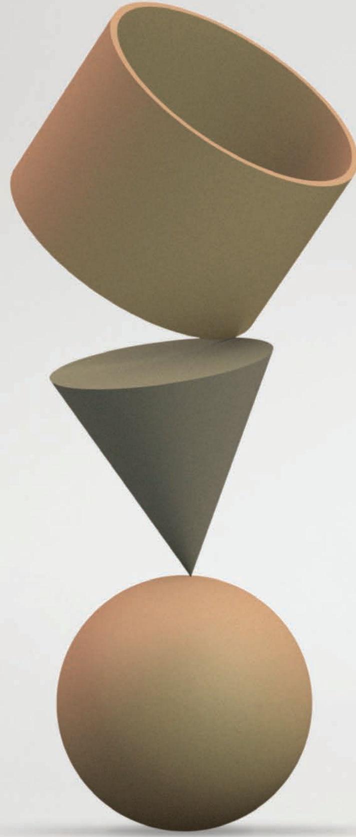

WILSONS

Asset Allocation Strategy: Balancing Uncertainty and Opportunity

14 October 2020

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Balancing Near-Term Uncertainties Against Medium-Term Opportunity

Global equity markets face an uncertain near-term outlook in respect of the run-in to the US election and short-term path of the pandemic. Nevertheless, the backdrop of ultra-low rates and massive fiscal spending provides a supportive environment for equities over the next 12 months.

Vaccine prospects have improved from mid-year, and with several candidates now well into stage 3 trials, there is potential for positive news flow either later in Q4 or Q1 next year. Any vaccine roll-out will take time, but the share-market will react to the news on trial success rather than waiting for a successful roll-out.

With vaccine trials now well advanced and the prospect of a clear (November 3) US election result (Biden) beginning to look more likely, we have edged our total equity weighting up from neutral to 2% overweight.

We have chosen to add the 2% weight to our existing neutral Australian equities position. The local equity market has been locked in a reasonably narrow trading range since early June. Australia has been dealing with its own COVID-19 second wave (Victoria) with economic momentum faltering somewhat; however, prospects for a broader reopening are becoming more tangible and a pro-growth Federal budget should lift business and consumer sentiment. The Australian equity market and the A$ are also well placed to participate in any global "recovery rally", so the risk return trade-off for the Australian equity market has become more appealing.

Key asset allocation changes

Asset Class	Tactical Tilt	Movement	Wilsons View
Cash	Neutral	Decreased	We have decreased cash to fund an increased allocation to Australian equites.
Fixed income (Domestic & Global)	Underweight -6%	No change	We retain a significant underweight in fixed interest due to very low yields and our view of a developing global recovery over the coming year. We prefer credit to government bonds but near-term economic weakness tempers our enthusiasm somewhat. Alternative fixed interest strategies not reliant on duration and long-term inflation protection also appeal.
Equities - Domestic	Overweight +2	Increased	We move to overweight from neutral. Prospects for a broader re-opening are becoming more tangible. A pro-growth Federal budget should lift business and consumer sentiment. The Australian equity market and the A$ are also well placed to participate in any global recovery rally, so the risk return trade-off for the Australian equity market has become more appealing.
Equities - International	Neutral	No change	We hold global equities at neutral due to the combination of the strong rally in global equities and the rise in COVID-19 infection rates. We retain our 40% hedge back to the A$ as we still believe the A$ has medium-term upside, particularly against the US$. We continue to overweight emerging markets.
Alternatives	Overweight +4	No change	We retain our overweight given above average economic uncertainty and unattractive valuations in government. bonds. We are diversified across defensive and growth strategies. Gold still appeals as a long-term portfolio hedge but could be cyclically vulnerable to a risk rally.

Our tactical tilt represents our view over the next 6 to 12 months though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments.

Source: Refinitiv

The Global Economy: Reviving but Still Constrained for Now

The global economy continues to recover from its second-quarter "shutdown collapse", but the pace of recovery has slowed.

