AUGUST 2020

HOUSE VIEW

EXECUTIVE SUMMARY

In recent times, investors — particularly Victorians who re-entered stage-3 lockdowns in July — could be forgiven for thinking they were stuck in a scene from the 1993 Bill Murray film, Groundhog Day. The US-China tit-for-tat is seemingly never-ending, COVID-19 cases continue to escalate globally, gold's lofty ascension persists and despite all this, share markets keep on keeping on — the S&P 500 gaining a further 5.6% in July. This continued rise in equity prices, against significant headwinds, has strengthened our belief that a short-term pullback lies ahead prior to a sustained recovery. We have recently trimmed growth assets further, specifically developed markets and Australian equities, and remain underweight growth assets.

OUR VIEW

July saw broader share markets rise for the fourth consecutive month, following improved macro-economic data and surprisingly positive outcomes from the US reporting season — both from low baselines. European equities however did come under some pressure, following COVID-19 flare-ups and disappointing GDP numbers across the region.

A significant drop in real interest rates across the US and Europe also saw the price of gold rise 10.9% in July — the biggest monthly gain since 2012 — to reach all-time highs, although the price has retraced somewhat recently, following a lift in global bond yields.

Whilst macro data has improved recently and appears to be stabilising across the globe, prints remain low at pre-crisis levels. We now have increased confidence in the recovery however believe it is likely to be a volatile road ahead.

As such, markets are teetering on an interesting precipice. On one side, the continued rise in equity prices has supported our mild dislike for risk assets at this stage — given they are more expensive. Equity risk premia has come down significantly following the fall in earnings — the drop even more pronounced than falling bond yields — and this can be interpreted as a rising risk factor. Escalating Sino-US conflicts present further near-term downside risk.

On the other side, the pipeline of potential COVID-19 vaccines, in particular a shift to phase 3 trials, has potential to provide an upside breakout for equities in the short-term, especially amongst some cyclical companies.

In trying to balance these views we believe risks remain weighted to the downside, portfolio positioning data suggests the 'pain trade' remains a real possibility and that TINA "There Is No Alternative (to stocks)" has been a catalyst for markets advancing further on the back of huge fiscal and monetary stimulus.

The AUD now appears over-valued and we believe it is likely to remain range-bound in the short-to-medium term.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

We allowed equity outperformance to run across portfolios in recent months, pushing our allocation to risk assets closer to benchmark. In late July, we rebalanced our portfolios in order to maintain our mild underweight to growth assets, expressed via a reduction in Australian and developed market equities.

We also took this opportunity to reduce our underweight to the AUD, however maintain an underweight position as a form of portfolio protection in the event of an equity market sell-off.

Within defensive assets we continue to favour global fixed income and cash.

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HOUSE VIEW

PORTFOLIO POSITIONING

	SAA	TAA	Over/ Under weight
Growth assets	70%	66%	-4%
Australian equities	26%	24%	-2%
Developed market equities	28%	27%	-1%
Emerging market equities	4%	4%	0%
Listed real assets[1]	6%	6%	0%
Alternative growth	6%	6%	0%
Defensive assets	30%	34%	+4%
International fixed income	8%	10%	+2%
Australian fixed income	12%	12%	0%
Cash	10%	12%	+2%
Foreign currency hedge ratio[2]	30%	22%	-8%

SAA – strategic asset allocation
TAA – tactical asset allocation

Figures may not add up due to rounding

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS:	Headwinds in the form of geopolitical tensions and increasing COVID-19 cases persist and as such we position our portfolios with an underweight to growth assets, with an expectation of further volatility ahead. This position was maintained towards the end of July, via a reduction in Australian and developed market equities, which had appreciated strongly.
Developed market equities:	Downside risks persist within developed market equities. We maintain a slight preference for European equities over other developed markets. If markets continue to rally European equities should offer some upside protection and benefit from style rotations — as seen in mid-August — into Cyclicals and Value, given their greater exposure to these areas.

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. Second-wave lockdowns in the state of Victoria have stalled the economic recovery further.
Emerging market equities:	Recent outperformance from the sector, has resulted in the region's ranking falling within our scoring framework we remain neutral at this stage however.
Listed real assets[1]:	Our view holds that a global recession is likely to put downward pressure on rents, with retail and offices expected to be hit harder than residential and industrial Real Estate. REITS remain under further pressure, with shopping centres challenged by e-commerce and office spaces suffering from the mobilisation of workforces into homes. Asia and Europe are expected to recover quicker than the United States. We see strategic opportunities in listed infrastructure given the "lower for longer" rates scenario and potential fiscal support via infrastructure spending, however without a compelling case for real assets outperforming or underperforming other growth assets, we remain neutral and seek to avoid unnecessary turnover in the portfolio.
Alternative growth:	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 continued to play out) and is therefore a valuable diversifier in periods of extreme markets conditions. Therefore, alternative growth assets remain at benchmark.
DEFENSIVE ASSETS	Our overweight position to defensive assets is expressed via global fixed interest and cash. Global fixed interest provides duration to the portfolio, which remains one of our preferred diversifiers in a volatile environment. Whilst yields are low and expected to remain so, this position provides downside protection in the event of an anticipated equity sell-off in the near-term. Rates markets remain well supported by central bank policies and geopolitical risks which continue to gather momentum.
International fixed income:	Unprecedented monetary stimulus should keep yields and spreads low, however fiscal stimulus needs to be financed and is leading to higher supply that needs to be absorbed. Overall we retain a slight overweight to global bonds, primarily due to its long duration characteristics and as as a low yielding but stable investment offering, diversification and downside protection.
Australian fixed income:	We maintain a close to neutral position in domestic bonds for the time-being, preferring to express our overweight to defensive assets via cash and global fixed income.
Cash:	We remain overweight cash. This position is retained to reduce risk in our diversified portfolios. Cash along with global fixed income remains our preferred asset class within defensive assets.
FOREIGN CURRENCY HEDGE RATIO[2]	During the month we reduced our underweight to the AUD based on valuation. We retain an underweight position to the AUD, given it is a risk currency and risk remains skewed to the downside. The position aims to provide further protection in the event of a global equity sell-off.

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 14 August 2020.