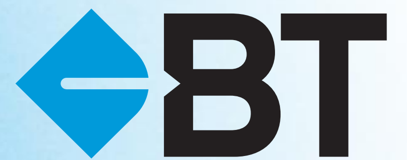


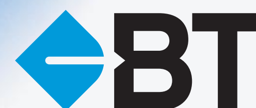
BT Investment Team Year in Review

2021

Contents

1. Capital Market Assumptions Page 3
2. Sustainability Page 5
3. Economic Landscape Page 6
4. Outlook 2022 Page 9
5. Asset Class Insights Page 11
6. Appendix Page 16

Capital Market Assumptions



As we update our strategic assumptions for the next 10 years the investment team continues to see challenges with regard to generating returns for investors from traditional portfolios. Markets have been well supported by economic policies throughout the pandemic, which has helped prevent recessions, but also supported high asset price returns with already elevated valuations. Our current 10-year asset class return expectations have fallen post the strong returns seen through 2021 and while equities will continue to provide a positive real long-term return, a rising yield environment and narrowing equity risk premia pose a challenge for investors that expect historical levels of performance from major asset classes to continue.

Table 1: BT Investment Team 10-year Capital Market Assumptions 2022

Asset Class	Jan-22	Jan-21
Australian Equities	6.1% ↘	6.8%
International Equities Unhedged	6.0% ↘	6.3%
International Equities Hedged	5.6% ↗	5.5%
Emerging Markets	7.6% ↘	8.7%
AREITs	5.0% ↘	6.0%
GREITs	4.8% ↘	5.9%
Unlisted Property	5.0% ↗	4.8%
Unlisted Infrastructure	6.4% ↗	5.8%
Commodities	3.0% ↗	2.6%
Liquid Alternatives (Alts Risk Premia)	2.8% -	2.8%
Private Debt	5.6% ↗	5.5%
Australian Fixed Interest	2.2% ↗	1.2%
International Fixed Interest	3.0% ↗	1.8%
Cash	1.3% ↗	0.8%

Source: BT, Bloomberg, Refinitiv, OECD estimates.

Below we have summarised key outcomes of the revision to our 10 year forecasts;

– **Marginally higher domestic cash yields (and inflation expectations).** Following the RBA reducing the overnight cash rate to a record low of 0.1%, an acceleration in the post-pandemic recovery in growth and inflation is resulting in a shift to tighter monetary policy going forward. Since the Global Financial Crisis (GFC) there has been little pressure on inflation, which has trended to below the RBA's target range (2.0% – 3.0%) pre-pandemic. Subsequently the current higher GDP growth expectations over the coming years as the economy recovers, a slow rebalancing of domestic pressures across the goods and service industries and an improving global outlook, has resulted in the eventual rise in cash yield expectations shift to 2022 -2023 from 2023 - 2024. This has resulted in an increase in the average nominal cash yield from 0.8% to 1.25%.

– **Higher bond returns.** Bond yields have risen from historic lows that were seen at the peak of the pandemic in 2020 - 2021. Higher starting yields make for an improved long-term return for defensive investors with most 10-year bond yields at least +1.0% per annum higher than their previous lows. Further increases in yields from these current levels is expected as central banks shift to a tightening of monetary policy, but are not expected to be significantly higher for now. Despite a fairly mature credit cycle, strong corporate earnings are balancing the risks of higher corporate leverage. Defaults and downgrades also remain low, supporting Investment Grade and High Yield spreads. We expect spreads to remain tight to government bonds given the positive fundamentals of the private sector. These dynamics have seen an increase in our return assumption for broad fixed income markets and an improvement in term premia for longer term investors, however longer term real returns continue to remain negative across most of the fixed interest universe

– **The AUD is still slightly above longer term 'fair value'.** A decline in the AUD of -5.6% in 2021 has now resulted in a narrower differential between hedged and unhedged asset price returns going forward. Considering reversion to Purchasing Power of Parity (PPP), our forecast of fair value for the AUDUSD is nearer the range of 68.0 – 69.0 US cents with the currency range trading between 70.0 – 75.0 US cents through most of 2021. Interest rate differentials between the US (current Fed Funds rate is currently at 0.0%) and Australia (current RBA overnight rate is 0.1%) are expected to widen in favour of higher US cash yields over the short term. However cash spreads to other major developed markets (i.e. Europe and Japan) are likely to remain positive, offsetting the expected shorter term negative USD cash rate differentials in the currency basket for hedged AUD investors. FX Carry earned on hedged equity assets is now expected to add an additional +0.5% p.a. over the next 10 year period whilst unhedged assets are now expected to reprice by +0.9% p.a. from spot FX moves lower to fair value for the period (down from +1.4% p.a. in 2021).

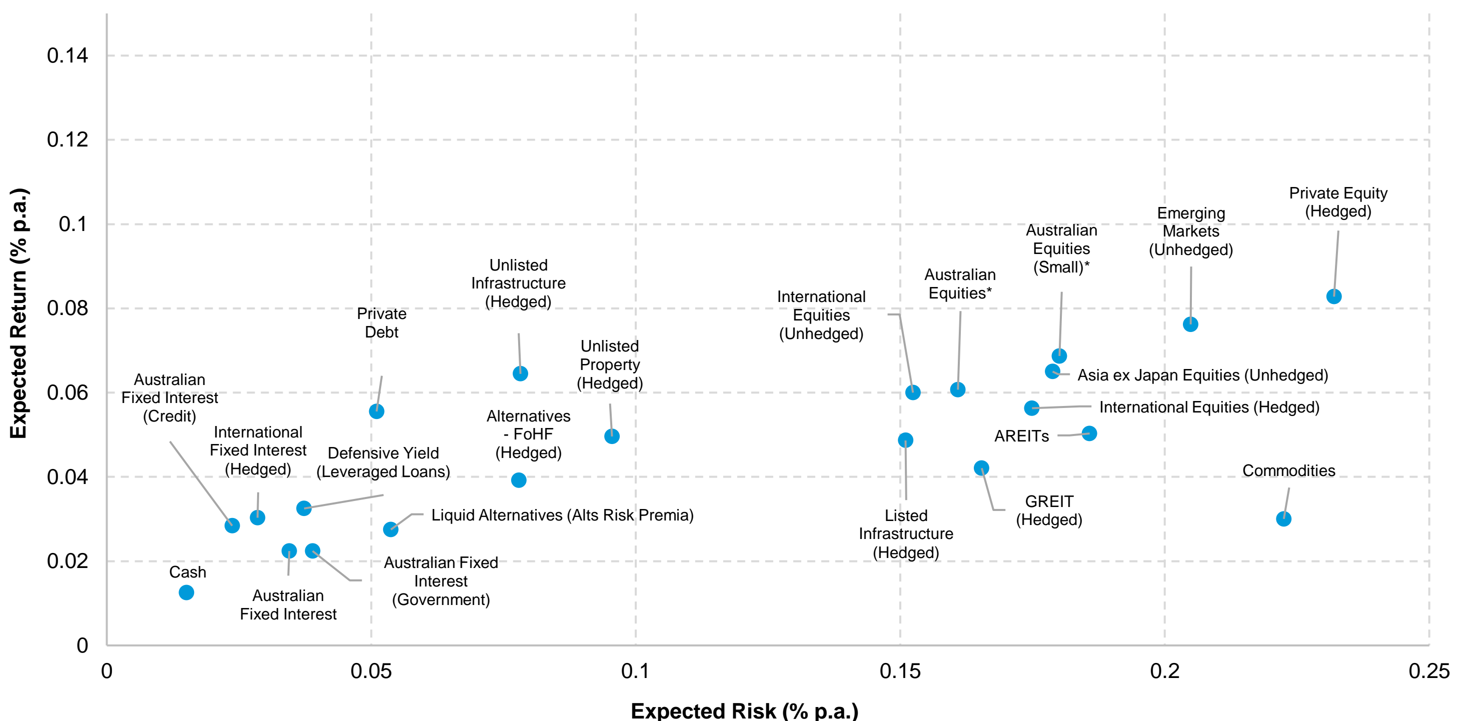
– **Positive real equity return expectations remain favourable on a relative basis.** Strong equity returns in 2021 have resulted in a decline in total return expectations for the next 10 years. The

