FEBRUARY 2020

HOUSE VIEW

EXECUTIVE SUMMARY

After moderately reducing risk in our diversified portfolios last month, we have put risk back on in non-US equities while reducing the duration overweight. With the rate of new coronavirus infections slowing down, and further easing in global financial conditions since the beginning of the year, we remain constructive on the equity outlook for 2020.

OUR VIEW

The outbreak of the novel coronavirus, initially centred in the Chinese city of Wuhan, has been a key focus of financial markets in the past month. Major equity markets initially fell in response to this news, as did bond yields and the Australian dollar. However, while the human and economic toll of the virus continues to mount, equity markets have begun to look through this, led by the US S&P 500 Index, which has posted new all-time highs.

The market's recent behaviour is in line with previous outbreaks of infectious diseases. Past episodes have pointed to short-term economic weakness and that the market correction would be followed by a recovery once the number of new infections starts to decline.

However, we are cautious about the limits to how far the comparison with the past can be extended given the increased size of the Chinese economy and Australia's dependency on it. But while there is no doubt there will be a soft patch of growth in the March quarter, particularly in China, we anticipate a rebound in subsequent quarters as the spread of the disease is contained. Further easing in global financial conditions since the beginning of the year, additional stimulus measures from China and lower oil prices add to this case. We continue to expect our base case to play out – moderate economic growth, restrained inflation, accommodative central banks and range trading bond markets – and retain a constructive outlook for equity markets in the year ahead.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

After moderately reducing risk in discretionary diversified portfolios last month on perceived short-term asymmetric risks to the downside, we have moved growth assets back to benchmark. The re-risking has been concentrated in increasing global equities back to a small overweight.

For portfolios with an exposure to Emerging Market (EM) equities – the Dynamic 70 and the D100 portfolios - we have moved to overweight EM from benchmark. We believe EM equities have medium-term catch-up potential versus developed markets, with more attractive valuations. Hong Kong protests, trade conflict and coronavirus have all been a drag on EM equity performance for some months. With coronavirus infection rates slowing, liquidity support by the Chinese central bank, and additional Chinese stimulus to ensure economic stability, we believe there is a medium-term opportunity for EM to outperform developed markets.

For the Dynamic 30 and 50 portfolios, which have no EM equity exposure, we have made the move back to benchmark growth assets by going overweight European and Japanese equities. These countries provide a cyclical/ value-oriented exposure at a better relative valuation to the S&P 500. We have reduced the overweight to US shares close to benchmark. Australian shares remain underweight.

Within defensive assets we continue to invest in a range of short and longer-dated fixed income securities. The price of a fixed income securities is sensitive to a change in interest rates - this is called duration. In a risk-off situation if bond yields decline this results in a rise in the price of the bond and the longer the period to maturity, the larger this impact will be. This duration effect remains one of our preferred diversifiers in a potential risk-off environment. Tactically, we see yields being range-bound. Australian fixed income remains at benchmark.

We have also modestly increased the hedge ratio following a weakening in the Australian dollar. The change within our regional equity exposure has driven this move, with a reduction in US dollar exposure offset in part by increased EM currencies, the Euro and the Yen. Overall we are still below benchmark on the hedge ratio, which provides a more defensive positioning for our international equity exposure.

ANZ PRIVATE

STRATEGY TILTS

	Dynamic 30 portfolio (D30)			Dynamic 50 portfolio (D50)		
	SAA	**TAA**	**Over/ Under weight**	**SAA**	**TAA**	**Over/ Under weight**
Growth assets	**30%**	**30%**	0%	**50%**	**50%**	0%
Australian equities	9%	8.7%	-0.3%	18%	17%	-1%
Developed market equities	11%	11.3%	**0.3%**	22%	23%	**1%**
Emerging market equities	-	-	-	-	-	-
Listed real assets[1]	5%	5%	0%	5%	5%	0%
Alternative growth	5%	5%	0%	5%	5%	0%
Defensive assets	**70%**	**70%**	0%	**50%**	**50%**	0%
International fixed income	20%	21.7%	**1.7%**	14%	16.5%	**2.5%**
Australian fixed income	30%	30%	0%	21%	21%	0%
Cash	20%	18.3%	-1.7%	15%	12.5%	-2.5%
Foreign currency hedge ratio[2]	**30%**	**24%**	**-6%**	**30%**	**23%**	**-7%**

