MARCH 2020

HOUSE VIEW

EXECUTIVE SUMMARY

In the near term, we believe markets will continue to be on edge as investors grapple with contradictory signals. On the one hand, there is the prospect of further government aid packages. On the other hand there are likely to be further negative reports on the virus and the consequences of its spread. Whilst short-term asymmetric risks to the downside have increased, we maintain our view that COVID-19 should be transitory in nature and remain positioned with a neutral stance to growth assets.

OUR VIEW

News of the coronavirus' (COVID-19) spread outside of China in the last week of February, and the war for market share among oil producers saw global share markets fall significantly in recent days. Global contagion picked up markedly in early March.

The moves were indeed dramatic: 10-year U.S. government yields peaked at 1.68% at the beginning of February then fell to 0.50% on March 9, far below their previous record low of 1.325% in June 2016.

Markets were also unsettled by sharply declining commodity prices. A price of $US45 per barrel for West-Texas-Intermediate (WTI) oil caused the Bloomberg Commodity Index to fall to its lowest level since 1987. But the most emphatic of all the moves was in stock markets. In the last week of February they underwent one of the most severe corrections in their history, which continued into March. Volatility, as measured by the Vix for the US S&P 500 index, was over 30 for several days at the turn of the month, peaking at almost 50, a level attained on only a handful of days in the past 10 years.

In the near term, we believe markets will continue to be on edge as investors grapple with contradictory signals. On the one hand, there is the prospect of further government aid packages. On the other hand there are likely to be further negative reports on the virus and the consequences of its spread. The World Health Organisation has added to the panic by declaring coronavirus a "pandemic" on March 11. In our view, indications that the virus is being contained will be key to how this situation eventually unfolds.

Clearly, uncertainties surrounding the virus and its disruption to supply chains and impact on demand will require us to re-examine existing growth forecasts, but many of our core scenarios from last month remain valid. In particular, the ongoing low interest-rate environment should continue to have a strong impact on all asset classes.

Overall, we expect the slowdown in growth will now be more pronounced but we continue to believe that the virus will only temporarily affect markets and that the global economy as a whole will more or less continue on its previous growth path later this year. However, this cautiously optimistic scenario has been tempered by recent events and is conditional on the dip in growth and profits not leading to lasting liquidity and solvency problems.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

In line with our base case scenario, we are maintaining our benchmark exposure to growth assets with a preference for emerging market equities over developed market (DM) equities. Emerging markets, in particular China, has the ability and willingness to stimulate the economy. We remain underweight Australian equities, primarily due to relative valuations and a subdued outlook for the market's key sectors (Financials and Resources).

We are moving international fixed income from overweight to benchmark after a strong move down in bond yields (significant price increase) in favour of cash. We retain our benchmark position for Australian fixed income. We will implement this in multiple tranches as we reverse market movement 'drift.'

STRATEGY TILTS*

	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%	10%	0%
Australian fixed income	12%	12%	0%
Cash	10%	8%	0%
Foreign currency hedge ratio[2]	30%	23%	-7%

SAA – strategic asset allocation
TAA – tactical asset allocation
* The strategic tilts are in the process of being implemented.

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: **Benchmark**	Recent record falls in equity markets have seen our benchmark growth position from last month drift to a mild underweight in our discretionary diversified portfolios. Growth assets will be returned to benchmark weight, with a continued slight preference for emerging market equities over developed market equities. While the coronavirus containment issue and its long-term impact remains to be seen, we retain a constructive outlook for equity markets based on our expectation that the virus would likely be transitionary, and fiscal and monetary policies to be supportive. That said, downside risks remain in the short term and as such we are only seeking to buy-back half our 'drift' at this stage. Upside volatility can be quite violent (if not more violent) after such a short and severe correction and as such we seek opportune times to re-enter the market.
Developed market equities: -1% underweight	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 suffer as a result. Market movements have taken us below our 1% underweight developed global equities target and we will rebalance half of this 'drift', returning all the way back to 1% underweight when we see signals indicating markets are normalising.
Australian equities: -1% underweight	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. Again market movements have taken us below our target and we will rebalance with half of this 'drift' in line with our approach to developed global equities.
Emerging market equities: 2% overweight	Our preference for emerging market (EM) equities is driven by the attractive price to earnings valuation discount of EM vs. the U.S. Additionally, exposure to China is favourable on the basis of infection rates peaking and stock prices being likely to rebound ahead of other markets. China is also expected to benefit from lower oil prices as production activity starts to pick up again. However, more sustained outperformance will depend upon the US dollar (USD) weakening.

Listed real assets[1]: Benchmark	Real assets remain at benchmark. Solid fundamentals and favourable conditions (due to low interest rates) should support listed real assets, which generally outperform equities in periods of uncertainty.
Alternative growth: Benchmark	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 and is therefore a valuable diversifier in periods of extreme markets conditions.
DEFENSIVE ASSETS Benchmark	Within defensive assets we are maintaining a benchmark strategy, but altering the mix by returning back to benchmark fixed income (from overweight) and cash (from underweight). However, for the moment with expectations of choppy market conditions continuing in the near term, with greater downside than upside likely, we are taking a measured approach to bringing the portfolios to these new targets. Our immediate move will bring us halfway back to our new target position and we intend to complete the second half as we see signals that markets are normalising. 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 potential risk-off 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: Benchmark	After the strong recent rally we look to reduce the portfolios' bias towards international fixed income. Our new target is benchmark but we will look to reduce it back to this new target in 2 stages given we see the immediate risks biased to the corresponding downside for risk assets. After the strong rally in bond yields and directional bull yield curve flattening in line with our range-bound view, we see it as appropriate to take profit and go back to benchmark – at least for now. 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 the range for bond yields.
Australian fixed income: Benchmark	Our preference to date has been towards international fixed income as U.S. Treasuries have been the most powerful diversifier for Multi Asset portfolios and should continue to do so. Bond yields are trading at all-time lows with the spread of Australian bond yields having narrowed significantly to only a few basis points. The fragility of the domestic economy remains supportive for Australian bonds. The unemployment rate has been stuck around 5.3% for a few years now and wages growth remains soft. The Reserve Bank of Australia has indicated a willingness to cut the cash rate by a further 0.25% and to undertake quantitative easing if necessary. We remain neutral for now.
Cash: Benchmark	At current yield levels we target fixed income and cash to be benchmark, from a bias for fixed income over cash. However, duration remains one of our preferred diversifiers in a potential risk-off environment. The upside on yields is limited at present as subdued inflation, below-trend economic growth and the fallout from the coronavirus continue to provide a supportive environment for bond markets.
FOREIGN CURRENCY HEDGE RATIO[2] -7% underweight	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 March 2020.

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