strong (+20.0%) returns for equities in 2021 has degraded future return expectations as both inflation and valuation headwinds have increased for 2022. Developed market equities, in particular US equities are more overvalued while Emerging Markets are trading nearer fair value (on a relative CAPE measure). Other return factors (yield and net issuance) have declined at the margin seeing a slight fall in expected returns overall. Domestic equities still benefit from an average tax reclaim (franking credit benefit) of 1.1% which significantly improves relative returns. Emerging Markets remain the most favoured over the strategic time period following domestic equities while overall global equities still remain attractive on a relative basis to bonds given the positive real risk premia earned.

– Domestic equities still benefit from an average tax reclaim (franking credit benefit) of 1.1% which significantly improves relative returns. Emerging Markets remain the most favoured over the strategic time period following domestic equities while overall global equities still remain attractive on a relative basis to bonds given the positive real risk premia earned.

Real Assets remain an attractive diversifier. The high relative yields on offer have persistently made these assets attractive to investors in a low bond yield environment. Strong demand has pressured total return expectations for core income producing assets across Property and Infrastructure however returns remain competitive and have improved with the expectations of higher cash rates. In particular infrastructure continues to provide useful diversification of more economic sensitive assets, improving diversification as we move through the later stages of the business cycle.

Chart 1: BTIS' 10-year Capital Market Assumptions updated as at the end of December 2021.



Source: BT

*Excludes Franking Credits

ESG

In a year as unpredictable as the last, we saw a landmark climate report from the Intergovernmental Panel on Climate Change (IPCC) warning of rapid warming, released amidst extraordinary weather events; all eyes fixated on Glasgow in November for COP26; and continued exacerbations of inequality as the COVID-19 pandemic raged on. The implications were felt across the globe; whether by deadly and unforeseen floods in Europe, or for those locked down at home, as spectators to diverse social issues including cultural heritage protection in Australia and ongoing concerns around forced labour.

At the end of September, global sustainable investments hit a record US$3.9 trillion, with Australia and New Zealand contributing US$27.2 billion[1]. This trend has been supported by continued investment into funds which, like BT's, have a commitment to responsible investment principles. The focus on investing with heightened consideration of ESG risk and active ownership has perhaps never been under such a spotlight, or as crucial as it is today.

Is 1.5°C still alive?

This was the deeply layered question looming over COP26 in November, foreshadowing each moment of climate diplomacy, every national pledge and private sector commitment bedded down in Glasgow. The pre-cursor was a report from the IPCC, with a grim assessment that the current trajectory of emissions will catapult the earth to 1.5°C as early as 2030.
If national governments, and their private sector compatriots make good on their promises at COP26, the world may be on schedule for warming of 1.8°C according to the International Energy Agency. With differing levels of fulfillment, the modelling varies, anywhere between 1.7°C and 2.6°C by 2100. All things considered, 1.5°C still has a pulse, but its survival rests on the success of many initiatives either launched or progressed at the conference.

One such initiative was the International Sustainability Standards Board (ISSB), which has brought several sustainability reporting standards under one umbrella. This will improve consistency and comparability in ESG company reporting, and address concerns around the utility of such disclosures. Another was the Glasgow Financial Alliance for Net Zero (GFANZ), who announced US$130 trillion in pledges from across the finance sector to accelerate global decarbonisation and reach net-zero emissions by 2050.

Proxy Voting Pressure

Proxy voting at company annual general meetings proved a sharp tool for driving ESG outcomes in 2021. In addition to key shareholder proposals featuring a continuing focus on climate change and human rights, we also saw dissident shareholders oust directors at Exxon Mobil's AGM over climate concerns. Putting companies on notice globally that ignorance of investor priorities like diverse board expertise, may have dire consequences. Several Australian companies will be taking matters into their own hands next year, with a number committing to advisory 'Say on Climate' votes seeking support for their climate transition planning.
With these votes increasing in complexity, the importance of thorough research and effective company engagement as stewards of capital is paramount to grasp the pertinent issues raised by the proposal and assess a company's management of the prevailing risks.

Outlook for 2022

Environmental issues look set to take centre stage yet again in 2022, with the implementation of new and improving disclosures. The recently launched Taskforce on Nature-related Financial Disclosures (TNFD) is one such example, likely to push biodiversity into the spotlight for investor consideration.
Escalating attention on social concerns is also expected, as the focus on instances of human rights abuse and their impact on company reputation is addressed. The first year of mandatory Modern Slavery reporting in Australia saw over 6,180 entities disclose their actions to manage risk in their supply chain. This continues to build momentum, with greater focus turning to outcomes as reporting under this legislation matures.

Encouragingly for cultural heritage protection, the Dhawura Ngilan Business and Investor Initiative is one of many emerging platforms investors have to highlight issues facing First Nations Peoples', with legislative reform a strong focus for next year, driving companies to pay careful attention to this critical issue

[1] Morningstar, 'Global Sustainable Fund Flows', November 2021 link

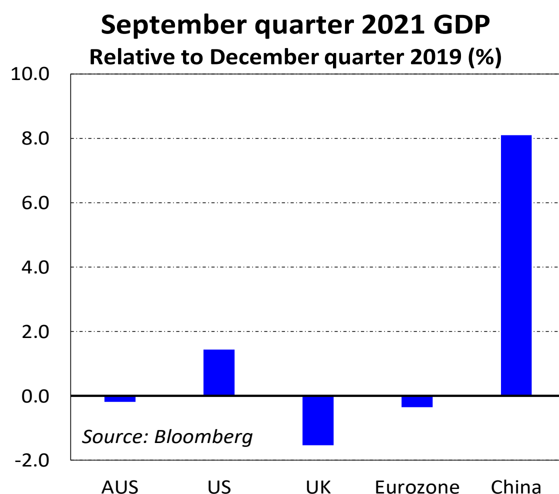
Economic Commentary

Several key themes dominated economic activity over 2021. The global economy continued its recovery from the pandemic, aided by extraordinary fiscal and monetary policy support. Uncertainty remained high, highlighted by the emergence of the Delta and Omicron variants. Lockdowns and disruptions continued as authorities worked to limit health impacts. The reported global COVID-19 death toll rose from 1.9 million to over 5.4 million by the end of the year.

