CAPITAL EDITION

A NEW AGE OF INFRASTRUCTURE ENERGY AND INVESTMENT IS DAWNING

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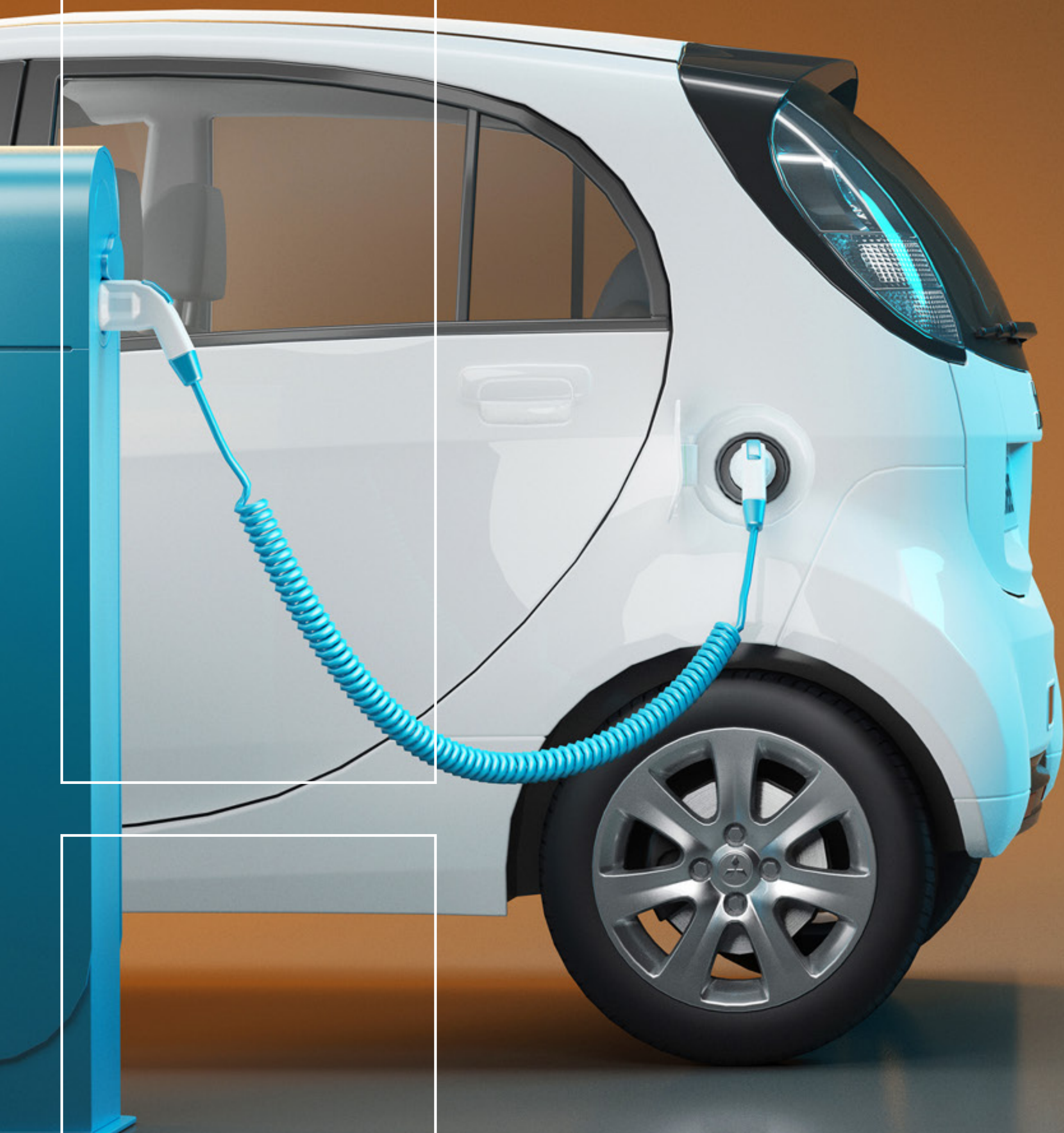

PREPARING FOR THE POST-COVID RECOVERY IN REAL ESTATE

COVID-19 was a black swan nobody saw coming, throwing even the mainstays of real estate into unchartered waters. Now, we are set for another game-changing 12 months – but in many ways, we're working in familiar territory.

TURN DOWN THE NOISE TO UNDERSTAND WHAT'S HAPPENING IN THE BONDS MARKET

As tends to be the case with headline market events, it's important to view them in context and with due credit to history. The bonds market in 2021 is no exception.

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Letter from the Managing Editor

Welcome to the latest issue of Capital Edition.

In this issue, we continue to spotlight the insights and ideas of the investment teams at AMP Capital. Fragile as the global economy and markets are, innovation and opportunity exists despite – and in the wake of – the COVID-19 crisis. The key is knowing what long-term trends, rather than short-term disruptions, are shaping opportunities.

Real estate is a prime example. Though our relationship with space was fundamentally impacted in 2020, in many ways, the pandemic has served to compound long-term trends that have been in the making for some time. Our head of real estate, Kylie O'Connor, shares her insights on what the period ahead could look like for the commercial market – with the learnings of a monumental year behind us.

For the real estate team at AMP Capital, Quay Quarter Tower is one example of what the future of commercial real estate looks like. With nods to its heritage and sustainability inextricably tied to its design and construction, the tower is setting a benchmark for modern offices. We share an update on Quay Quarter's progress and tell the tale of its inspiration and beginnings.

Another inescapable long-term trend is energy transition, and it is impacting – and set to impact – infrastructure at its very heart. Our portfolio manager and analyst, Joseph Titmus, in the global listed infrastructure team shares his insights on the dynamics in North America, and how this may impact investments and investors in the long term.

Finally, our economists join us in this edition to discuss two major events on the global stage. Our chief economist, Shane Oliver, shares his insights on the dynamics and future of the bonds market. True to style, he suggest we turn down the noise before leaping to conclusions. Our senior economist, Diana Mousina, also shares her thoughts on the United Kingdom's economy, which has suffered substantial disruption and chartered a new course with its separation from the European Union.