	Dynamic 70 portfolio (D70)			Dynamic 100[3] portfolio (D100)		
	SAA	**TAA**	**Over/ Under weight**	**SAA**	**TAA**	**Over/ Under weight**
Growth assets	**70%**	**70%**	0%	**97%**	**97%**	0%
Australian equities	26%	25%	-1%	37.5%	36.5%	-1%
Developed market equities	28%	27%	-1%	39.5%	38.5%	-1%
Emerging market equities	4%	6%	**2%**	6%	8%	**2%**
Listed real assets[1]	6%	6%	0%	7%	7%	0%
Alternative growth	6%	6%	0%	7%	7%	0%
Defensive assets	**30%**	**30%**	0%	**3%**	**3%**	0%
International fixed income	8%	10%	**2%**	-	-	**-**
Australian fixed income	12%	12%	0%	-	-	-
Cash	10%	8%	-2%	3%	3%	0%
Foreign currency hedge ratio[2]	**30%**	**23%**	**-7%**	**30%**	**24%**	**-6%**

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: D30/50: benchmark D70/100: benchmark	After moderately reducing risk in the discretionary diversified portfolios last month on perceived asymmetric risks to the downside, we have moved back to benchmark growth assets. The re-risking has been concentrated in raising global equities back to a small overweight. The move back to benchmark for the D70 and D100 portfolios is from going overweight Emerging markets (EM) and for the D30 and D50 portfolio an overweight to European and Japanese equities. There is no doubt that the timing of the current coronavirus outbreak poses risks to the investment cycle. However, we retain a constructive outlook for equity markets in the year ahead on the back of a slowing in the rate of new infections, a further easing in global financial conditions and falling oil prices all supportive for the market.
Developed market equities: D30/50: overweight D70/100: underweight	Economic indicators over the past month continue to point to a base forming in the global industrial and trade cycle after slowing for most of the past two years. Along with ample liquidity this has driven a further rally in equity markets. Developed markets (DM) are fully priced, particularly the United States which after a mild set back in late January has bounced back to a new all-time high. In the D70 and D100 portfolios, we have a mild preference for EM over DM. For the D30 and D50 portfolios, which have no EM equity exposure, the move back to benchmark in growth assets is via an overweight in European and Japanese equities, which provide a cyclical/ value-oriented exposure at a better relative valuation to the S&P 500. We have reduced the overweight to the US close to benchmark.
Australian equities: D30/50: underweight D70/100: underweight	Australian macro lead indicators have improved by still point to relatively modest growth. Valuations are stretched and are now above the top of our fair value range as the market has factored in policy support from tax cuts, lower interest rates and some easing in lending restrictions. Earnings indicators are mixed with risks still present from the subdued economy in addition to stock specific risks flowing from the coronavirus outbreak. Given the relatively large concentration the market has in both Banks and Resources, investors not wanting an exposure to either of these are forced to buy elsewhere - the Industrials ex Financials PE ratio is trading at over 26 times, and above its average of a little below 16 times. The Australian market tends to do well relative to other markets during periods of risk aversion or when global bond yields are falling – with little earnings support the market appears to be running on "lower for longer" bond yields.
Emerging market equities: D70/100: overweight	Macro lead indicators for the region and earnings-per-share (EPS) growth are still weak, although signs of a base in the global industrial cycle are supportive. However, valuations remain generally more attractive than developed markets and we believe EM equities have medium-term catch-up potential versus developed markets. Hong Kong protests, trade conflict and coronavirus have all been a drag on EM equity performance for some months. With coronavirus infections slowing, liquidity support by the Chinese central bank, and Chinese stimulus to ensure economic stability we believe in a medium-term opportunity to see EM outperforming DM.