A rapid recovery in demand coincided with supply-side constraints, alongside energy, materials, and labour shortages. This sparked a surge in inflation across many countries. Subsequently, the withdrawal of emergency monetary policy settings came into focus.

After a turbulent year, GDP has recovered to be above pre-pandemic levels in some economies. However, GDP remains below pre-pandemic levels in countries heavily impacted by COVID-19 lockdowns.

Chart 2 – GDP by Country – Q3 2021



Australia

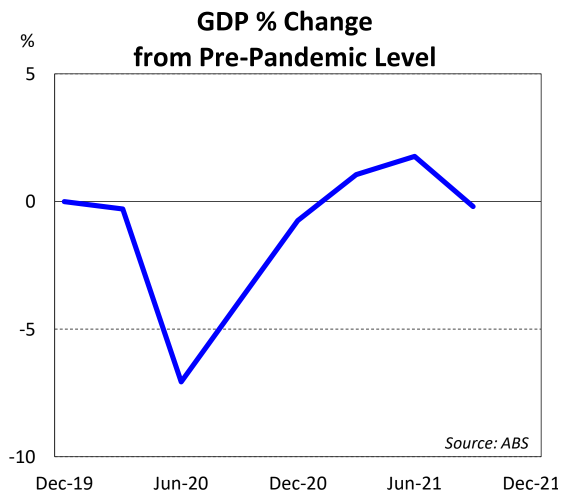
Early in 2021, the spread of COVID-19 was limited. Small outbreaks were curbed with short, sharp lockdowns, as governments pursued a zero-COVID strategy. The recovery gained momentum and key support packages, such as JobKeeper, were unwound. Business and consumer confidence rebounded sharply. At the same time, housing prices were increasing dramatically, underpinned by record low interest rates, government incentives, surging confidence and constrained supply. Business investment was building momentum and the pipeline of government investment was robust, as state governments increased infrastructure spending. By the March quarter, GDP had returned to pre-pandemic levels.

This changed when the Delta variant hit in June. As cases rose, lockdowns across NSW and Victoria stalled the recovery. Business and consumer confidence pulled back from high levels, clipping business investment and retail spending. The labour market also took a blow, however, the economy was resilient as the negative impacts were muted relative to earlier in the pandemic.

The great vaccination race ensued. After a slow start domestically compared to other advanced economies, Australia's vaccination rate climbed rapidly. Business and consumer confidence rebounded, as high vaccination rates, partially in NSW, ACT & VIC, allowed governments to provide roadmaps out of lockdown.

Output contracted by 1.9% over the September quarter. While this was the third largest quarterly fall on record, it was significantly smaller than the 6.8% contraction in the June quarter of 2020.

Chart 3 – Quarterly GDP (%) - Australia



Pent-up demand was unleashed as restrictions eased. Spending surged and the labour market bounced back. By November, all of the jobs lost during the Delta lockdowns had been recovered and the unemployment rate reached 4.2% in December - its lowest level in over a decade. Reports of labour shortages were prevalent.

The great inflation debate raged on in 2021. Central banks argued price pressures were transitory, but markets were unconvinced. In Australia, inflation gradually picked up over 2021, as the economic recovery continued, and the housing boom and supply disruptions added to price pressures. The headline Consumer Price Index (CPI) hit 3.0% over the year to the September quarter. Underlying inflation, as measured by the trimmed mean, the Reserve Bank's (RBA) preferred measure of inflation, rose 2.1% over

the same period – the first time underlying inflation was within the RBA's 2-3% band since 2015.

The economic recovery and pick-up in inflation was faster than expected by the RBA and markets. As a result, the RBA adjusted its policy settings. The RBA dropped the yield curve control target in late-2021, which was targeting a yield of 0.10% on the April 2024 bond. The RBA also dropped its forward guidance that its "central scenario" was that the cash rate would not increase before 2024. Instead, the central bank stated that "the board is willing to be patient". Meanwhile, markets brought forward their expectations for the first RBA rate hike to mid-2022.

The picture looked bright as we headed to the end of the year, with borders reopening and restrictions lifting. However, the emergence of the Omicron variant presents fresh uncertainties. Case numbers rocketed to record levels. Hospitalisations and deaths are climbing but have remained low relative to the high case numbers. The outbreak has underpinned material disruptions to the economy, albeit temporary. With millions of Australians in isolation, the surge in cases has weighed on consumer spending, exacerbated labour shortages and put more pressure on supply chains.

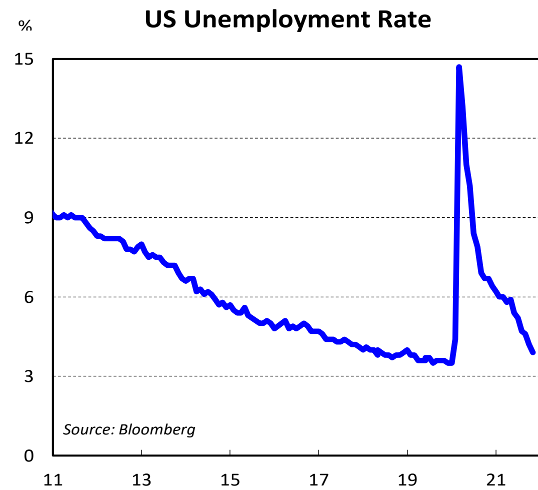
United States

Following his inauguration in January, President Biden progressed various aspects of his economic agenda. This included the passage of a US$1.9 trillion support package in March. Key initiatives included household stimulus payments and expanded unemployment benefits. A US$1.2 trillion infrastructure package was also passed in November.

The massive fiscal support built on already substantial monetary stimulus, boosting demand and supporting the recovery. A V-shaped recovery was building. GDP growth recovered quickly, with the economy growing at an annualised rate of 6.3% in Q1 and 6.7% in Q2. Real GDP eclipsed its pre-pandemic level in Q2 2021. Growth slowed to an annualised rate of 2.3% in Q3 as the country was impacted by a Delta wave. However, the economy is on track to regain that lost momentum in Q4.

Employment also recovered rapidly from the pandemic-related downturn. The unemployment rate fell from 6.7% to 3.9% over 2021, finishing just above its pre-pandemic level.

Chart 4 – US Unemployment Rate (%)



As the economy improved, reports of labour shortages were common. The improving jobs market made people more confident about their economic situation and ability to find better job opportunities. The 'great resignation' was underway. In November 2021, a record 4.5 million workers left their jobs. Additionally, some took advantage of higher asset prices to bring forward their retirement. Wages and benefits growth reached 3.7% over the year to the September quarter, its highest level in more than 15 years.

Inflation surged to levels not seen for over three decades. Headline inflation jumped to 7.0% over the year to December. The spike was driven by supply and demand factors, as a swift recovery intersected with supply constraints. Underlying inflation, as measured by the core Personal Consumption Expenditure (PCE) deflator, the Federal Reserve's (Fed) preferred measure of inflation, rose by 4.7% over the year to November. Both measures were well above the Fed's inflation target of 2% over the longer run.

The rapid recovery and rising inflationary pressures drove the Fed to signal an earlier-than-anticipated withdrawal of its extraordinary stimulus measures. The Fed began to taper its bond purchase program in the latter part of 2021 and accelerated the taper by the end of the year (2021). On the current trajectory, the Fed is expected to end asset purchases by March 2022, paving the way for an increase in the federal funds rate.