As always, and above all, we hope you are keeping safe and well. Please enjoy this issue, and feel free to share your feedback with us. ☐

Many thanks.

Rachael Dickinson
Managing Editor, AMP Capital

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A new age of infrastructure energy and investment is dawning

A great energy transition is underway from fossil fuels to zero-carbon renewables. Infrastructure investors need to understand both the supply and demand drivers of the transition – as well as the policy background – to successfully navigate this historic change.

Story by JOSEPH TITMUS

It is known as the Gusher Age. On 10 January 1901, a well at Spindletop, Texas, hit oil, sending an oil gusher 150 feet in the air and spilling 100,000 barrels of oil in a day. It took more than a week to get the gusher under control.

The discovery changed the course of human history. Suddenly, using oil for fuel was feasible and the global economy was rebuilt around access to cheap petroleum.

Today, America is on the brink of another historic change. This time, the word is moving away from fossil fuels in a great transition to clean, renewable energy sources like wind, solar and hydrogen. >

Known as the energy transition, this change will once again alter the fundamentals of the energy industry – and the global economy itself. From an investment perspective, the energy transition offers an evolving and significant opportunity.

Infrastructure – as the fundamental base of our economy and society – faces an increasing challenge to adapt to changes that will be wrought by the transition, whether new government policies and regulations, changes to supply and evolving preferences and demands from consumers.

The energy transition

The term 'energy transition' is used to refer to the many changes required to move the global energy system from fossil fuel to zero-carbon energy sources.

The entire industry – supply, demand, and regulation – faces transformation if the world is to realise the goal of a zero-carbon future. It is a big ship to turn.

Fossil fuels dominate energy because they are cheap and plentiful. In the history of the US, the fossil fuel industry has only been impacted twice – by the emergence of hydro-power in the early 1900s and the development of nuclear in the 1960s.

Recently, US government policies, like federal tax credits and state government renewable energy targets, have given renewables a foothold. And as technologies mature, renewables are becoming increasingly competitive with traditionally cheaper fossil fuels.

Already, wind and solar are cost-competitive with conventional generation technologies even without subsidies. Coupled with the need for fiscal stimulus to revive the US economy, policymakers are also turning to green investments as a way to drive economic growth.

Consequently, countries around the world – or in the case of the US, certain states – have started setting zero-carbon emission targets.

The energy transition is underway.

Energy demand

Key to the speed of the transition will be the evolution and nature of energy demand.

Efficient use of energy has been a feature of the market for decades and will only increase as the benefits of efficient energy use – both lower costs and better environmental outcomes – become greater.

"Infrastructure – as the fundamental base of our economy and society – faces an increasing challenge to adapt to changes that will be wrought by the transition, whether new government policies and regulations, changes to supply and distribution and evolving preferences and demands from consumers."

And as the market becomes more flexible, energy users can more easily switch to cleaner or cheaper sources of electricity – or even produce their own.

Different trends are affecting the different types of consumers.

Transport is the largest energy consumer in the US – and the most reliant on fossil fuels.

Just two million of the 360 million vehicles in North America are electric but numbers are growing rapidly[1].

The key to widespread adoption of electric vehicles will be price parity with petrol and diesel cars, which is a few years away yet. This means government policies will be the important driver of demand.

One intractable issue is road funding: petrol taxes fund roads. The rollout of the charging network is also a critical consideration.

Buildings are another key energy consumer. The building sector is a diverse set of relatively small power users with differing local regulations across cities that are trending towards more environmentally friendly consumption.

Heating and cooling comprise two-thirds of building energy demand in North America, which goes a long way to driving supply preferences[2]. Gas is more effective for heating than electricity, particularly in cooler climates.

Smart technologies like internet-connected meters and thermostats are also impacting demand by making customers more aware of pricing and consumption.

These new technologies are allowing demand-side management, where consumers are rewarded for managing their power use, which can help moderate demand in peak hours.

In contrast to the building sector, power usage in the industry segment is characterised by a smaller number of large energy customers, each with quite different needs and often with direct, unique relationships with energy suppliers.

The industry sector is increasingly seeking green energy and is increasingly using Power Purchase Agreements – longer-term contracts to buy energy – to source renewable supply.

Energy supply

From a supply point of view, continued technological advancement supported by government policy means renewables will continue to grow strongly as fossil fuels play a declining role.

Oil will stay a significant part of the energy mix for decades as it is embedded in the economy as an input to goods and services – and the US still has significant oil resources available.

Similarly, gas will play a role – especially as a flexible resource supporting renewables – because it is cheap and plentiful in the US. It will also continue to play an important role as a heating source, for reasons already mentioned.

But coal-fired generators will continue to be retired as they face increasingly unfavourable economics versus renewables. And the eventual deployment of so-called renewable diesel and renewable natural gas – essentially manufactured versions of the fuels that are more environmentally friendly – will require ongoing subsidies as these are not economic in their own right. >

1. https://www.statista.com/statistics/183505/number-of-vehicles-in-the-united-states-since-1990/#:~:text=How%20many%20registered%20motor%20vehicles,12%20million%20units%20in%202019
2. BNEF

“Countries around the world – and even some states – have started setting zero-carbon emission targets. The energy transition is underway.”

Meanwhile, renewable, zero-carbon energy technologies will continue their growing momentum. Technology advances are driving wind and solar's inroads into the energy mix, despite concerns about variability.

Rooftop solar continues to grow, comprising a third of total solar capacity. And while more than half of the 2.7 million solar installations in the US are in the southwest, penetration is pushing north and across the continent[3]. Technology advances in panels and battery storage will put a tailwind behind the sector.

Despite some mixed success, utility-scale batteries are continuing to see a build in momentum, particularly for short durations. The focus going forward will increasingly be on long-duration technologies, where today only pumped-hydro energy storage has been effective.

3. Solar Energy Industries Association

Carbon capture and storage has significant potential but is not yet economic at scale. A technological breakthrough would be a meaningful catalyst for the transition, and continues to be a focus of R&D and pilot projects.

And in the background is hydrogen, considered the holy grail of the energy transition.

Hydrogen can be made with renewable energy. It is easy to store and transport.

And when used to make electricity, its only emission is water.