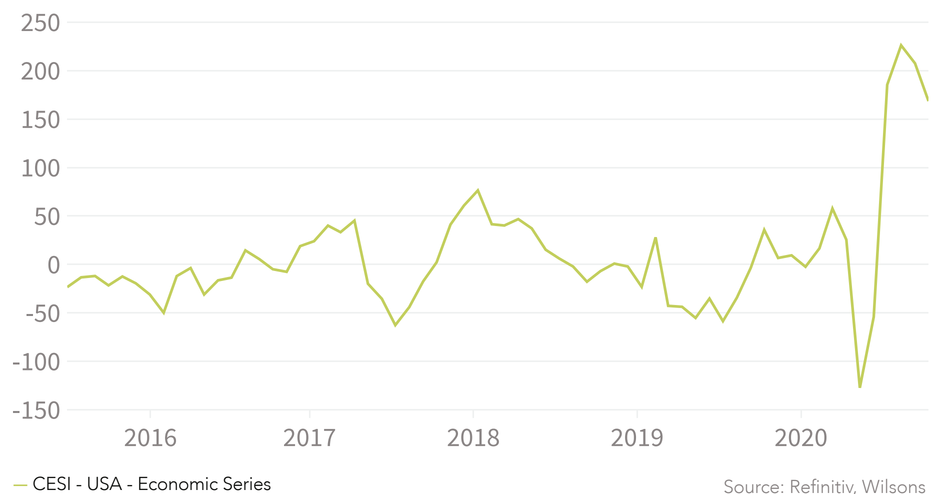
This is in part due to the inevitable fading of the sharp bounce that came as much of the world exited lockdown through May and June. More recently, the recovery has been hampered by a second wave of COVID-19 with mobility restrictions bringing an associated relapse of consumer and business confidence.

A renewed economic recovery phase is likely to be the key thematic for the coming 1 to 2 years. The prospect of a successful vaccine will boost confidence even though it will take some time to roll-out across the globe, and a new and substantial US stimulus bill appears inevitable in the coming months. While it is looking increasingly likely the bill will be delayed until after the election, it is likely to be substantially larger than any compromise bill cobbled together ahead of the election. With the odds of a Biden victory seemingly firming, the prospect of a US corporate tax hike from 21% to 28% may unsettle investors; however, there appears to be an emerging consensus on Wall Street that the size of any Democrat post-election stimulus package (potentially in the vicinity of US$ 2.0 to 2.5 trillion) will neutralise the impost from higher corporate taxes. Markets are also likely to factor in a relatively more stable period (or at least more orthodox) of US-China relations.

Exhibit 1: Global manufacturing PMI - activity has rebounded

Source: Refinitiv, Wilsons

Exhibit 2: Citi US Economic Surprise Index - US data has surprised but shows signs of easing

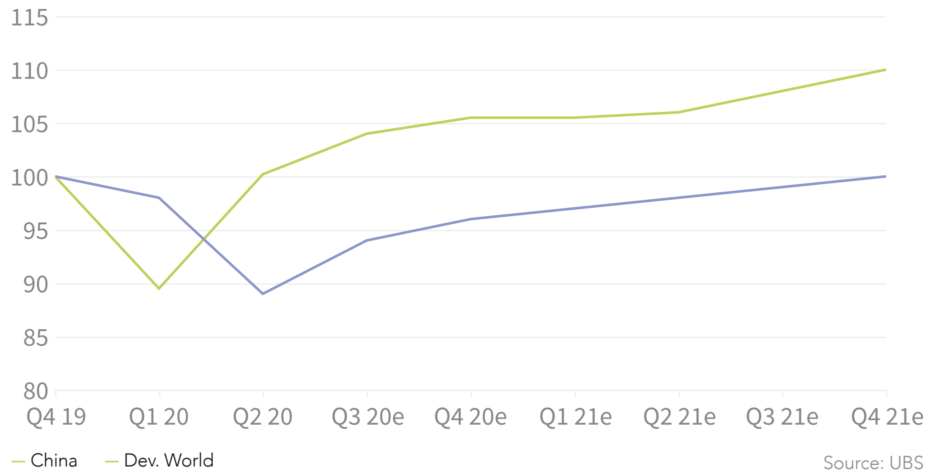


Source: Refinitiv, Wilsons

In contrast to the still depressed state of activity in the rest of the world, China has led the global recovery with activity already back to pre COVID-19 levels. China's relative success in normalising activity has supported the performance of the emerging market (EM) index (China is 40% of the EM index), and we continue to see good prospects for emerging market equities given our view of better global growth, ongoing robust Chinese growth and a resumption of the US$ downtrend. We remain overweight Emerging Markets.

