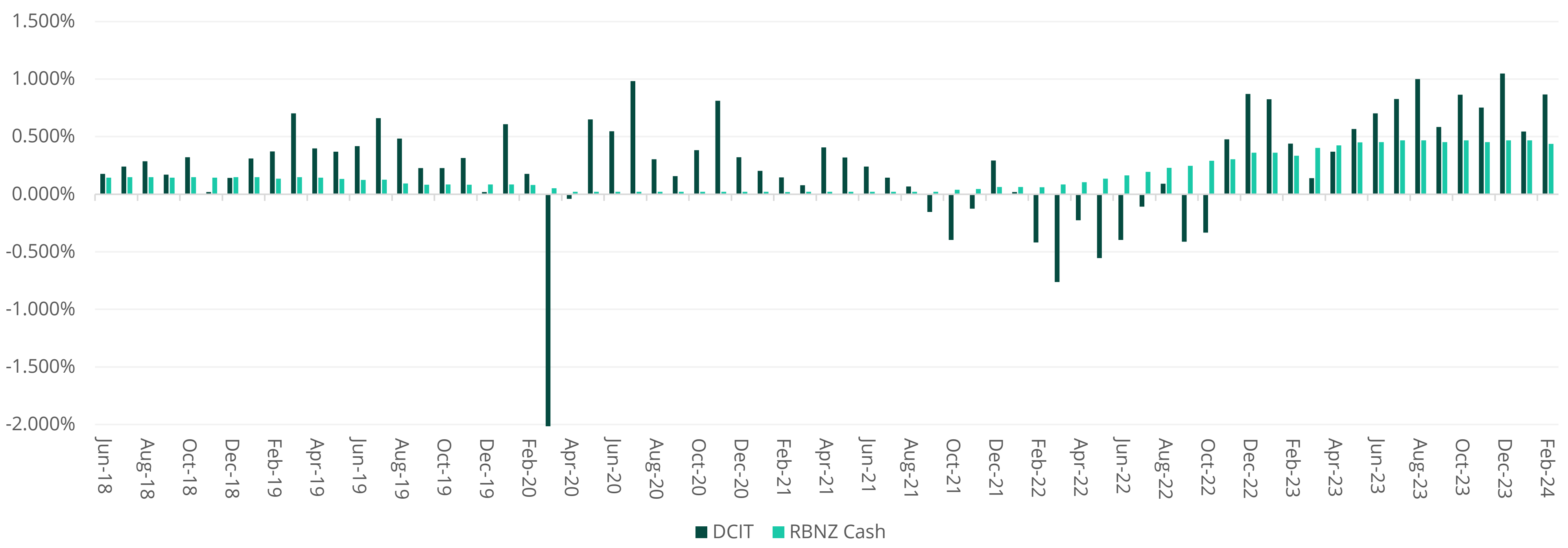
CRITERIA	CORE INCOME - AUT Exchange ticker: ECOR	CORE INCOME – PIE	HIGH INCOME
Return Target (net)	**RBNZ Cash +200-250bps**	**RBNZ Cash +200-250bps**	**RBNZ Cash +300-400bps**
Application	Defensive Income	Defensive Income	Moderate Risk/Return
Cash Range	0-100%	0-100%	0-100%
Investment Grade, High Yield	90-100%, 0-10%	90-100%, 0-10%	50-100%, 0-50%
Average Credit Quality	A / A-	A / A-	BBB/BBB-
Foreign Country Risk	0-40%	0-40%	0-35%
Duration	Range -1 to +3	Range -1 to +3	Range -2 to +4
AUD exposure	90% - 110%	90% - 110%	80% - 120%
Securities	150-300	150-300	200-400
Distribution Frequency	Monthly	Monthly	Monthly
Liquidity	Daily	Daily	Daily
Recommended Min Timeframe	3 years	3 years	3 – 5 years
PDS Total Fee	55bps	70bps	75bps

CORE INCOME PERFORMANCE

DCIT VS CASH

With higher cash rates and credit spreads, the fund has been generating consistently positive returns now for fifteen months. Current yield is 8.1%.



Source: Bloomberg, Daintree
Returns are net of standard PDS fees. Past performance is not a reliable indicator of future performance.