Hydrogen is already used in industrial processes in the US and Canada and pilot projects have been established for energy storage and generation. A commercialised hydrogen industry would create significant demand.

Nuclear remains a fundamental and well-supported zero-carbon energy resource and reliable provider of baseload electricity.

Nuclear will play an important role during the transition, but it is unlikely to see growth due to the prohibitive cost of new nuclear power plants and instead will likely slowly decline as a source of supply.

The impact on infrastructure

So, what does this all mean for infrastructure investors?

The energy transition would not be possible without the infrastructure connecting supply and demand.

Energy infrastructure has seen considerable change over the past 100 years but arguably no change has been as significant as the change the industry is facing today.

Change is driven by new technology and rapidly evolving customer preferences. But regulators are often reminded of the dangers of moving too fast. Blackouts in California last year highlight the need for reliability, as does the Texas power crisis which unfolded earlier this year[4].

Regulators need to strike a balance between making sure capital is available for new investments and ensuring existing assets do not become stranded.

AMP Capital's global listed infrastructure team sees five main opportunities for the infrastructure sector from the energy transition in North America:

1. Oil and gas pipelines becoming increasingly strategic

Fossil fuels will be a meaningful source of supply for many decades to come, which means the pipelines connecting supply with demand will continue to play a key role.

Different markets will have different values, but given the difficulty in getting new pipeline infrastructure approved, certain assets already in the ground will be that much more valuable.

2. Repurposing existing infrastructure

Some infrastructure assets could be repurposed for technologies like hydrogen and carbon transport, and storage development. Pipelines and storage assets could be adapted for use by another commodity, although conversion costs could be a barrier.

Canada is using depleted oilfields and saline aquifers to store carbon emitted from refineries, industrial processes and power plants. The related transportation infrastructure has also proven to be a growth area.

3. Electricity transmission for renewables

Transmission for renewable electricity is a large growth driver partly because these types of assets – offshore and onshore wind and solar – are often located well away from demand centres.

This result is the need for a meaningful extension of transmission networks to connect them to the grid.

These opportunities will likely continue for many years.

Similarly, the changing generation mix and the different locations of supply means investment is also needed to adapt networks to cope with the different flows.

4. Electric vehicle (EV) charging and electricity distribution networks

The growth of EVs is requiring an entirely new infrastructure of charging points.

Policymakers recognise the environmental and economic potential from EVs, but range anxiety – the fear of running out of charge and being stranded – is real. It's also a serious headwind to increased EV market share.

There is no consensus on who should pay for charging stations – there are arguments for and against governments, energy utilities and private enterprise footing the bill.

There's also no sight of standards across chargers, meaning EV drivers will need to find a charging station compatible with their vehicle.

Estimates in the US suggest only 4 per cent of the chargers needed to support growth to 2040 are operational today, so the opportunity is considerable[5].

5. The future of gas distribution networks

Gas remains the cheapest source of supply for heating in the US – and much cleaner than some of the existing alternatives like oil.

However, some cities have banned gas in new buildings putting a question mark over the growth of the industry.

Despite this, the economics of electric heating remain unfavourable and – in the medium term – is unlikely to change.

Gas networks have considerable investment programs available to repair aged and leaking pipes, improve safety and reduce methane emissions.

Ultimately, renewable natural gas – gas manufactured from renewable sources – or hydrogen may take their place in the gas infrastructure. ☐

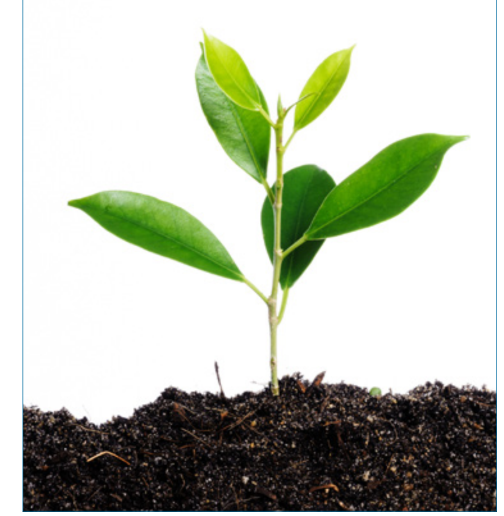
This article was drawn from Joseph Titmus's whitepaper, The Energy Transition in North America[6].

4. https://www.forbes.com/sites/davidblackmon/2021/03/17/texas-power-blackouts-last-standing-puc-commissioner-resigns-amid-controversy/?sh=47c889415581
5. Morgan Stanley, Utilities: The Unintended Bottleneck to Mass EV Penetration?
6. https://www.ampcapital.com/au/en/insights-hub/articles/2021/march/the-energy-transition-in-north-america

The US in focus

US President Joe Biden has proposed many ambitious climate change policies. Details are limited and the proposals need to be passed into legislation, but some of the most significant include:

- Re-enter the Paris Climate Agreement
- 100% clean energy economy and net-zero emissions by 2050
- $1.7 trillion (over 10 years) federal investment in climate and environmental proposals (total of $5 trillion with state and local governments, and private sector)
- $400 billion investment (over 10 years) in clean energy innovation
- 100% of new sales of light and medium vehicles are zero emissions, improvements for heavy vehicles
- 500,000 new EV charging outlets by 2030
- Reducing carbon footprint of buildings by 50% by 2035
- Aggressive methane reduction targets
- First economy to achieve net-zero emmissions from the agriculture sector
- Creation of 10 million new jobs
- Improve environmental justice across society



Preparing for the post-COVID recovery in 2021

COVID-19 was a black swan nobody saw coming, throwing even the mainstays of real estate into unchartered waters. Now, we are set for another game-changing 12 months – but in many ways, we're working in familiar territory.

KYLIE O'CONNOR
Head of real estate, AMP Capital

Last year, the real estate market found itself in an almost unfathomable situation. For over 100 years, Australia hasn't known a public health emergency so intense, that people were kept away from their offices, shopping centres, and each other.

Albeit well-contained in Australia, the pandemic is still a live issue, and its impacts will continue to be a major challenge to manage in 2021. However, as the dust settles on 2020, it's clear that many of the challenges we're facing are an accentuation of existing trends and forces. For us, a deep understanding of those long-term movements will be key to identifying opportunity and minimising downside for the year ahead.