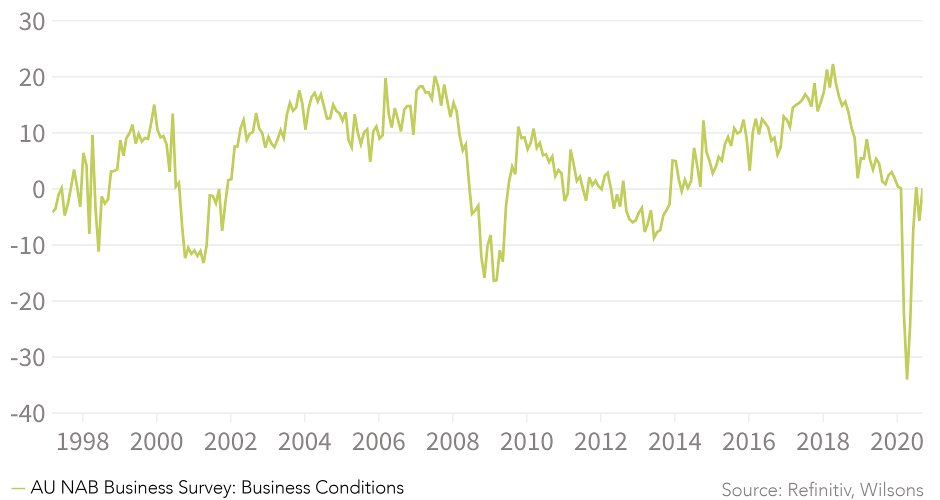
Like much of the developed world Australia has also suffered from an ebbing in recovery momentum, but we also see the local economy as being on the cusp of the next leg in the recovery cycle as restrictions are eased. The tapering of JobKeeper and JobSeeker raises some risks for the pace of near-term recovery, but the combination of Victoria emerging from its lockdown, a potential re-opening of state borders and the pro-growth, pro-business tone of the Federal budget should tilt the odds in favour of a decent recovery.