On the virus front, health outcomes have been marred by vaccine hesitancy, and vaccination rates slowed significantly in the second half of 2021. By the end of 2021, 62% of the US population had been fully vaccinated and the death toll passed 800,000.

Europe

Strict lockdowns were introduced during the beginning of 2021, driving the Eurozone into a double-dip recession in Q1 of 2021.

Vaccination rates increased rapidly across the UK and other European nations. However, vaccination rates have been uneven, with low vaccine coverage in some countries, particularly in Eastern Europe. Countries imposed vaccine mandates to varying degrees to encourage greater vaccine take up. At the end 2021, almost 70% of the population was fully vaccinated in the UK, and around 60% in Europe.

As vaccination rates began to increase and the summer approached, restrictions gradually lifted and the economy entered recovery mode in Q2. Consumer spending was a key driver. Pent-up demand, combined with higher incomes supported spending.

The labour market rebounded. UK unemployment fell to 4.1% in November, down from 5.1% at the beginning of 2021. Eurozone unemployment fell from 8.1% to 7.3% over the same period.

In the latter part of 2021, the region was impacted by supply-chain disruptions in various sectors, including construction and transportation. These bottlenecks impacted growth and contributed to inflationary pressures. Headline inflation in the Eurozone rose to 5.0% over the year to December, the highest rate since the creation of the single currency union in 1999. UK headline inflation rose to 5.4% over the year to December.

In December, the Bank of England raised interest rates, citing inflationary pressures. The European Central Bank held its policy rate at a record low but announced the end of bond purchases under the Pandemic Emergency Purchase Program by March 2022.

Energy concerns were prevalent in late 2021, as natural gas prices skyrocketed driven by a number of factors. This included strong energy demand fuelled by the global recovery, low inventories following a colder-than-usual winter and higher-than-usual consumption, reduced production from other sources, and political tensions impacting supply from Russia.

UK natural gas futures spiked by over 700% from the beginning of 2021 to their peak just before Christmas. Wholesale prices jumped while consumer prices were limited by regulation, putting retailers under pressure and leading to the failure of various firms. Prices and supplies in mainland Europe were also impacted.

China

The Chinese economy expanded over 2021 despite challenges. The economy grew by 18.3% over the year to the March quarter of 2021 as growth rebounded from the significant contraction in the March quarter of 2020. Expansion continued, but at a slower pace, with growth of 4.0% over the year to the December quarter of 2021. China's economy was around 10% above its pre-pandemic level in the December quarter 2021. Since the pandemic hit, Chinese growth has been among the strongest in the world, underpinned by significant stimulus from authorities.

The Chinese authorities are seeking to transition away from traditional growth sectors, such as real estate development and infrastructure, towards broader growth drivers with the goal of 'common prosperity'. This has underpinned significant regulatory change, including efforts to reduce leverage in the economy, and speculative activity in the property sector.

In September, global market volatility jumped as fears emerged over the solvency of Evergrande, one of the largest and most heavily indebted property developers in the world. The company was impacted by the tightening in regulation and teetered on bankruptcy.

Chinese policymakers intervened to facilitate an orderly resolution. Evergrande and other property developers continue to face issues meeting their debt commitments. However, overall financial conditions in China remain stable. The authorities' efforts to reduce risks in the financial system, although driving short-term volatility, will support long-term sustainable growth in China.

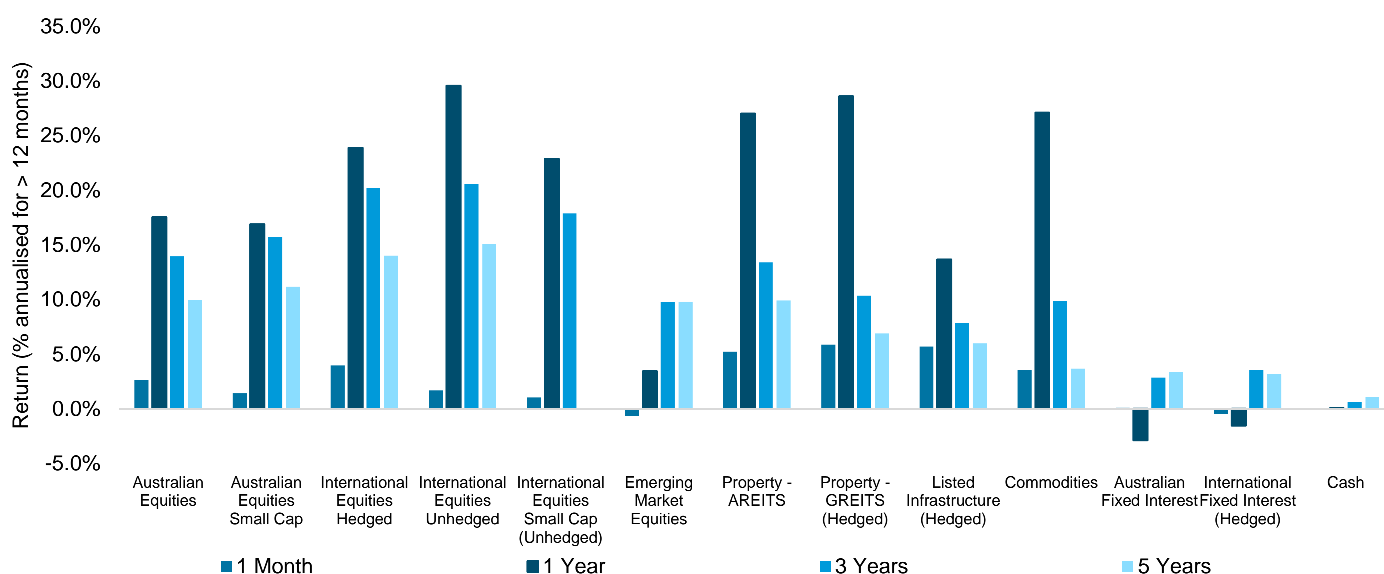
Energy shortages also impacted production, causing blackouts and electricity rationing for industrial users and households. Several factors contributed to shortages, including high coal prices amid an environment of low inventories, and policies to limit pollution ahead of the 2022 Winter Olympics.

On the virus front, China continued its aggressive zero-COVID approach. The country faced several small outbreaks but was largely successful in implementing strict containment measures. How authorities will manage the highly transmissible Omicron variant remains a key uncertainty.

The Path Ahead

We have a mildly constructive outlook for the year ahead, but asset returns, in particular for equities, will likely fall short of 2021's. Entering 2021 we expected economies and markets in general to continue being supported by fiscal and monetary policy in the hope that the impending vaccine roll-out built confidence permitting an end to lockdown and social distancing measures. As a result, fundamentals remained well supported, however valuations were stretched. In a world that experienced above average economic growth and zero nominal interest rates, markets in hindsight delivered what would be expected; above average equity returns and flat bond returns.

Chart 5: Asset Class Returns to 31 December 2021.