ESG is key

As a lens to any real estate investment, ESG is critical, and had begun transforming industries well before COVID-19. AMP Capital launched our 2030 Real Estate Sustainability Strategy last year, in recognition that long-term sustainable outcomes across the real estate assets we manage, the supply chains we work with and the communities we operate in are increasingly non-negotiable.

Prior to 2020, ESG had become a business megatrend, and importantly, one that is recognised and treated as a dominant global economic risk. After a year where we've been trained to be constantly conscious of our surroundings and our health, we can only expect this will continue on a skywards trajectory.

As such, we see that ESG principles will remain crucial to underlying earnings and the stability of cash flow. In particular, we think that wellness in all its forms will be important across the sectors, with implications extending to workplace design and retail tenant mix.

New heights for the resilient logistics market

In our view, the undoubted winner of 2020 was the logistics market. This market was already being driven by e-commerce and has been accelerated by the requisites of lockdown.

For example, this year we've needed to store more medical supplies and rely more heavily on online shopping. >

Importantly for life beyond COVID-19, it's not just e-commerce or the pandemic which is underpinning the success of the logistics market. Companies across a number of industries have long been pursuing greater automation, preferencing a more efficient asset located in proximity to their customer base, which can meet escalating demands for shorter delivery times. Also, sudden events (like a pandemic) which disrupt supply can lead to permanent changes in inventory practices, translating to greater demands for space. Effectively, suppliers may consider housing additional stock, in an effort to maintain continuity.

Looking ahead, from a pricing point of view there is an enormous amount of capital chasing logistics globally, particularly in safer markets like Australia. For instance, domestically we have lower volatility relative to global counterparts, and our view is that prices could be driven to record highs to match demand.

"Prior to 2020, ESG had become a business megatrend, and importantly, one that is recognised and treated as a dominant global economic risk. After a year where we've been trained to be constantly conscious of our surroundings and our health, we can only expect this will continue on a skywards trajectory."

– Kylie O'Connor

Offices in the 2020s

Undoubtedly, the impact of COVID-19 on the office market has been significant. Capital cities like Brisbane and Perth have held up relatively well so far, but markets like Sydney and Melbourne – home to the majority of COVID-19 cases this year – have felt the heat. However, we anticipate global investor appetite for these markets to remain strong, as they typically recover sooner from downturns relative to the smaller office markets.

As restrictions ease and the full impact of the pandemic evolves, businesses will be reconsidering their organisational structures and ways of working. 'Health security' will be top of mind amongst employers, as they seek to rebuild their team cultures and enhance collaboration in their workplaces. With that in mind, in many ways the pandemic has amplified existing demands of a modern workplace, one which is in line with ESG principles and supportive of ever-popular and now expected flexible working arrangements. In our view, more than ever, commercial landlords will need to come to the table with design and functionality which supports those expectations.

There are a few other key considerations on our radar in the office market, not least of which are the demands of space beyond this year. For example, there is not a one-for-one relationship between office space and flexible working. That is, an increase in flexibility of 20% for the workforce does not directly translate to a decrease of 20% of occupied space. There are a few reasons for this, such as enforceable regulations around people permitted per square metre. In short, commercial landlords will need to work closely with their tenants and be flexible and sensitive to their requirements in a post-pandemic world.

Retail evolution gathering pace

In a year where reduced foot traffic was effectively a government mandate, the retail sector took a significant hit, with sales across most categories falling. However, as those restrictions are eased, we think the market will be dealing with the familiar pre-pandemic changes as challenges, as opposed to an entirely new set of expectations. Global changes in consumer behaviour, household economics and the emergence of increased competition from online commerce are driving performance changes to bricks and mortar retail. These have been accelerated by COVID-19, but they are known to asset managers in the market.

Compared to other developed markets, Australia is well placed to defend asset valuations, due to constrained supply against a historic backdrop of robust population growth, prior to our borders being temporarily closed. However, we also believe asset owners and managers will need to adapt to find new opportunities against this backdrop.

The goal for investors in retail assets is typically low volatility and stable long-term income from a diversified pool of tenants. This formula has not changed. However, with significantly more structural than cyclical factors influencing returns at this point in the cycle, the outlook appears less certain than in previous cycles. This uncertainty may present opportunities, as pockets of pricing become dislocated from fundamentals which, compounded by low interest rates, makes yields on well-positioned assets more attractive.

Thinking for the long term

2020 was a radical year for the global economy and barely an investment market has remained unaffected. However, closer inspection of these impacts actually reveals a path well-trodden: real estate is a long-term investment, shaped and decided by long-term trends. We can't downplay the impact of 2020, but for AMP Capital Real Estate, recovery lies in sticking to that tried-and-tested truth. □

"There are a few other key considerations on our radar in the office market, not least of which are the demands of space beyond this year. For example, there is not a one-for-one relationship between office space and flexible working. That is, an increase in flexibility of 20% for the workforce does not directly translate to a decrease of 20% of occupied space."

– Kylie O'Connor

The AMP Centre

An artist's impression of the completed Quay Quarter Tower

A new statement in the sky

AMP Capital is close to completing a building project so large, it dwarfs a long history of firsts.

Story by SIMON ANDERSON

The AMP Building in Sydney, Australia's Alfred St was the first, and tallest skyscraper in the city when it opened in 1962[1].

Less than a decade later, the Australian Mutual Provident Society, as it was then known, awarded Australia's largest ever construction contract to build an even taller tower on a neighbouring block. 50 Bridge Street, or the AMP Centre, as it became known, was the tallest in the country when it opened in 1976[2].

Now, using the original core, AMP Capital is close to completing a building project that tops the lot. >

1. https://trove.nla.gov.au/newspaper/article/104924326
2. https://trove.nla.gov.au/newspaper/article/110462333

Enter: Quay Quarter

The Quay Quarter precinct, or 'Quay Quarter' as the new development is known, represents the culmination of AMP Capital's real estate experience, bringing together office, retail, dining and residential into an exciting new neighbourhood.

After years of planning and construction, the gleaming new building with its unique twisting form and white façade, is taking its place in Sydney's famous skyline.