Exhibit 3: China has led the world in rebounding to pre COVID-19 activity levels



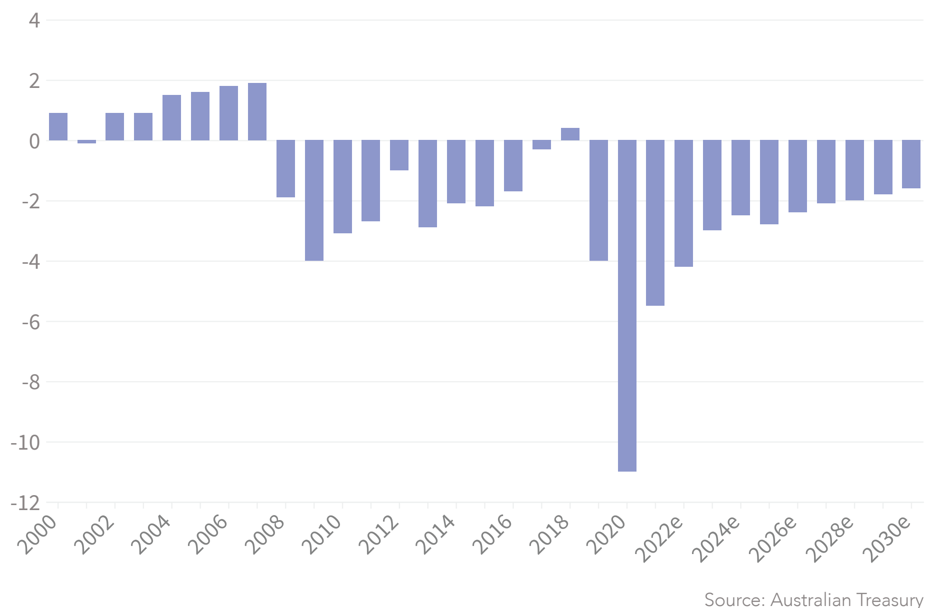
Source: UBS

Exhibit 4: National Bank Business Survey - business conditions index



Source: Refinitiv, Wilsons

Exhibit 5: Federal Budget deficit as a % of GDP (treasury projections)



Source: Australian Treasury

OVERWEIGHT

Equity Market Backdrop – Edging Back Overweight - Buy Australia

In our last asset allocation quarterly in mid-July, we trimmed our total equity positioning down to neutral based on both the rapid pace of the equity rebound from the March lows and an emerging second wave in COVID-19 infections.

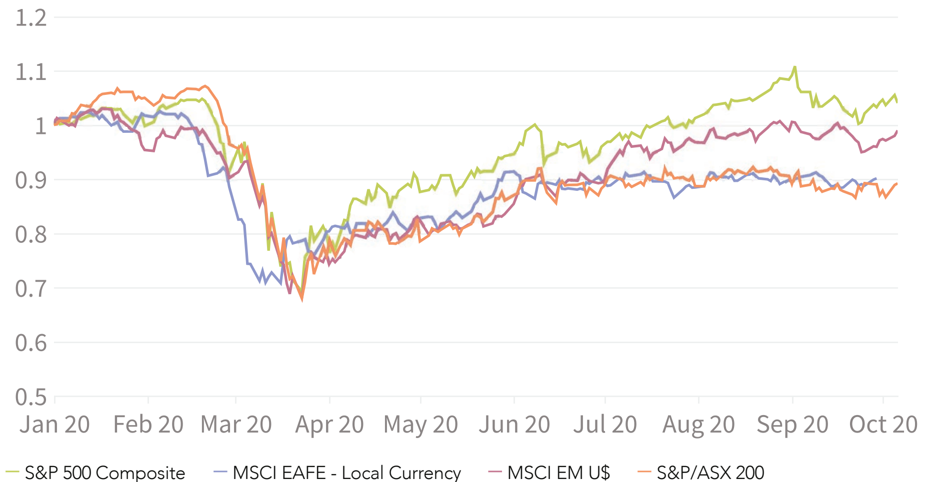
Since then, global equities have still managed to advance another 3-4% in US$ terms but less than 1% in Australian dollar terms, while the Australian equity market is roughly flat.

US equity market leadership (via mega-cap tech) became particularly marked in Q3; however, September saw the US market correct almost 10%. The US market is a few percent above its late September lows, but October has proved quite choppy as the market hones in on the US election, and sentiment around the prospect of a new Stimulus Bill waxes and wanes by the day.

While there has been a degree of bubble talk surrounding the US market, US valuations do not look to be in bubble territory, particularly given the superior earnings growth delivery of the US equity market in recent years. Keeping in mind we also need to calibrate valuations relative to what are ultra-low interest rates (See Exhibit 8). On this basis, we are still relatively relaxed on the prospects for the US equity market.

Here we Dissect the recent US Tech Sector Sell-Off.