Listed real assets[1]: D30/50: benchmark D70/100: benchmark	Real assets are at benchmark. While valuations in global listed property and infrastructure are expensive in absolute terms and relative to core equities, relative to bonds this asset class is trading broadly in line with its own historical experience. Real assets generally do well in periods of uncertainty while bond yields are low given attractive dividend yields and the low cyclicality around much of the sector's earnings. The direction of bond yields going forward is important for this asset class. We hold a strong structural low for longer world view, in which real rates, especially in the US, are still too high and need to converge further. The US Fed's structural change in its asymmetric reaction function will keep them on a dovish footing and therefore duration represents a good diversifier in a potential risk-off environment.
Alternative growth: D30/50: benchmark D70/100: benchmark	Alternative growth assets are held at benchmark. This asset class adds to diversification and it typically has less volatility than listed real assets. It should provide protection if volatility in risk assets increases in the months ahead.
DEFENSIVE ASSETS D30/50: benchmark D70/100: benchmark	Within defensive assets we remain long duration (except the D100 portfolio). Global fixed income is overweight however this month we have reduced this on the back of lower bond yields. Duration remains one of our preferred diversifiers in a potential risk-off environment. Rates markets remain supported by a modest recovery in 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: D30/50: overweight D70: overweight	After the strong recent rally and directional bull curve flattening in line with our range-bound view, we have reduced, but still maintain an overweight in international fixed income. As we hold a strong structural low for longer world view, in which real rates, especially in the US, are still too high and need to converge further; where negative rates increase (not decrease) savings rates; and where structural short duration gaps by pensions funds and insurance companies are still significant, we are buyers of any material dip. Coronavirus, and in particular, the question of whether or not the possible peak in infections will be reached soon is likely to be key for global risk sentiment and potentially breaking the defined range in rates. In the near term, central banks are still expected to deliver on market expectations. The Fed is in a 'wait and assess' mode while the European Central Bank seems cornered for now (with credit easing more likely down the line versus deposit cuts and additional quantitative easing). We do not expect US Fed hikes to be priced in any time soon. The US Fed's structural change in its asymmetric reaction function will keep them on a dovish footing. Hence, US yields are asymmetrically skewed towards lower levels and therefore duration represents a good diversifier in a potential risk-off environment.
Australian fixed income: D30/50: benchmark D70: benchmark	Australian fixed income has rallied strongly and signals remain neutral on subdued inflation and expectations that the Reserve Bank of Australia would ease rates further in 2020. Inflation expectations are subdued compared to the rest of the world, and in conjunction with an improved fiscal outlook, should anchor yields below the US. The fragility of the domestic economy creates the bull case for Australian bonds. The unemployment rate has been stuck around 5.3% for a few years now and wages growth remains soft. The RBA has indicated a willingness to cut the cash rate by a further 0.50% if required, but recent data and concerns over financial stability have raised the bar for any short-term move.
Cash: D30/50: underweight D70: underweight D100: benchmark	Within defensive assets we have a mild preference for fixed income over cash. Duration remains one of our preferred diversifiers in a potential risk-off environment. The upside on yields is limited at present as subdued inflation and below-trend economic growth continue to provide a supportive environment for bond markets.
FOREIGN CURRENCY HEDGE RATIO[2] D30/50: underweight D70/100: underweight	We have increased the hedge ratio following a weakening in the Australian dollar. The change within our regional equity exposure has driven this move, with a reduction in US dollar exposure offset in part by increased EM currencies, the Euro and the Yen. Overall, we are still below benchmark on the hedge ratio, which provides a more defensive positioning for our international equity exposure. Weakness in the domestic economy provides a clear downside risk to the currency from its current level.

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.
3. Dynamic 100 Tax Payer model

As at February 2020.