Source: Bloomberg

After a tumultuous two years navigating a pandemic, the global economy has accelerated away from a coronavirus induced slump, helped at first by overwhelming policy support and later by a surge in capital spending with the support of pent-up consumer demand. We are now closer to a sustainable economic recovery with the potential growth of the global economy seemingly undiminished by the experience of COVID-19. The policy interventions at the height of the crisis will have a long-lasting impact. In the short run, they have created a strong (if not distorted) cycle, supporting risk assets. Added to this, the ongoing pandemic has partly shifted the demand and supply model that investors and consumers have been accustomed to, generating imbalances, price pressures and labour dislocations. These challenges have wounded the favoured 'just-in-time' supply chain models, adding cost pressure to business models. The recovery in business investment, and continued improvement in labour productivity suggest the underlying dynamics of economic growth are still strong. In the longer run, those distortions will eventually be resolved though the mechanisms by which this happens are unlikely to be imminent.

2022 is likely to see a broader recovery in global growth with a potential return to more normal economic conditions seen pre-COVID and although financial markets are likely to experience more volatility, we still expect risk assets to outperform at the margin. Achieving broader population immunity, the current spread of the Omicron strain and its less severe health impacts hypothesises that consideration of endemic type attitudes will support a return to more normal activities in time. Such a shift will result in a continuation of the cyclical recovery with a release of pent-up demand from consumers (e.g., travel and services) as mobility improves. A shift in demand from goods to services may stabilise the current price pressures, in a backdrop of still-easy monetary policy dynamics and interest rates well below historical norms. A shift however in labour mobility and perceived collective bargaining power resulting in higher wage growth could risk offsetting a coming deflationary demand shift from

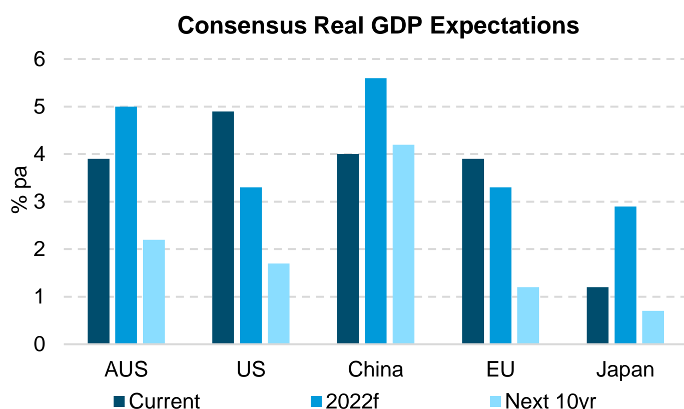
goods to services which ultimately may halt the current pricing pressures.

Outside the US and UK, negative real interest rates are likely to continue through 2022, while for Emerging Markets, China is stimulating its economy again and cutting interest rates. Given these dynamics, we continue to remain favourable for equities to outperform bonds at the margin, cyclical assets and value should outperform with headwinds (increase in bond yields, inflation, and economic reopening) likely for the more defensive bond proxy assets, high-multiple growth stocks, low volatility strategies and those market segments that had benefited from the pandemic. This should lead to a continued narrowing of the current discount between Value and Growth across equity markets.

The year ahead looks to be another year of transition, led by an important shift in central bank policy where the actions of the US Federal Reserve will be key. Following years of expansion in central bank balance sheets, tapering of bond purchase programs is now underway; a precondition to broader interest rate hikes. Markets are now pricing a year end cash rate of 1.1% in the US, representing four to five hikes now expected from the US Fed. The US is leading the developed world in the recovery, with quarterly inflation running at pace +7.0% p.a and GDP growth of +5.0% p.a. for 2021. Despite forecasts of inflation now at a peak, price pressures remaining at current or higher levels for an extended period would risk faster tightening of monetary policy. Easing of pressures in key supply chain bottlenecks (i.e., ports and increases in container through-put, manufacturing, and transportation) is evident but stronger labour and housing markets will warrant closer attention for any persistence in above trend dynamics as the year progresses.

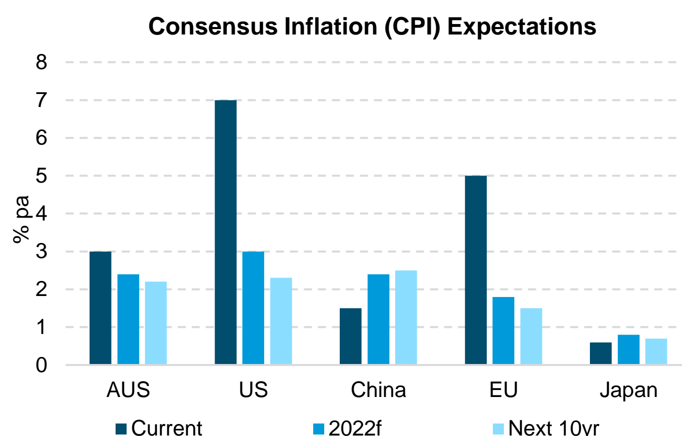
Chart 6 & 7 - Consensus GDP growth expectations sees more mixed economic momentum falling back to longer term levels towards the end of 2022

Chart 6: GDP



Source: Macrobond, Refinitive, BTIS,

Chart 7: CPI



Source: Macrobond, Refinitive, BTIS,

Overall, we should expect 'more of the same' from recent macro themes but with lower returns and higher market volatility. Considering the mosaic of information available to us there are clear consensus views consistent with our outlook over the short term being:

- Above trend global growth;
- Beginning of the monetary policy tightening cycle;
- Yields rising modestly;
- and COVID turning into an endemic risk.

Key risks are also similarly considered to be focused on inflationary impacts and stretched valuations. Headwinds for equities are likely to only arise once real rates provide a positive return premium which we do not expect is a likely outcome in the short term. Nominal rates would have to rise substantially from their current levels or inflation to fall back to post-cycle lows, neither seems highly probable in the short term. The greatest divergence in views relates to the risks from China. In particular, prospects for recovery in Emerging markets ex-China assets and expected returns and impacts from ESG investments. COVID-19 has however accelerated the prospects of a change in market regimes impacting political, macroeconomic and market dynamics as we move away from the era of the 'Great Moderation' characterised by low inflation and macro volatility. Following the pandemic, investors are entering a new paradigm of higher inflation, larger deficits, higher macro volatility and as currently experienced, faster business cycles.

BT

Equities

A tale of two halves of a different kind ….

Australian Equities

Australian shares had a strong year, exceeding pre-pandemic highs by May. Overall, the S&P/ASX 300 Accumulation Index finished 2021 up 17.54%. The earlier half of the year favoured cyclicals and value stocks which then reversed as macro factors including inflation and new COVID outbreaks prompted a rotation back to growth. Our managers' active approach to investing places them in a good position to take advantage of market volatility, while identifying longer-term opportunities through bottom-up analysis.

From a sector perspective, Telecommunications, Financials and Consumer Discretionary for the S&P/ASX 300 rallied +32.20%, +23.42% and +22.14% respectively. Energy was heavily impacted by volatility from oil prices, ending the year down -2.59%. Of the size groupings, the mid-caps outperformed the small and large cap end of the market. The S&P/ASX 20 rose by 12.1% and the S&P/ASX 50 lifted by 12.4%. Overall, the All-Ordinaries Index ended the year up 17.74% and the ASX Small Ordinaries Index was up 16.90%.