Exhibit 6: The US market has led the world this year



Source: Refinitiv, Wilsons

Exhibit 7: US equities performance vs rest of world

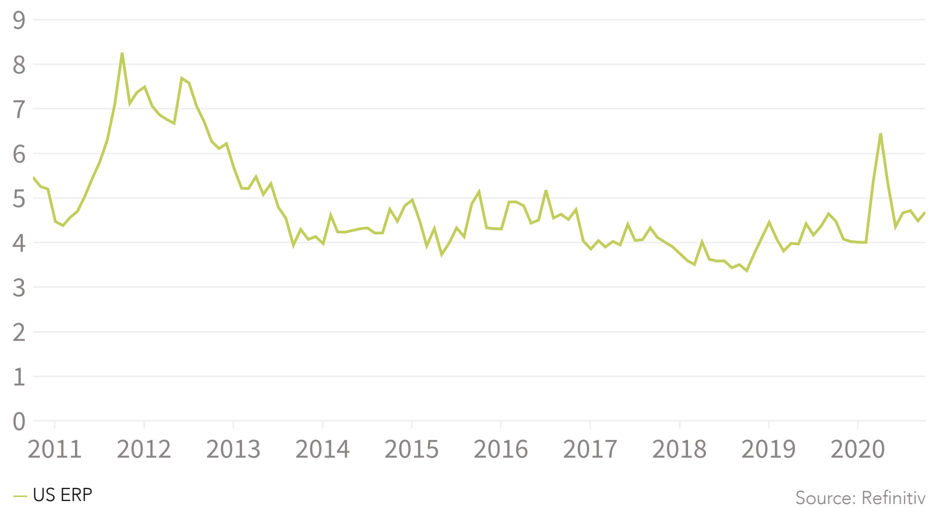
Source: Refinitiv, Wilsons

We do believe we could see at least a cyclical leadership rotation away from the tech-dominated US market toward the "recovery trade" over the coming year. Not necessarily a poor outlook for US stocks in an absolute sense, we could witness a passing of the leadership batten to the rest of the world where valuations are cheaper and cyclical earnings recovery potential is greater.

We are positioned for this rotation via an overweight to emerging markets (a position we have had in place for a few months now), and have now opened an overweight in Australian equities as an alternative way to play the recovery trade.

Europe and Japan are other ways to play a global recovery, yet we prefer the risk-return trade-off for emerging markets and Australia at present. Digging down below regional allocations suggests looking at global mid and small caps over the US mega-cap trade and also allocating back toward value or style neutral managers.

Exhibit 8: US equity risk premium suggests shares are not overly expensive



Source: Refinitiv

Exhibit 9: Global equity market fundamentals

	PE 12 MTH FWD EPS	EPS GROWTH CY 2020%	EPS GROWTH CY 2021%	CONSENSUS EPS REVISION LAST 3 MTHS
AUSTRALIA	18.2	-22	16	1
WORLD	20.2	-21	29	1
US	22.0	-19	30	5
EUROPE EX UK	17.2	-34	41	-6
UK	14.6	-30	35	-6
GEM	14.4	-9	32	-1
JAPAN	17.7	-10	33	-11

Source: Refinitiv

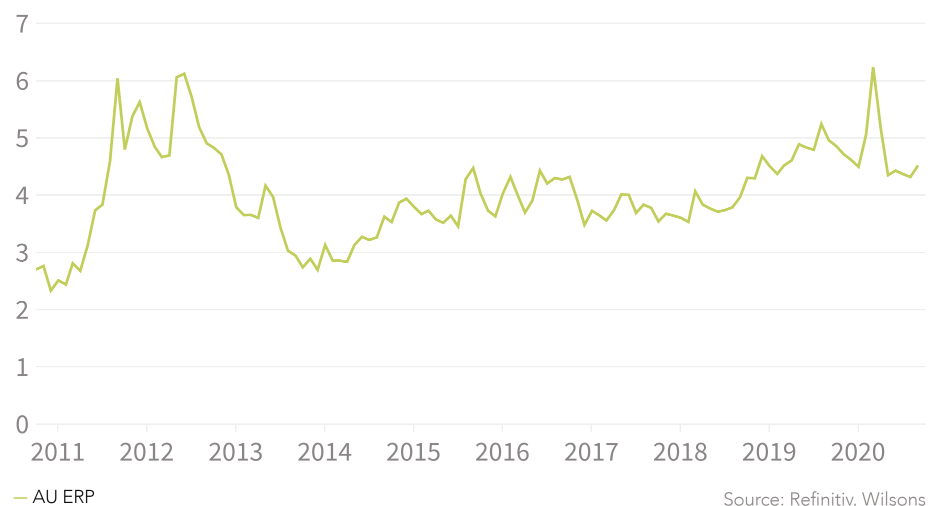
Australian Equities – Reasons to be Positive

Australia has lagged the US equity market run-up in recent months, trading in a tight range since early June, with the relatively small size of our tech sector dragging on our performance.