"This is a best-in-class version of all the things that we truly believe in," says Luke Briscoe, AMP Capital Real Estate's Chief Operating Officer and Managing Director, Office and Logistics.

This time around though, height isn't the name of the game.

Instead, Quay Quarter is focused on rejuvenating life at street level for Sydney's Circular Quay district – and for the city of Sydney itself.

Occupied by the Aboriginal Gadigal people for at least 60,000 years, Circular Quay was the landing site of Governor Arthur Phillip and his First Fleet in 1788[3].

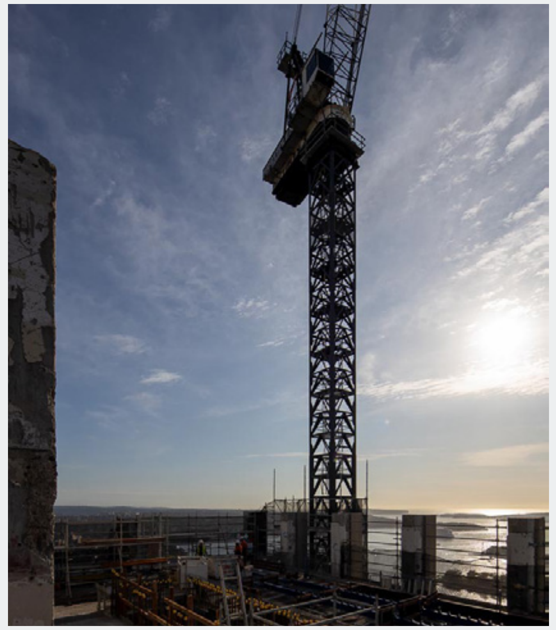
Some two hundred years later, decades of planning neglect had seen it decline into a tired cluster of office buildings adjoined by tourist eateries, fish and chip shops and a train station.

Now, the promise of the transformation of Circular Quay as the modern gateway to Sydney is coming to life, with a new light rail connection, refreshed pedestrian streets and clusters of laneways alive with cafes, bars and restaurants.

Quay Quarter is the centre of this activity, with its presence over two city blocks creating the kind of dense street-level life that Sydneysiders have always craved.

Inhabiting the lanes will be a cluster of bespoke retailers and boutiques, cafes, bars and restaurants.

Already, renowned restaurateur Scott Brown has committed to a 1,000 square metre, four-level Italian-themed restaurant and basement bar in a heritage-listed wool store. The historic Gallipoli Memorial Club, formed



Construction begins at Quay Quarter

Quay Quarter on the road to completion

An artist's impression of Quay Quarter Tower completed, overlooking Sydney Harbour

"The building retains 68 per cent of the original construction from the 1970s. This world-first decision to retain rather than demolish has saved 6.1 million kilograms of carbon emissions."

to remember the World War I campaign that killed 7,818 Australians[4], is looking forward to moving into newly restored premises in their own restored wool store.

Meanwhile, construction continues on more than 100 low-rise, high-end apartments – sold out in 2017 within two hours of release – which will see residents start to move in this year.

But it's above the street level that Quay Quarter is already having an impact on Sydney.

As Quay Quarter Tower's iconic façade rises through the rotating stacked blocks that protect from the sun and open views from the heads to the Sydney Harbour Bridge, the Sydney Opera House and beyond, Sydney is seeing a new landmark appear.

The rotation itself is a unique part of the design. The twisted form facilitates penetration of natural light into the workplace and gives occupants harbour and park views. The building features a series of indoor-outdoor workplaces with terraces and a podium garden, creating 4,000 square metres of green space.

"We expect this to be an example for future development," says Briscoe.

Inside, other features are taking shape.

Being a workplace designed to support high performance for its tenants, the 2,000 square metre floorplates, are connected by unique internal multi-level atria which help form one of the world's first true 'vertical villages'. The one-of-a-kind façade includes sculpted shading designed to reduce glare on windows, minimising the need for blinds.

Construction of Quay Quarter Tower by Multiplex is on schedule for delivery in Q2 2022. With more than 8,000 square metres of retail across the precinct including Quay Quarter Lanes, which is due to open later this year, the retail leasing program, finely tuned towards lifestyle, wellbeing and dining, is well under way, with several new retail leases signed in the last six months, including Hinchcliff House, Tokki (Jnr), Marrickville Pork Roll, The Men's Grooming, Tribe Lifestyle Hair, Zini Gelatisserie and Skittle Lane.

As the leasing program for the dining, lifestyle and wellbeing retailers in the podium continues, the office building itself is already over 85 per cent leased with three anchor commercial tenants: accounting and consulting firm Deloitte Australia, legal firm Corrs Chambers Westgarth and AMP Limited.

"We're working very closely with our customers – Deloitte, Corrs, EQT and AMP – and making sure that we're creating a great platform with them," says Briscoe.

"They see Quay Quarter as being their global exemplar of workspace and we want to work with them to ensure that can happen."

"It's not just our investor's building, it's theirs." □

3. https://sydneylivingmuseums.com.au/exhibitions/gadigal-place
4. https://gallipoli.com.au/about/

Turn down the noise to understand what's happening in the bonds market

As tends to be the case with headline market events, it's important to view them in context and with due credit to history. The bonds market in 2021 is no exception.

Story by SEAN AYLMER

"With apologies to Warren Buffet, it's not just the share market that can be described as manic depressive, but financial markets in general," says Shane Oliver, chief economist of AMP Capital.

"Just a year ago, investors were worried about depression and deflation with bond yields and share markets plunging. Now they're worried about overheating and inflation with bond yields rising rapidly, causing agitation in share markets."

Oliver has a point. Economists are known as dismal scientists. But maybe investors should be included as well.

A history lesson first. Warren Buffet, the so-called Oracle of Omaha and among the world's most successful investors, was a disciple of Benjamin Graham, who in 1949 published The Intelligent Investor – the most famous book ever written on investing. Graham invented the idea of Mr Market – an investor who was driven by panic, euphoria and apathy, on any given day. That's what Buffet means when he talks about markets being manic depressive. And in Oliver's eyes, there's just a touch of that going on in markets at the moment.