CORE INCOME DISTRIBUTIONS

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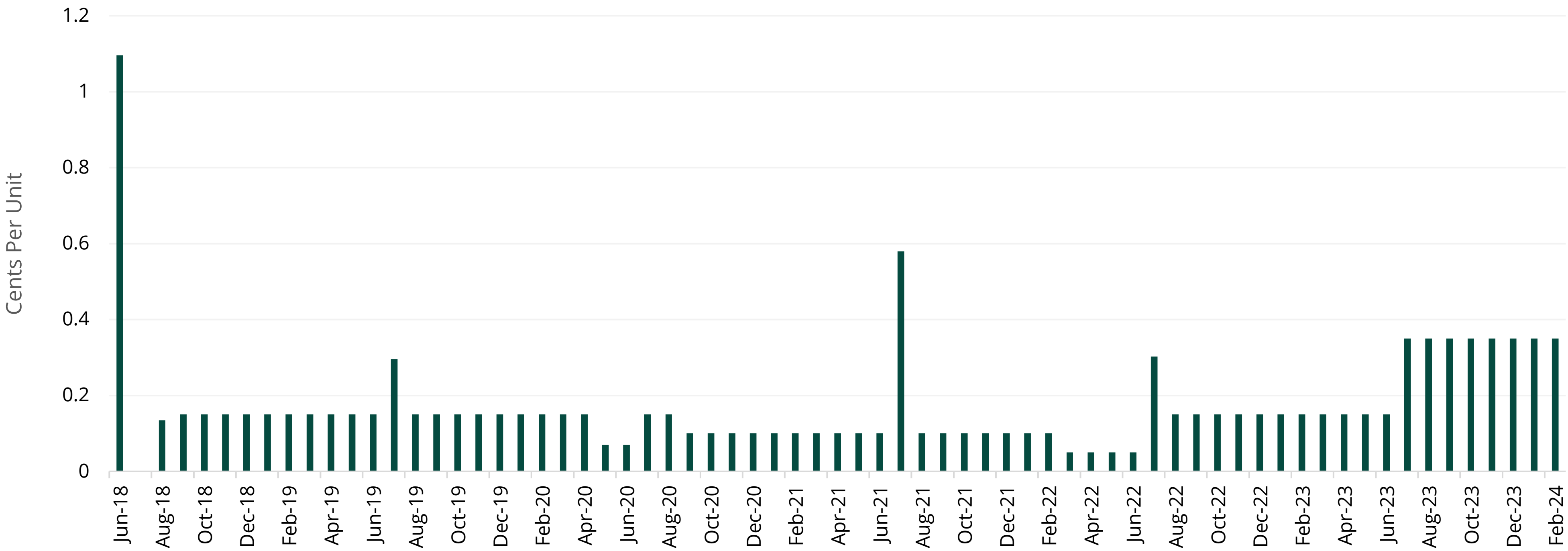
CORE INCOME FUND DISTRIBUTIONS

Distributions will be likely be higher in FY24 (est 4.5-5.5%)*



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* While due care has been used in preparing this estimate, actual outcomes may differ materially from estimates as distributions may be influenced by factors outside of Daintree's control

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CORE INCOME PLATFORMS/RATINGS

PLATFORMS & RATINGS

CORE INCOME PLATFORM AVAILABILITY		
AEGIS	HUB24	NETWEALTH
AMP NORTH	MACQUARIE	NZXWT
ASGARD	MASON STEVENS	PRAEMIUM
BT PANORAMA	MLC NAVIGATOR	UXCHANGE
FNZ	MLC WRAP	XPLORE WEALTH

Zenith Investment Partners
HIGHLY RECOMMENDED
Recommended
APPROVED
NOT RATED
REDEEM