Against this backdrop, our managers are generally looking for companies that can continue to grow earnings, while avoiding those faced with challenging outlooks. For example, managers are generally cautious on the banks due to the longer-term headwinds related to competition, regulation, and cost pressures. There is a broad preference for companies with pricing power that can withstand rising inflation and for companies whose operating environment stands to benefit from economic reopening trends. Managers are cautious about holdings stocks trading at high valuations given their vulnerability to higher interest rates.

International Equities

Many viewed 2020 as a tale of two halves with the biggest daily falls in over 3 decades followed by the quickest bounce back. A similar tale could also be told about 2021. Performance in the first half was largely value-driven, with rapid vaccination campaigns providing a boost to economic activity. Optimism around the reopening of economies, similar to the sentiment in Australia, led to broad gains across global equities with US indices hitting record highs in Q2. Rising inflation and concerns regarding Delta in the second half of the year saw a rotation back to growth, with a narrow band of US technology companies driving index performance. Over the course of 2021, the ten largest companies by market value contributed more than a quarter of the benchmark's performance.

In aggregate, managers were positioned over the year for strong economic growth, inflation to continue with a focus on more cyclical areas of the market, and also opportunities down the cap spectrum. More recently there has been caution on the macro environment and managers have been shifting their portfolios to be more 'balanced' with the aim that stock selection rather than factor exposure should drive excess returns. The MSCI World ex Australia was up 29.58% for the year on an unhedged basis and 24.14% on a hedged basis.

Emerging Markets

While 2020 saw more of a synchronisation across the Developed and Emerging world, 2021 painted a very different picture, with Emerging Markets ending the year moderately positive in AUD terms. Apart from headwinds from China's troubled property sector and broad regulatory reforms, there were reasons for optimism in Emerging Markets. Taiwan and India proved to be the top performing regions in EM over the year. Taiwan's performance was driven by persistent demand for semiconductors, aided by capital flows from investors seeking alternatives to the volatile Mainland Chinese market. The story in India was one of strengthening recovery and earnings growth, with the nation's 12-month consensus earnings outpacing regional peers over the course of the year. Despite turbulence from COVID-19 outbreaks and concerns around accelerated tapering of asset purchases in developed markets, both Taiwan and India posted returns approaching 34% in net AUD terms.

Looking ahead, our managers are optimistic on commodity-led economies, particularly those with exposure to energy as prices strengthen going into 2022. Latin America is particularly promising with a strong macro environment, despite potential uncertainty arising from general elections in Brazil later in the year. India remains an attractive market, owing to signs of a nascent credit-led recovery and consensus GDP growth outpacing all other large economies. India faces risks from tightening monetary policy in Developed Markets, however the country's tamed current account minimizes the risk of another 2013-style taper tantrum. Elsewhere in Emerging Markets, Chinese monetary policy, along with Russia's actions in Eastern Europe remain the key risk considerations going into 2022. Despite the reduced pace of regulatory reforms in China, risks persist in the form of slowing domestic demand growth, with more limited application of stimulus than investors expected. Our EM managers are watching for signs of improving monetary conditions before taking larger positions in China. In Russia, energy names would be

attractive were it not for the country's actions in Ukraine. However, there is an opinion that the unacceptably high costs of a prolonged conflict and subsequent occupation will prove to be a disincentive for military action. Taking a macro view of Emerging Markets, the risk of rising US rates has led our managers to be more cautious on countries with weaker current accounts. Opportunities are being sought out in sectors leveraged to the ongoing recovery of the real economy.

Fixed Income

Rates & Credit

In 2020 we saw central banks globally throw whatever it took at the economy in the form of stimulus to keep economies ticking along. As we entered the second year of the pandemic the 'transitory' inflation debate has dominated market discourse for most of the year, with central banks being forced to moderate their stance in recent months by the weight of evidence that price increases are, at the very least, more persistent than they first thought.

Positive signs spread across most bond markets with US 10-year yield up 60 bps to 1.63% for the calendar year 2021 and credit spreads approaching all time tights once again. As for Australia, 10-year government bonds started the year close to 1% and ended the year at 1.81%.

To that effect, our underlying managers have been quite active with respect to active duration and yield curve strategies. The earlier part of the year was dominated by adaptation of a 'trading the range approach' whereby managers would go long duration when bonds sold off and yields peaked, and conversely a short duration stance would be adopted when bonds rallied and yields bottomed out. This however gave way to a more persistent short bias more recently as more investors accept that inflation pressures are here to stay – at least in the medium term.

Looking ahead to 2022, our managers expect bond yields to trade with elevated levels of volatility. Rates have become a significant source of risk in fixed income as they seem perpetually primed for a sell-off. This is perhaps why the BT Investment team believes active management is even more imperative than ever as our managers seek to navigate the difficult landscape in the year ahead. Bond markets are also likely to show greater divergence, as progress towards central bank goals varies by region. Clear differences are already emerging in terms of the path of policy normalisation. This will likely create additional uncertainty over duration allocations, but also cross-market yield spread opportunities, making it a rich hunting ground for active bond strategies.

Across credit, general consensus is that we will start the year with lofty valuations, growth and earnings slowing down, and a number of central banks starting to hike rates. Fortunately, credit fundamentals remain strong, with high yield default rates in both the US and Europe below 1% and upgrades far outnumbering downgrades. The BT Investment team however expects to see greater performance dispersion in credit (particularly in high yield) and therefore credit selection will be more important than it has been in the last 12 to 18 months.

From a strategy perspective, we think the best approach is to keep credit duration relatively short and ensure your portfolio has enough higher yielding assets to cushion any losses from rising rates. We do not believe the portfolio should stretch out the credit curve in search for yield, preferring rather to maintain strong levels of liquidity. 2022 may very well provide intra-cycle dips and accompanying them, an opportunity to further improve our portfolios and take on additional risk – should the risk/return dynamics justify.

Private Debt

2021 has been a calmer year from a credit volatility perspective and this has allowed the sector to consolidate on its strong performance from the year prior. Concerns over potential rising defaults failed to materialise given ample liquidity and the unprecedented fiscal and monetary policy support from central banks. However, the scale and complexity of global credit markets are changing rapidly and with that, there are emerging trends that could potentially impact both issuers and investors in the private debt market.

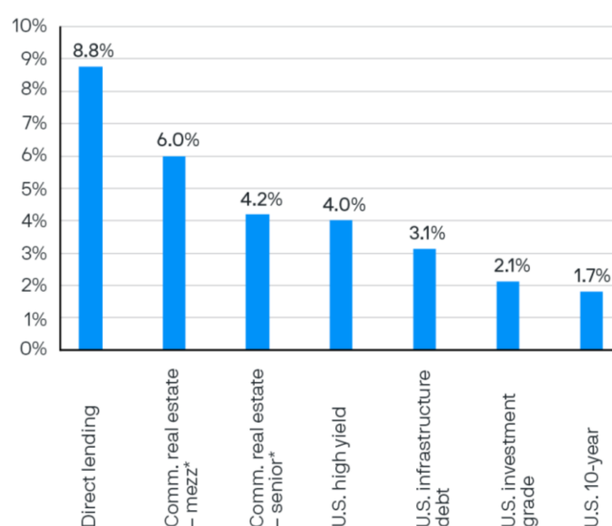
For issuers, capital is more widely available in this space, which therefore allows companies to seek the capital that is best aligned to their particular needs. As businesses adapt to these opportunities, the greater availability and flexibility of capital may make credit cycles smaller, more frequent and sector-specific as conditions become increasingly dependent on sector dynamics. This reinforces our view that active selection is likely to play a key role for the foreseeable future.