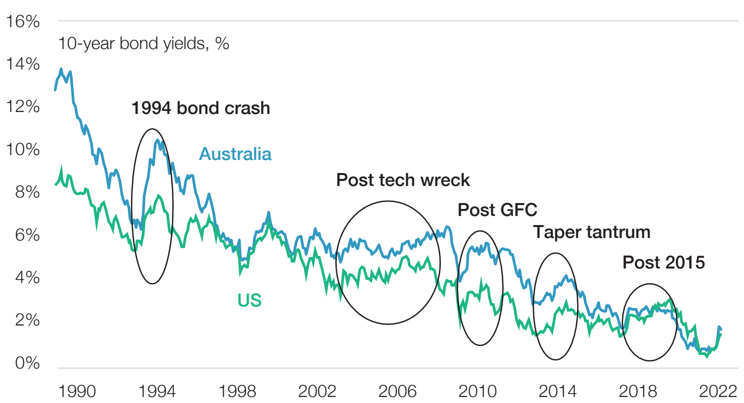
"From their lows in March, April of last year, 10-year bond yields have now increased by around 0.9 per cent in the US and one per cent in Australia," Oliver explains. "And a rise in bond yields means a fall in bond prices or a capital loss."

The rise in yields reflects confidence in the economic recovery. The roll-out of vaccines and massive policy stimulus in the US has convinced some investors that the Fed will have to tighten monetary policy, by lifting interest rates, earlier than planned. And there's a whiff of inflation around, which has also pushed up yields.

Higher energy and raw material costs and supply bottlenecks will push up goods prices, and given this year's data will be compared to price falls 12 months ago, the headline numbers could be high.

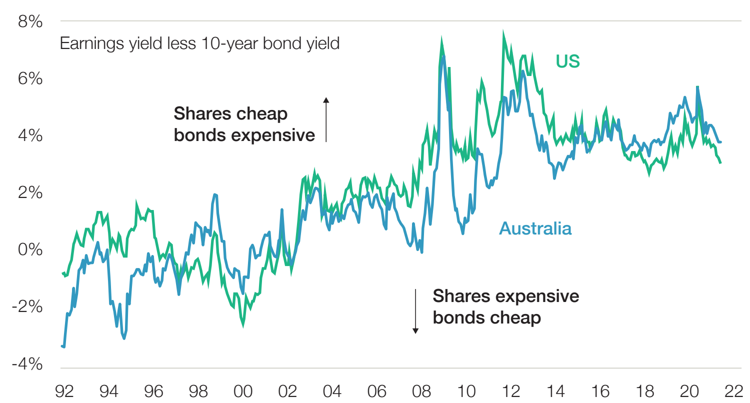
"We will likely see annual headline inflation measures rise to around 3.5 per cent to four per cent by mid-year in the US and Australia," Oliver says. >

US and Australian 10-year bond yields



Source: Bloomberg, AMP Capital

Shares remain cheap relative to bonds



Source: Thomson Reuters, AMP Capital

Bond yields normally rise during economic recoveries

When an economy is recovering, investors switch out of safe-haven bonds, and invest in growth assets like shares, Oliver says.

"It's normal. Bond yields rose after the early 1990s recession, in the mid-2000s after the Tech Wreck, and after the 2011-12 growth slowdown. They also rose after the 2015 global growth scare," he says. "The latest move is not unusual historically, although it has been very rapid this year."

Are higher bond yields a problem for shares?

At its most basic, lower bond yields are good for shares because they make investing in equites relatively more attractive. The opposite occurs when bond yields are higher.

"But it's never quite that simple as it depends on what happens to company profits," Oliver says.

"As we saw last year, a collapse in earnings expectations and share prices can occur alongside a plunge in bond yields."

The key factor is whether the return on offer from shares is enough above the return on bonds, given that equities are riskier.

"Despite the rally in shares since their lows in March last year, and the recent rise in bond yields, shares still provide a decent risk premium over bonds," Oliver says.

"In other words, bond yields have risen and so too have earnings expectations, by 13 per cent in the US and 12 per cent in Australia since mid-January."

"Bond yields rose after the early 1990s recession, in the mid 2000s after the Tech Wreck, and after the 2011-12 growth slowdown. They also rose after the 2015 global growth scare… The latest move is not unusual historically, although it has been very rapid this year."

– Shane Oliver

Do bond yield spikes hit some sectors harder than others?

In short, yes, says Oliver. "Particularly at risk are tech and health care stocks that will experience less of a cyclical uplift in earnings, and trade on higher price-to-earnings multiples," he explains.

These stocks' share prices rely more on earnings in the future. They are called 'long duration' stocks. Calculating the future profile of earnings involves bond yields, and if yields are higher, the value of future earnings is lower.

"Also at risk are stocks that normally have higher yields. There was a search for yield flowing from falling interest rates and bonds yields, and that helped telcos and utility stocks," Oliver says.

"But cyclical stocks like materials, retailers, industrial and even financials are less at risk as their earnings will rise more with the economic recovery. They are more likely to see earnings upgrades," he says.

Is 2021 different to previous bond crashes?

Undoubtedly some bond crashes have led to share markets tumbling, notably in 1994 when the local equity market ultimately fell 22 per cent. The economic recovery from the early 1990s became entrenched, and central banks lifted interest rates. The Fed hiked and then the RBA increased the official cash rate from 4.75 per cent to 7.5 per cent over a short period and the share market tumbled.

Again in 2013, bond yields rose sharply after the Federal Reserve in the US said it would slow bond purchases at a time when investors were still uncertain about growth. Wall Street fell eight per cent and the ASX was down 11 per cent.

"There's a strong case to be made that the disinflation seen since the 1970s is coming to an end and that the long-term trend in inflation is at or close to bottoming… Central banks are now throwing the kitchen sink at beating deflation and disinflation, just as they threw it at high inflation in the 1980s and early 1990s."

– Shane Oliver

The 1994 bond crash, and the 'taper tantrum' in 2013 were temporary, but both triggered a sell off on share markets.

"Today is a bit different because the recovery is less advanced than in 1994 or 2013, and central banks are not tightening or contemplating tightening," Oliver says.

The central banks have learnt their lessons

Central banks are full of smart people and the lessons of 1992 and 2013 have been well learnt, Oliver says.