ZENITH FUND AWARDS
2020 FINALIST

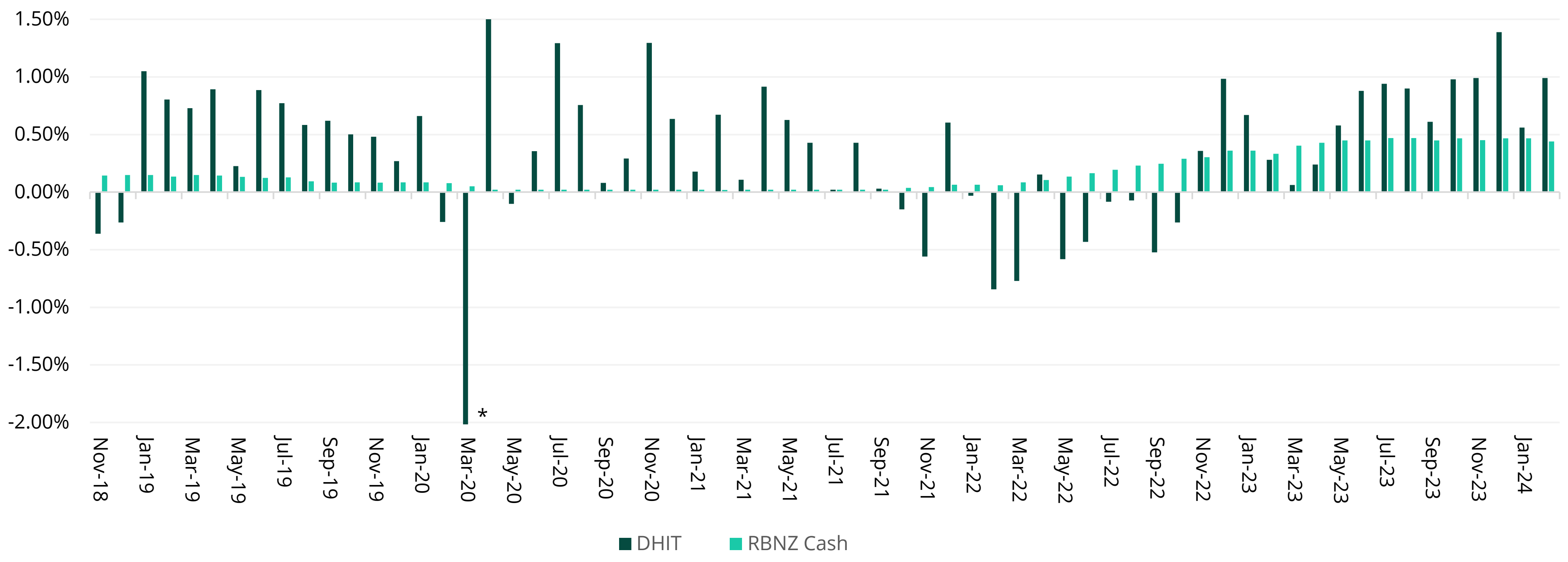
Recommended
Lonsec Research

FUND MANAGER OF THE YEAR 2019
MONEY MANAGEMENT | Lonsec
FINALIST
Emerging Manager

HIGH INCOME PERFORMANCE

DHIT VS CASH

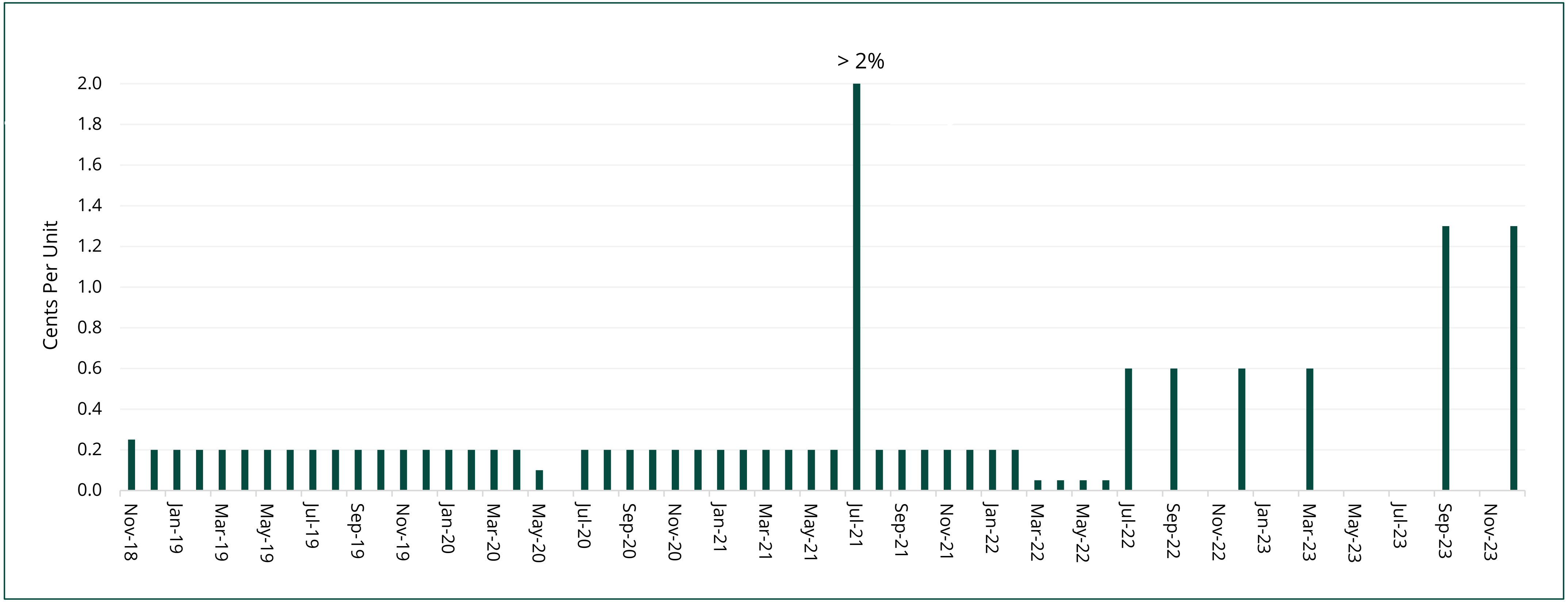
With higher cash rates and credit spreads, the fund has been generating consistently positive returns now for fifteen months. Current yield is 9.7%.



