MAY 2020

HOUSE VIEW

EXECUTIVE SUMMARY

Global share markets staged an impressive recovery in April despite some very bleak economic data releases. In the near term we expect a pullback in equities and a corresponding fall in the Australian dollar once markets wake up to the full extent of the state of economies globally. As a result, we are underweight Australian equities and global hedged equities, and we have reduced our Australian dollar hedge ratio.

OUR VIEW

Global share markets bounced back emphatically in April, driven by record-high stimulus packages from governments and central banks, an easing in new COVID-19 infection rates and vaccine hopes. It would have been difficult to imagine in mid-March that by the end of April we would only see the S&P 500 down by 15% from its February peak and the Nasdaq 100 ahead of its level at the beginning of the year. Similarly, China's CSI 300 index is down less than 5% in the year to the end of April, having recovered most of its earlier losses. That said, emerging market shares have suffered more given collapsing commodity prices.

The April rally happened despite bleak economic data releases with GDP dropping by 4.8% annualised in the United States from the previous quarter, and 3.8% (not annualised) in the Eurozone. In France, some 40% of the workforce is working reduced hours, while unemployment is pushing 15% in the United States (the highest level since the Great Depression).

The latest macro figures also offer little hope. In China, for example, which has been largely freed from restrictions, the Purchasing Managers' Indices fell again in April compared to March. In particular the sub-index measuring export orders slipped from 46.4 to 33.5 points.

We expect most countries will likely hit the low point in their economic growth in the second quarter, and then recover slowly. For the US, for example, we expect GDP to decline by 9% from the first quarter. And yet the Americans are reacting more forcefully than any other country in terms of fiscal stimulus and central bank balance-sheet expansion. The US Federal Reserve's (Fed's) balance sheet has already risen from 4.5 trillion dollars in mid-February to its current level of 6.7 trillion dollars. By the end of the year, it could surpass 10 trillion dollars.

Meanwhile, our estimates predict the US budget deficit could rise to as much as 18% of GDP this year. We expect 7.5% for the Eurozone.

We expect global GDP to decline by 2.6% in 2020, a year in which economic normalisation is likely to be slow and incomplete by the end of it. This core scenario assumes there will not be a second, strong wave of coronavirus contagion in major industrialised countries.

In the short term, key risks are US-China trade tensions and a second wave of coronavirus cases setting back economic recovery. Many emerging market countries are seeing continued escalation in new infections and in developed countries there have been numerous upticks in cases, which may well persist. Relief over the gradual easing of the pandemic restrictions may be followed by disillusionment over the stuttering restart. Essentially, it is then a question of how high demand really is when supply returns. Business and consumer behaviour is likely to remain cautious until the virus is largely contained.

We expect equities to fall back after the strong recovery in recent weeks, and we do not rule out further severe setbacks. In the fixed interest sector, the medium-term picture remains dominated by a weak economic outlook, the enormous rescue packages and the associated high refinancing needs of governments.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

Our concerns have led us to reduce risk in the discretionary diversified portfolios by reducing exposure to the Australian dollar, Australian equities and global hedged equities.

PORTFOLIO POSITIONING

	SAA	TAA	Over/ Under weight
Growth assets	70%	67%	-3%
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%	33%	+3%
International fixed income	8%	10%	+2%
Australian fixed income	12%	12%	0%
Cash	10%	11%	+1%
Foreign currency hedge ratio[2]	30%	17%	-13%

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS:	We have a small underweight position to growth assets, brought about both through equity values falling and us then trimming our allocation further. Concerns around US-China trade tensions and economic headwinds (that we believe are yet to be fully priced into market expectations) are the key drivers of this position.
Developed market equities:	Significant downside risks persist within developed market equities. Weak earnings and economic growth forecasts and continued global COVID-19 infections will likely lead to more falls.
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.
Emerging market equities:	We have removed our preference for emerging markets after strong outperformance of China, and stay sidelined for the time being.
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 continued to play out) and is therefore a valuable diversifier in periods of extreme markets conditions.

DEFENSIVE ASSETS	Offsetting an underweight growth position, we are overweight global fixed interest and cash. Whilst yields are low, this position will protect downside in the event of an expected equity sell-off. Duration remains one of our preferred diversifiers in a volatile environment. Rates markets remain supported by an accommodative central bank stance and (geo)political risks.
International fixed income:	US Treasuries continue to be a 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 have increased our exposure to cash to a slight overweight position, in order to reduce risk in our diversified portfolios.
FOREIGN CURRENCY HEDGE RATIO[2]	We have reduced our Australian dollar (AUD) hedge ratio for global equities given the AUD is a risk currency and risk appears skewed to the downside.

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 May 2020.

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