"The Fed and RBA fear that bond markets are jumping at what will be a transitory hike in inflation over the months ahead as the deflation from a year ago drops out and higher commodity prices and goods supply bottlenecks impact," Oliver says. "Rather than repeat the mistakes of previous times where central banks tightened only to see growth slow again and inflation remain below target, they would rather look through any short-term spike in inflation."

In recent months central banks from the US to Japan, Europe and Australia, have worked hard to either boost bond buying to keep a lid on short-term rates, or use speeches to emphasise that there was still a long way to go in the economic recovery, Oliver says.

"There's been more push back from the central banks. The Reserve Bank has stepped up the pace of bond buying to maintain its 0.1 per cent target [for yields on three-year bonds] and brought forward purchases of longer-term bonds. Governor Philip Lowe said he would do more if needed[1].

"The central bank's focus is to allow the recovery to reduce the number of unemployed and underemployed workers. They want to see much higher wages growth before tightening, and that might be several years away," Oliver says.

Is it business as usual?

While the rise in inflation over the next couple of months will in all probability be transitory, it is possible that the world is coming to an end of a 40-year period of a declining trend in inflation and falling interest rates.

"There's a strong case to be made that the disinflation seen since the 1970s is coming to an end and that the long-term trend in inflation is at or close to bottoming," Oliver says. "Central banks are now throwing the kitchen sink at beating deflation and disinflation, just as they threw it at high inflation in the 1980s and early 1990s."

Oliver says there is now a possibility that massive government spending, more interventionist government policies, a reversal in globalisation and a decline in the number of workers, relative to consumers combined with aggressive central bank reflation, will defeat deflation and disinflation. The fiscal stimulus in the US in 2020 and 2021 will amount to about 23 per cent of gross domestic product – the largest since the Great Depression.

"Ultimately that could result in a sustained rise in inflation, though that is probably still a few years away. But it is consistent with the notion of the 40-year bond bull market in bonds being over. That means the bond sell off is quite possibly the start of a longer-term rising trend in yields," Oliver says.

"But as with inflation bottoming, this will take years to play out in the bond market."

What's the bottom line for investors? In the near-term bond yields could still go a lot higher before they fall back again. That could cause the long overdue correction in the equity market, Oliver says. "But the big cyclical backdrop for the next 12 months or so of still low underlying inflation and spare capacity in the jobs market, combined with economic and profit recovery and low interest rates is a positive one for growth assets." ☐

1. www.rba.gov.au

Britain in the wake of its big, bold move on the global stage

If it wasn't for COVID-19, the most important geo-political event in 2020 would have been Britain's exit from the European Union. In the wake of a brutal pandemic and political upheaval, Britain is facing a very different future.

Story by SEAN AYLMER

Instead, the most significant parting recent decades has gone relatively uncommented. What have been the consequences? Was it a success? Has the British economy collapsed as naysayers predicted?

There's no clear answer because so much economic activity across the global has been swamped by the coronavirus pandemic and its impact. But the early signs are that Brexit has possibly benefited the UK.

Perhaps more accurately, some European economies have been hamstrung by being part the Union in these unprecedented times. And that's not something the UK has had to worry about.

One way to think about it is through the prism of fiscal policy response and COVID-19, says Diana Mousina, senior economist at AMP Capital.

"There's a central block for the Eurozone controlling all economies," Mousina says. "But what countries need is greater flexibility around individual governments having more say around budget deficits and debt-to-GDP levels."

Weaker economies such as Greece, Spain and Italy, have been tied to rules about keeping a cap on debt levels. They haven't been able to devalue their own currency to boost economic growth.

"Britain was never quite as tied into the economic policy-making of Europe, even before Brexit. It still issued its own currency which was wise," Mousina says.

"Today in the UK, along with Australia and the US, the government is issuing huge amounts of debt which has been financed by the central bank printing money. Individual European countries whose currency is tied to the euro can't do that as easily."

The single currency across the Eurozone has not worked for many countries.

"Countries can't use their own currency to improve economic outcomes," Mousina explains. "Countries that are struggling like Italy, Spain and Greece … need a cheaper currency to compete in the global market."

The euro has appreciated sharply over the past 12 months again the US dollar, notwithstanding it has come off its peaks in the past couple of months. Appreciating currencies act as economic handbrakes.

"The euro has been performing well because Germany is a huge exporter in the global market," Mousina says.

"The region's largest and strongest economy has benefited from having a weaker currency than it would have had otherwise. Germany runs a very large current account surplus which tells you its currency would be more elevated if it were trading on its own terms."

While being independent of Europe may be advantageous to Britain in the future, it hasn't meant the country has done better than the rest of Europe.

Britain's growth rate last year during the pandemic compared poorly to the Euro area and was close to some of the worst performing European nations. But it was difficult to tell whether that was a function of Brexit, the pandemic, or something else.

"It's really quite difficult to see how Brexit has changed the economic backdrop in the UK because of the pandemic," Mousina says.

"COVID is the biggest driver of the economy in the UK and Europe, so it's hard to read the data and see the impact of Brexit. Is growth the result of the pandemic or the result of the UK leaving Europe?" she asks.

"Because individual countries in Europe can't devalue their currency to kickstart their economies, other reforms are needed in the Eurozone," Mousina says.

"They need to come up with some form of deposit insurance scheme. They need to strengthen their international institutions and they need to make people more accountable for their decisions around the financing of budgets. At the moment, the situation is not very coherent."

"There has been some improvement in recent years. The unemployment rate has come down a lot in the region, for example. But in some individual countries like Greece and Italy, there are a lot of problems in areas like youth unemployment and the banking sectors," she says.

More recently economists have cut growth forecasts for the region as the third wave of COVID-19 hits Europe. Delays in the roll-out of vaccinations have triggered further tightening of restrictions in major economies including Germany, Italy and France.

Forecasts that the European Commission made in February say that the near-term outlook had deteriorated as the pandemic tightened its grip on the continent. It forecast growth for the EU of 3.7 per cent this year, and 3.9 per cent next year. By the end of this year, some member states will reach pre-pandemic output levels. But others, particularly those reliant on tourism, would take longer. Inflation was likely to remain subdued[1].