Furthermore, issuers continue to look to the private market due to its relatively greater speed and certainty of execution. Increased deal volumes and deal size (which corresponds to increased economic activity as economies rebound from post COVID lock downs), should ensure that deal flow remains robust with a strong pipeline likely for 2022 and beyond.

On the demand side, the higher yield and proportion of return from income coupled with lower interest-rate sensitivity keeps private credit attractive relative to fixed income assets. We see investors increasing their allocations to the private credit asset class over time.

Arguably, Private Debt is one of the few remaining sectors that still offers relatively high spreads over public markets, covenants (lender protection), and low volatility due to its less liquid nature as show in chart 4 below.

Chart 8 – 2021 Returns for Rates & Credit



Source: Source: BofA Securities, Bloomberg, Clarkson, Cliffwater, Drewry Maritime Consultants, Federal Reserve, FTSE, MSCI, NCREIF, FactSet, Wells Fargo, J.P. Morgan Asset Management.

As such, the demand & supply dynamics described above should ensure that deal flow continues to be robust and investor demand remains strong. Investors remain well compensated given the less liquid nature of these investments. In any case, the BT Investment Team continue to believe that the private debt markets continue to offer attractive opportunities, whether they're expressed through real estate debt, infrastructure debt or direct corporate lending.

Alternatives

Property

COVID outbreaks and new variants remain a risk that could derail the recovery, but the market mostly appears willing to look through this to capture reopening opportunities. The strong returns over the year, in both listed and unlisted markets, reflect the improved conditions in the real estate market. The most impacted sectors of last year have experienced the sharpest rebound so far and may have further to go, although there is still uncertainty with respect to longer-term fundamentals of traditional property types such as Retail and Office. On the other hand, sectors aligned to secular themes such as Data Centres and Housing, continue to hold up after a strong 2020. Industrials and logistics have also performed well and in some cases, the cap rates across those sectors are now below that of CBD offices. While the long-term demand across these favourable sectors is evident, the challenge facing our managers is determining the appropriate valuation.

Deep fundamental research can identify mispriced opportunities at the individual stock level. Despite headwinds for some sectors, and stretched valuations for others, there are opportunities amongst the higher quality REITs with stronger balance sheets, higher grade assets, and sustained earnings power. Our managers' active approach (in both the listed and unlisted space) allows them to take advantage of the entry points created by market short-termism and to build positions in their highest conviction names.

Infrastructure

2021 served to highlight the resilience of core private infrastructure as an asset class. Returns were stable over the year despite the global repercussions of the pandemic. Capital appreciation as a proportion of total returns stabilised back to pre-2020 levels and returns from income remained consistent. Overall, the long-term contracted, regulated nature of many core infrastructure assets helped the sector overcome the difficulties of the pandemic, while the inherent inflation protection evident from infrastructure assets helped cushion the asset class through recovery.

From a deal flow perspective, deal activity across infrastructure continues to be resilient particularly across Europe and America. In Australia itself, renewable energy opportunities have dominated deal flow as wind and solar hardware costs continue to decline. In any case, the level of activity continues to be sector specific. We have seen a total collapse in deal activity in the transport sector in the light of the COVID pandemic whereas there has been a surge of generation assets coming online both in renewable and traditional forms. Rail and toll roads have materially contributed to deal activity while activity in airports remains limited.

For the year ahead, we expect to see continued strong transaction activity in regulated utility and energy sectors for assets with long term stable and visible revenue streams. These trends are generally consistent across geographic areas. North America continues to provide a diverse mix of opportunities, dominated by transportation and renewable energy generation, in the brownfield space. Asia has seen a large increase in total deal activity, dominated by India and China, in a mix of sectors. Further, we believe there will be increased activity in water utilities and telecommunications, and continued interest in the renewables sector across regions (Australasia, North **America** and Europe).

From a return perspective, 2022 is expected to be another reasonable year for core private infrastructure despite the uncertainty caused by the ongoing impacts of the pandemic and the stumbling blocks on the road to recovery. Core private infrastructure is expected to return between 7-9% on a net basis in 2022 with assets benefitting from further economic reopening and increased inflation. One area of concern is the impact of rising cash rates as monetary policy tightens over the medium term. In our view, the higher yields available from infrastructure returns and the inflation-protection inherent from infrastructure assets should insulate the portfolio from any downside pressures. This in turn should keep the asset class attractive to institutional investors.

Liquid Alternatives

Investors are increasingly turning to liquid alternatives to satisfy their need for strategies that use liquid instruments that may offer low or even negative correlations with equities, reduced drawdowns in times of stress, and improved risk-adjusted returns. Many liquid alternative strategies lend themselves to indexing given that they are often rules-based and utilize liquid underlying instruments. Liquid alternative strategies saw big inflows in 2021 with Morningstar's data indicating $28.86 billion of inflows into the sector during the year. Investors concerned about inflation, potential interest-rate increases, and market frothiness appeared to be seeking ways to limit their downside risk while remaining somewhat exposed to risk or to damp losses should market sentiment turn.

Strong performing categories, including relative value arbitrage, options trading, and multi-strat offerings - dominated 2021 inflows. These categories provide greater clarity on the expected investment profile than the higher alpha-seeking mandates. Weaker-performing categories, such as systematic trend, macro trading, and equity market neutral, had the least inflows. However, the fact that these groups still received inflows still supports the theory that investors are positioning themselves for a potential volatility ahead. This is particularly so traditional fixed income offers little by way of yield and tighter monetary policy is likely to erode returns. Furthermore, strong equity performance in 2021 has created outsized equity positions in portfolios. Overall, the universe of liquid alternatives has grown and diversified substantially in the last decade, and consistent with the industrywide trends, the market has moved towards lower fee offerings which is advantageous to investors.

However, it remains important to understand how different investment strategies might impact diversification and the returns across an entire portfolio. The range of return dispersions within most alternative categories highlights the importance of manager selection in this sector - especially when the need for an equity hedge has increased and stocks and bonds may struggle to offer the same benefits and returns in a less accommodating regime during the year ahead.

Foreign Exchange

After a wild and exciting 2020, the Australian dollar resumed its normal programming – range bound from low to mid/high 70 cent level. As discussed earlier in this paper, with the realisation the US will most likely raise rates before Australia, the AUDUSD ended the year down -5.60% at 0.7263.

Commodities

Commodity prices were mixed over 2021. Gold, the traditional 'safe haven' commodity, ended 2021 down - 3.64% at US$1829.20. While time will tell if Gold continues to hold its risk off status – many are turning to digital currencies such as Bitcoin to seek what some believe as pure uncorrelated diversification. Unlike Gold, security plays a major issue in electronic currencies with many being hacked instantaneously.

Iron Ore, the former market darling, ended the year down -25.40% to US$114.09. As referenced earlier in the piece, with China facing its domestic growth struggles, particularly across the property sector, overall demand for Iron Ore fell.

