APRIL 2020

HOUSE VIEW

EXECUTIVE SUMMARY

Coronavirus continues to be the focus as questions remain over whether a second wave of contagion will eventuate. The market's reaction to the earnings season will be telling and should provide an understanding of how much bad news has been priced in. Growth assets are mildly underweight in our diversified portfolios. We prefer not to chase the current relief rally and instead will wait for confidence that recovery will be sustained before returning to our neutral weight.

OUR VIEW

The spread of COVID-19 continued to dominate headlines into April, from lockdowns in European countries to the world's leading economy, the United States, and now spreading to numerous emerging markets. From no more than 100 cases recorded in the US at the beginning of March, the death toll reached more than 21,000 at the time of writing. The situation in New York looks particularly dire, partly because more and more doctors and nurses are becoming infected due to a lack of protective equipment. In other US cities, too, the number of cases and deaths is skyrocketing. The oil price war between Russia and Saudi Arabia also added to investor concerns in March, although both sides now appear committed to agreeing to a resolution.

We currently assume that the extensive international lockdown of society and the economy will continue into May. We expect the subsequent defrosting will take place in small steps, and anticipate it would be another two months before the economy returns to more or less normal capacity utilisation.

This would mean that the Eurozone and US economies would likely contract by around 3% to 5% this year. But there are many question marks. Will there be a second wave of contagion? And how strongly would policymakers react to it? In addition, there is the question of what other domino effects could result from corporate or even state bankruptcies? We are particularly concerned about countries whose economies are heavily dependent on exports, especially oil, and tourism. But we are also worried about Italian public debt, which is likely to get out of hand, and the stress this may place on the unity of the Eurozone. In the longer term, we will again be dealing with fundamental questions of debt sustainability in all nations and the outlook for inflation and yields.

Adding to all the uncertainties around the virus is the lack of clarity around the earnings season, which we expect will likely disappoint and potentially cause the market to re-test recent lows.

In the short term, however, the virus remains the focus. The infection and death rates, medical progress in combatting the illness, and society's ability to manage the pandemic are all going to be crucial. It is important to note that while uncertainty conjures more bad associations than good, as asset managers, we should also focus on the upside of potentially good surprises.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

In line with our base case scenario, we are maintaining our mild underweight to growth assets with a preference for emerging market equities over developed market (DM) equities. We prefer not to chase the current relief rally but will wait for what we expect to be better entry points later this quarter to increase the weighting to growth assets in the diversified portfolios.

PORTFOLIO POSITIONING

	SAA	TAA	Over/ Under weight
Growth assets	70%	70%	0%
Australian equities	26%	25%	-1%
Developed market equities	28%	27%	-1%
Emerging market equities	4%	6%	2%
Listed real assets[1]	6%	6%	0%
Alternative growth	6%	6%	0%
Defensive assets	30%	30%	0%
International fixed income	8%	8%	0%
Australian fixed income	12%	12%	0%
Cash	10%	10%	0%
Foreign currency hedge ratio[2]	30%	23%	-7%

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS:	We have allowed growth assets to drift in a mild underweight range in our discretionary portfolios as market volatility persists at a high level (albeit significantly reduced from its peak several weeks ago). There is a possibility of a second wave of negative coronavirus news flow. As a result, we prefer not to chase the current relief rally and instead wait for confidence that a recovery can be sustained before returning to our strategic weight.
Developed market equities:	Short-term asymmetric risks to the downside persist within developed market equities. While countries continue to close borders, supply chains remain disrupted and as global COVID-19 infection rates rise, global economic growth will continue to suffer as a result. Market movements during the month originally took us below our 1% underweight developed global equities target but have since rebounded back close to target. US remains slightly preferred within developed market equities given quality and structural growth characteristics.
Australian equities:	We remain underweight Australian equities, primarily due to relative valuations and a subdued outlook for the market's key sectors (Financials and Resources). As domestic equities are heavily biased towards these sectors relative to global peers, both lower interest rates and lower commodity prices are detrimental. Market movements have taken us below our -1% TAA target and we remain comfortable with this position whilst we wait for clear market signals to return to target and benchmark.
Emerging market equities:	Our preference for emerging market (EM) over developed market equities is largely driven by positive outlook for Chinese equities given China's ability and willingness to stimulate the economy, with COVID-19 seemingly under control. China is also expected to benefit from lower oil prices as production activity starts to pick up again. However, more sustained outperformance will likely depend upon the US dollar (USD) weakening. Actual asset allocation is close to our 2% overweight target.
Listed real assets[1]:	Despite lower yields we have seen significant underperformance from REITs relative to global equities. Valuations look more reasonable but parts of the sector might face more structural challenges ahead. We see strategic opportunities in listed infrastructure given lower for longer rates scenario and potential fiscal support via infrastructure spending. No compelling evidence to suggest real assets will outperform or underperform other growth assets drives the neutral position.

Alternative growth:	Alternative growth assets are held at benchmark. We continue to advocate a long-term strategic allocation to alternative risk and return drivers in order to provide diversification from equity beta. This asset class typically has less volatility than listed real assets (which has played out in recent weeks) and is therefore a valuable diversifier in periods of extreme markets conditions. Drift has taken us slightly above our benchmark weight.
DEFENSIVE ASSETS	We have allowed drift to give us a mild overweight position to defensive assets. As a result portfolios will remain long duration (except the portfolios with no fixed income exposures) in the near term, concentrated in international fixed income. Duration remains one of our preferred diversifiers in a volatile environment. Rates markets remain supported by a modest growth, easy central bank stance, hunt for (positive) yield by investors and (geo)political risks. Tactically, we see yields being range-bound and hence there are opportunities to use flexibility in order to manage portfolio risk.
International fixed income:	US Treasuries have been the most powerful diversifier for our portfolios in the last few weeks and whilst yields are very low, they remain a worthwhile risk hedge as elevated market unpredictability prevails. We have allowed drift to bring us overweight international fixed income and will look to reduce this once markets stabilise. We have a preference for the more liquid parts of the fixed income universe.
Australian fixed income:	Australian bond yield spreads have narrowed further. The fragility of the domestic economy remains supportive for Australian bonds. We may look to reduce our mild overweight drift once markets stabilise.
Cash:	We are close to our benchmark weight to cash, which we see as an important risk mitigation measure.
FOREIGN CURRENCY HEDGE RATIO[2]	We have retained our underweight Australian dollar (AUD) hedge ratio for global equities given the AUD is a risk currency; that is AUD tends to fall in equity market sell-offs.

Notes:
1. Comprises of 50/50 split between GREITs and infrastructure securities.
2. Percentage of developed market and emerging market equities hedged from foreign currency into Australian dollars.
Representative diversified portfolio with 70/30 growth/defensive assets.
As at April 2020.