In the United Kingdom[2], the Bank of England said that economic growth was expected to recover strongly over 2021 back towards pre-COVID levels. But unemployment was tipped to rise during the next couple of quarters. Britain started this year with GDP still about 10 per cent below its pre-pandemic level[3].

Growth rates in the region have real importance for Australia. The United Kingdom is the significantly bigger trade partner of the two. It takes 4.2 per cent of Australia's total exports, including gold, wine, lead and pearls and gems. The EU takes three per cent of exports, including gold, coal and oil seeds[4].

While it is too early, and too difficult because of the COVID-19 impact, to judge the success or otherwise of Brexit, Mousina says that many of the concerns voiced initially may prove unfounded.

"If Europe goes down the path of continued slow growth, that would have impacted the UK, because even though the UK wasn't part of the Eurozone, it was part of the European Union and it would have been impacted by some of the rules in the EU," she says.

"Also, the UK would have had to make a big contribution to the European budget, and they would have had less say in the services the money was spent on."

Another benefit of Brexit, it seems, has been in the roll-out of the COVID-19 vaccine. "One of the benefits of Brexit, potentially, has come with the vaccination of citizens. The UK has vaccinated a large portion of its population. If they were still part of the European Union, I'm not sure they would have been as successful," Mousina says.

"They have been able to act more independently. I don't think they would have been able to do all the vaccine production that they've done onshore if not for Brexit," she says. "Europe is clearly having issues, organising its supplies, and its redirecting supply to Australia and the UK to get its own vaccinations going."

For Brits, some of the more pessimistic forecasts of economic disaster post Brexit haven't eventuated.

"When Brexit happened people were worried about food shortages and supplies in supermarkets. But it hasn't actually happened. Some regulation around fresh food has been a bit of a problem because it is more time consuming and fresh food is getting stuck in trucks. But that is probably just a teething issue," Mousina says.

But it's not all positive.

"The services component of UK exports to Europe could be an issue, particularly for financial services and insurance. For example, openings in finance jobs in London have been declining. Amsterdam recently took over from London as the biggest share trading centre in Europe. We need to be careful interpreting the figures because of the impact of COVID, but it is interesting that they have declined," Mousina says.

While the UK may have benefited from not having to follow EU rules, many weaker economies in Europe are suffering, Mousina says. "That's what make me question the future growth of the Eurozone. The medium-term average for Eurozone GDP growth has been two per cent which is very low," she says.

"Productivity growth is extremely low. Youth unemployment in some countries is extremely high – 30 to 50 per cent – which is just unacceptable. And there's issues with population outflow because there's no future for some of those people. "

The inflexibility of the rules that come with being in Europe, post pandemic, seems to outweigh the benefits of being part of a trading bloc. And by good fortune or management, Brexit doesn't appear to have had overly negative consequences.

And Mousina's final word: "I think the concerns about Brexit in the UK may not actually turn out to be as bad economically as anticipated." □

1. https://ec.europa.eu/info/sites/info/files/economy-finance/ecfin_forecast_winter_2021_overview_en.pdf
2. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/march-2021
3. https://www.ons.gov.uk/economy/grossdomesticproductgdp
4. https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Foreign_Affairs_Defence_and_Trade/tradewithUK/Interim_Report/section?id=committees%2Freportjnt%2F024101%2F25066

About AMP Capital

AMP Capital is a global investment manager offering private market and public market solutions to clients, with a strong focus on ESG.

Our home strength in Australia and New Zealand has enabled us to grow internationally, and today we have operations in Dubai, China, Hong Kong, India, Ireland, Japan, Singapore, Luxembourg, the United Kingdom and the US. With over 250 investment professionals working in 19 locations around the world, we're able to deliver the capabilities and investment solutions that help our clients achieve their financial goals. We also collaborate with a network of global investment partners, leveraging our shared capabilities to provide greater access to new investment opportunities.

We are entrusted to manage A$190 billion[1] in assets under management on behalf of our clients, across a range of single sector and diversified funds. We work with more than 350 international clients and manage over A$20 billion in assets on their behalf[1].

Direct real estate

With a heritage spanning over 50 years, we actively manage real estate across all stages of the cycle. We realise true value for clients through the investment management, property management and development of a portfolio of some of the most iconic shopping centres, industrial estates and office buildings, from Australia's first skyscraper to the transformational Quay Quarter Sydney development.

Direct infrastructure

Backed by a truly global infrastructure platform, we're able to capture what we consider to be the best investment opportunities from around the world. It's earned us a name on a global stage, and a place as one of the top 10 infrastructure managers worldwide[2].

With 30 years' experience, we bring a breadth of insight that spans energy, power, transport, utilities, airports, seaports, communications infrastructure, social infrastructure, aged care and more. The combined expertise of close to 100 infrastructure investment specialists also allows us to cover all aspects of capital structure giving our clients more investment options for their future.

Public markets

Our well-established public markets business, including fixed income, listed equities and multi-asset solutions, requires shifting from traditional actively managed products to a specialist active offering of targeted solutions which meet specific client needs. Our public markets team remains focused on delivering investments that match our client's needs as we manage A$126.3 billion[3] across our global fixed income, multi-asset solutions, Australian equities, global listed real estate, global listed infrastructure and global equities solutions.

ESG and responsible investment

We believe considering ESG factors provides greater insight into areas of risk and opportunity that impact the value, performance and reputation of investments we make on behalf of our clients.

We recognise that all investments we make have a purpose and a wider impact and it's up to us to help make it a positive one for our clients and the global markets and communities in which we invest.

By looking at what we do as part of a bigger picture, we've developed a portfolio of responsible investment options for our clients. We are one of the first investment managers globally to sign the UN-backed Principles for Responsible Investment (PRI)[4]. Many of our funds have been recognised for their ESG performance. We continue to challenge and evolve our thinking, our processes and product offerings to meet our clients' growing expectations, partnering with them as they too look to fulfil their own goals and commitments to responsible investing. □

1. Data as at 31 December 2020. Note: AMP Capital AUM includes a 14.97% share of CLAMP AUM (8.8b).
2. Infrastructure Investor ranking 2020
3. As of 31 December 2020.
4. www.unpri.org

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