Oil continued to face both supply and demand imbalances as a result of pandemic related issues, in addition to ongoing OPEC grumbles. Despite this Brent finished the year at US$77.78 or 50.15% and WTI at US$75.21 or up 50.01%.

Initiatives

BT signed the **Global Investor Statement to Governments on the Climate Crisis**, joining 587 other investors representing over **USD $46 trillion in assets**, urging governments to raise their climate ambitions with more robust policies.

Achievements

SuperRatings made BT and Super for Life **Infinity Recognised** funds, in affirmation of our commitment to sustainability and responsible investment.

In the **RIAA Super Study**, BT Super were recognised as one of thirteen **Leading** Australian responsible investment super funds.

Lonsec upgraded the **ESG integration** of our funds from moderate to **high**, and our Advance funds were upgraded from ESG Aware to **ESG Integrated** by **Zenith**.

PRI Signatories

96.87%

of our FUM is held by managers that are signatories to the Principles of Responsible Investment.

Engagements

As of September, our international equity engagement provider **EOS at Federated Hermes** had conducted **953 engagements** on our behalf, with 39% of these progressing at least one milestone set by their programme.

For our domestic equity holdings, **Regnan**'s objective to undertake more concentrated, outcome-driven engagement yielded progress, with **90 engagements** up to December focussing on a range of issues including industry lobbying on climate change and cultural heritage protection to name a few.

Directed Resolutions

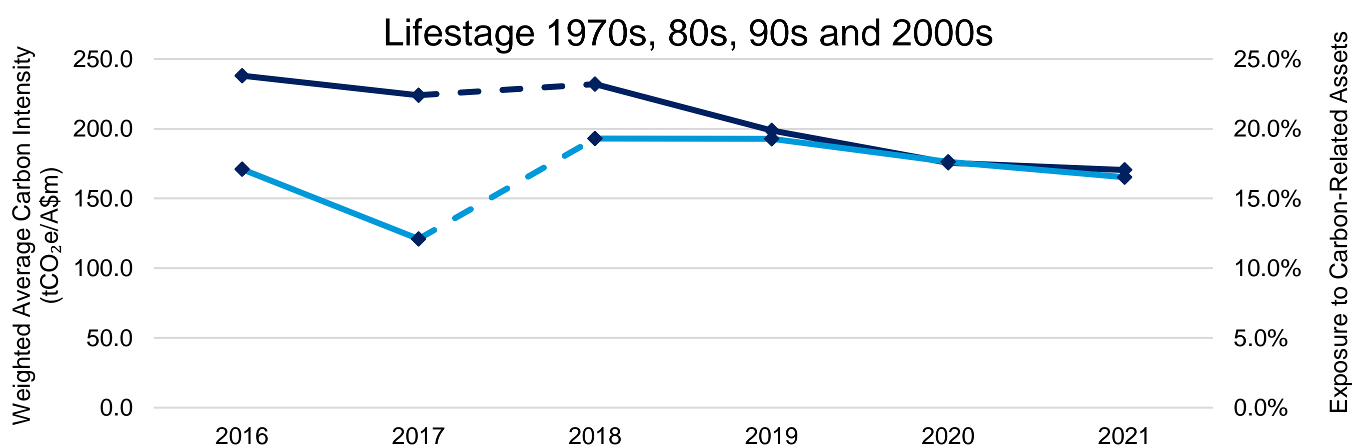
BT directed votes on **60 ESG-related contentious resolutions**, after assessment by the Sustainability & Equities teams in alignment with our Proxy Voting Principles.

Environmental	Social	Governance
26	10	24

During 2021 BTIS and its managers voted on a total of **48,674 proposals** across **2,096 meetings.**

Climate-Related Disclosures Trend Analysis

As part of our TCFD-aligned disclosures, BT analyse and report on two carbon metrics for each of our funds, as well as monitor how they trend over time. In the below example, the **weighted average carbon intensity** (fund footprint) and **carbon-related asset exposure** has **trended lower since 2018**. This trend aligns to a modest but promising shift in the relative benchmarks. Information on BT's approach to climate change, including data from other investment options is available in the BT Climate-related disclosures at bt.com.au/sustainableinvestment



Note: between 2017-2018 BT updated its methodolgy to more closely align with the TCFD, as such data between these two periods is not directly comparable but is provided here for information.

Appendix

Market Data

December 2021 Market Data

Australian shares	1 Month	3 Months	1 Year	3 Years	5 Years
S&P/ASX 300 Accumulation	2.65%	2.21%	17.54%	13.96%	9.94%
S&P/ASX 300 Industrials Accumulation	1.79%	0.50%	19.45%	13.71%	8.97%
S&P/ASX 300 Resources Accumulation	6.37%	9.92%	10.18%	14.89%	14.30%
S&P/ASX 300 Accumulation A-REIT	5.24%	10.07%	27.03%	13.41%	9.90%
S&P/ASX Small Ords Accumulation	1.41%	2.03%	16.90%	15.71%	11.17%

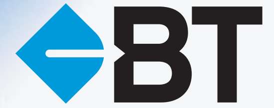
Global shares	1 Month	3 Months	1 Year	3 Years	5 Years
MSCI World ex Australia Unhedged in $A	1.68%	7.19%	29.58%	20.58%	15.08%
EPRA/NAREIT Developed Index Hedged A$	5.89%	10.17%	28.60%	10.36%	6.91%
STOXX Europe 600 Total Return	5.37%	7.25%	22.25%	13.05%	6.18%
S&P 500 Total Return	4.48%	11.03%	28.71%	26.07%	18.47%
Nikkei 225 Total Return	3.62%	-2.08%	6.66%	15.05%	10.63%

Fixed interest	1 Month	3 Months	1 Year	3 Years	5 Years
Bloomberg AusBond Bank Bill Index	0.00%	0.01%	0.03%	0.63%	1.11%
Bloomberg AusBond Composite (0+Y)	0.09%	-1.46%	-2.87%	2.87%	3.36%
Barclays Global Aggregate TR Hedged A$	-0.44%	0.03%	-1.53%	3.52%	3.17%

Commodities	Month End Price	1 Month	3 Months	1 Year	3 Years	5 Years
Bloomberg Commodity Index	99.1694	3.52%	-1.58%	27.05%	8.93%	2.53%
Generic Brent Crude Oil	77.78	10.22%	-0.94%	50.15%	13.07%	6.48%
Generic WTI Crude Oil	75.21	13.64%	0.24%	55.01%	18.32%	6.96%
Gold US$/oz	1829.2	3.08%	4.11%	-3.64%	12.56%	9.77%
Iron Ore	114.09	20.87%	-5.26%	-25.40%	17.36%	7.89%

Currencies	Month End Price	1 Month	3 Months	1 Year	3 Years	5 Years
AUD/USD	0.7263	1.91%	0.50%	-5.60%	1.00%	0.15%
EUR/USD	1.137	0.28%	-1.81%	-6.93%	-0.28%	1.57%
USD/JPY	115.08	1.69%	3.41%	11.46%	1.61%	-0.32%
GBP/USD	1.3532	1.75%	0.43%	-1.01%	1.99%	1.86%

Source: Bloomberg



For more information

bt.com.au | 132 135 | GPO Box 2861 Adelaide SA 5001

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