MARCH 2021

HOUSE VIEW

EXECUTIVE SUMMARY

Market expectations surrounding a return of inflationary pressures saw bond markets nosedive in February, despite governments continuing to voice rhetoric around loose monetary policy. Given the existing output gaps globally and the fact unemployment levels remain below their pre-pandemic peak we believe concerns surrounding the potential return are currently overstated. We expect markets to continue focusing on the economic reopening trade and vaccination roll-outs in the near-term. As such, we have increased our exposure to growth assets via positions in emerging markets and global REITs.

OUR VIEW

In February, murmurings and expectations about one word, inflation, sent global markets into meltdown. Participants are in a frenzy as to when, how quickly and with what velocity it will return.

The global economic reopening and potential for further fiscal stimulus has seen government bond markets sell-off as investors' eye greater optimism around the longer-term outlook. This has seen the yield curve steepen significantly, with the long-end of the curve rising much faster than the short-end — the US ten-year yield reaching 1.5% during February, up from 0.9% at the beginning of the year.

While expecting near-term inflation prints to be elevated from their current levels, we don't see inflation meaningfully materialising in a sustained manner until at least 2022.

Financial markets and central banks appear to be at a stand-off as to who will blink first with investors banking on the prospect of policymakers being late to the party and having to hike rates aggressively in the longer-term. Central banks have maintained their comfort with the current environment and pledged their commitment to loose monetary policy in the near-term. We view the current concerns surrounding rising rates as overstated — particularly given unemployment levels remain below their pre-pandemic peak and outputs gaps exist globally.

Amongst the mayhem, equities have continued their outperformance and while valuations remain challenging, markets have been buoyed by growth prospects associated with successful vaccination roll-outs and falling COIVD infection rates. Any interruptions to vaccine roll-outs are considered the greatest downside risk.

Within the equity bucket, we see a continued outperformance of 'value' stocks in the short term, as the reopening of economies supports cyclical industries which were supressed by COVID restrictions. 'Growth' stocks are typically driven by longer term dynamics, making them more sensitive to a higher discount rate. Put simply, if rates rise, growth stocks are typically hit hardest.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

We believe the risk of inflationary pressure is overstated and that markets should continue to be supported by the growth story from the economic reopening trade. As such, we have increased our exposure to growth assets.

Given our view that 'value' should outperform in the near-term, we have taken emerging market equities overweight. The asset class is highly cyclical, and should continue to benefit from the reopening trade and a weakening US dollar.

We've also increased our exposure to listed real assets via global REITs (GREITs). GREITs are another cyclical asset likely to profit from the reopening trade. The asset class faces longer-term structural issues but we believe it is presently undervalued. GREITs should also provide a potential hedge to inflationary pressures if they materialise.

These positions have been funded from cash. Within defensive assets we still favour fixed income, believing the current challenges faced by government bond markets should be transitory. Credit exposures within the fixed income allocations should continue to perform well in this environment.

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PORTFOLIO POSITIONING

	SAA	TAA	Over/ Underweight
Growth assets	70%	75%	5%
Australian equities	26%	26.5%	0.5%
Developed market equities	28%	29.5%	1.5%
Emerging market equities	4%	5.5%	1.5%
Listed real assets[1]	6%	7.5%	1.5%
Alternative growth	6%	6%	0%
Defensive assets	30%	25%	-5%
International fixed income	8%	9%	1%
Australian fixed income	12%	12.5%	0.5%
Cash	10%	3.5%	-6.5%
Foreign currency hedge ratio[2]	30%	28%	-2%

SAA – strategic asset allocation
TAA – tactical asset allocation

Figures may not add up due to rounding

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 4 March 2021.