Source: Bloomberg, Daintree
Returns are net standard PDS fees. Past performance is not a reliable indicator of future performance.
* Fund drawdown in March 2020 was 8.34%, followed by a 3.08% uplift in April 2020

HIGH INCOME DISTRIBUTIONS

Distributions will be likely higher in FY24 (est 5.5-6.5%)*



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HIGH INCOME PLATFORMS/RATINGS

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PLATFORMS & RATINGS

HIGH INCOME PLATFORM AVAILABILITY	
AEGIS	HUB24
BT PANORAMA	MACQUARIE
CFS Wrap	NETWEALTH
FNZ	NZXWT
AMP North (coming soon)	

FUND MANAGER OF THE YEAR 2019
MONEY MANAGEMENT Lonsec
FINALIST
Emerging Manager

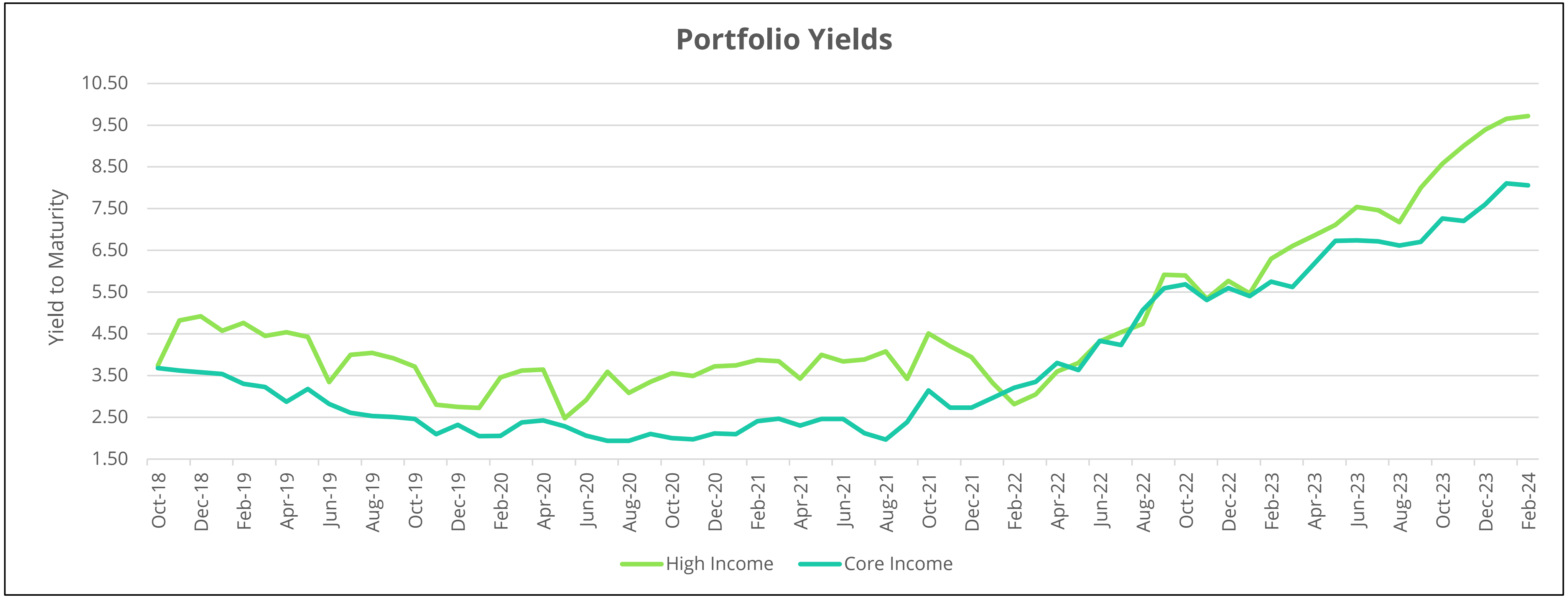
Zenith
APPROVED

Investment Grade
Lonsec Research

ZENITH FUND AWARDS
2020 FINALIST

PORTFOLIO YIELDS

Liquid, high quality investment grade credit funds can now offer equity like returns (8-10%) with considerably lower risk



Source: Daintree

CONCLUSION

"Daintree is well placed to be the core defensive allocation for client portfolios"

- **An experienced investment team** with excellent track record
- Support by a **strong successful organization**
- **Strong alignment** of interests through equity ownership
- **Better expected future returns** than many defensive alternatives given low cash rates and government bond yields
- Ability to generate steady return even in a **rising rate environment**
- **Flexible approach** with diversified sources of return
- **Strong ESG focus**

NEW ZEALAND DISTRIBUTION

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