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS:	We have increased our overweight to growth assets, taking a previously neutral position in emerging market equities to overweight and further increasing our allocation to listed real assets via GREITs. We maintain an overweight to developed market and Australian shares also. The cyclical exposure from the emerging markets position should benefit the portfolio in the medium-term due to the global reopening of economies. GREITs significantly underperformed global shares during the pandemic and while longer-term structural issues remain, they are appealing on a valuations basis and should benefit further from the reopening trade.
Developed market equities:	We expect equities to continue to outperform cash and fixed income over the course of 2021. Despite this it will not be a linear pathway and we expect volatility to remain in the near-term. We continue to favour the US amongst the major developed markets due to its quality/growth characteristics. While we favour 'value' in the near-term we expect 'growth' to marginally outperform over 2021.

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	Valuations have deteriorated further across all regions but look most concerning in Japan. We have upgraded European equities within our developed market scoring. Despite their stretched valuations, their cyclical exposure looks appealing in the short-term — particularly financials. A defensive barbell approach to equity exposure remains via quality/growth (U.S) and cyclical/value (Australia and EM) characteristics.
Australian equities:	We retain our mild overweight position to the asset class. Given the highly cyclical nature of Australian equities, the position is expected to provide exposure to this segment of the market, which is expected to outperform in the short-to-medium term. Longer-term we see more favourable opportunities in other developed markets.
Emerging market equities:	We have been watching EM closely having viewed the asset class favourably on a number of metrics recently. Given this and the potential for cyclicals to outperform in the short-term we have increased our exposure to EM taking portfolios to overweight from neutral. EM's cyclical exposure means it should continue to benefit from the reopening trade. The asset class also offers favourable sector tilts, with high exposure to Tech and Consumer Services. Within EM, the Asian region is where we expect to see the most upside.
Listed real assets[1]:	We are now overweight listed real assets, having further increased our overweight positioning in GREITs following our last IC meeting. GREITs remain attractively valued on a relative basis, having significantly underperformed equities during the pandemic. Should inflationary pressures continue to pick-up in 2021 the sector should provide some protection for portfolios. We continue to see strategic opportunities in listed infrastructure given the "lower for longer" rates scenario and increased potential for fiscal support via infrastructure spending that a Biden administration brings. We maintain a benchmark weight and prefer GREITs at this stage.
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 equities (which has continued to play out) and is therefore a valuable diversifier in periods of extreme markets conditions. Therefore, alternative growth remains at benchmark.
DEFENSIVE ASSETS	We are underweight defensive assets, further reducing our defensive exposure following our last IC meeting. The positioning is in place due to a significant underweight to cash within our portfolios. Despite the pressure which bonds have come under recently, we expect structural forces to keep yields capped in the medium-term and may seek to build our position here in the months ahead if we believe growth assets have run too far.
International fixed income:	While inflation risks have increased since last month, it is the persistence of global output gaps and labour market slack which supports our base case for inflation risks remaining limited within the forecast horizon – and most likely for some time after. Coupled with accommodative central bank policy, nominal yields should remain low and many real rates in negative territory, ensuring the economic recovery and rising levels of fiscal debt can be sustained for a prolonged period. We remain overweight international fixed income for the time-being as a result. Our position holds decent exposure to credit (which has held up relatively well) in which see the potential for further upside.
Australian fixed income:	We are overweight Australian fixed income. 'Aussie' rates look attractive on many metrics and have the second most room to zero in the Developed Markets rates space. We like Aussie duration as an addition to the U.S. duration position. This position is due to the additional yield pick-up, relative to cash, from the asset class.
Cash:	We are underweight the asset class, preferring the relatively low-risk yield pick-up afforded by fixed income at present.
FOREIGN CURRENCY HEDGE RATIO[2]	We are at benchmark weight for the AUD. The AUD appreciated strongly in 2020 and has started 2021 with reasonable volatility reaching as high as USD 0.82 in February before retracing late in the month. There is still potential for further upside before the year finishes, particularly if 'TINA' and stronger commodity prices eventuate. Despite this, the AUD is a risk currency and we remain close to benchmark at this stage as a defensive hedge.

Notes:
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