We see 4 main reasons why Australia should perform relatively well:

1. Australia's low tech and high bank and resource sector weightings position it as a recovery/value trade beneficiary.
2. Local COVID-19 trends are relatively good in a global context. Prospects for a broader economic reopening are brightening.
3. The recent budget is a pro-growth, pro-business and pro-equity market budget.
4. Finally we believe the market is likely to be underestimating the degree of potential earnings recovery over the next 2 years due to the current depressed level of earnings estimates.

Exhibit 10: Aus equity risk premium suggests local shares are relatively attractive



Source: Refinitiv, Wilsons

Exhibit 11: Australian earnings have significant recovery potential

Source: Refinitiv, Wilsons

UNDERWEIGHT

Fixed Interest Backdrop – Keeping a Sizeable Underweight

The global backdrop of ultra-low cash rates and bond yields should continue to give equities a natural buoyancy.

However, these low levels of cash and fixed income yields create an ongoing dilemma for diversified investors.

We retain a significant underweight to fixed income with a tilt toward non-traditional forms of fixed interest and inflation-indexed bonds over traditional duration linked bond strategies.

Read more about Fixed Interest in a World of Ultra-Low Rates and The Case for Inflation-Linked Bonds.

Our central case of a re-acceleration in the global recovery phase over the coming 12 months is unlikely to usher in a large rise in bond yields. Central banks are intensely committed to keeping cash rates anchored at effectively zero levels for several years and will not hesitate to expand QE programs to keep long bond yields from rising significantly. The most likely path for long bond yields over the coming year is a relatively flat to moderately higher (moderate capital losses).

A very low single-digit gain or a low single-digit loss is an uninspiring outlook for traditional fixed interest, but this is the current cost of portfolio insurance. We continue to believe inflation-linked bonds, alternative fixed interest strategies and selected credit exposure can profitably supplement fixed interest holdings.

Credit spreads themselves do not present as particularly compelling relative to long-term averages. The total yield is also uninspiring given the low government yield these credit spreads are being struck off.

Exhibit 12: Bonds have not reacted to the equity rally

Source: Refinitiv, Wilsons

Exhibit 13: US high yield corporate bond spreads are back close to average

Source: Refinitiv, Wilsons

Our central case of recovery will likely see some tightening in spreads over the coming year as investors embrace recovery. Prospects for capital gains are better in spread products than government bonds, so we prefer the 12-month risk-return outlook for credit (neutral) over government bonds (underweight).

Alternatives

While we have increased our equities weighting from neutral to 2% overweight, we have maintained our 4% overweight to alternatives. Our current absolute weighting is 12%. See page 10 for our full asset allocation.

While we are constructive on the 12-month outlook for equities, we acknowledge that both near-term and long-term uncertainties are higher than usual. At the same time, traditional fixed income allocations are offering very low yields. We see a clear role for enhanced portfolio return and effective diversification via alternative assets.

Our recommended alternatives exposure encompasses a range of growth, defensive growth and defensive strategies. We are employing a diversified mix of five strategies based on their prospects:

1

Private Equity

While private equity has delivered strong returns in the 10 years post the GFC, we still see a constructive outlook, with post-recessionary private equity vintages typically delivering the strongest returns. The relatively short duration of the downturn (particularly in respect of the share market correction) may limit the capacity of private equity investors to reload. The comparative narrowness of the recovery suggests there will still be plenty of opportunities to pick up attractively priced assets.

2

Private Debt

With the gradual retreat of the banking sector from business lending due to more onerous capital regulations, private debt continues to present as an interesting opportunity. Interest rates are typically in the high single digits (or sometimes higher) despite the rock bottom levels of official rates. As a result, we prefer private debt to listed market credit.

3

Long Short Equity

Equity Hedge funds performance has been varied with more growth-orientated funds typically doing well, while those focused on relative valuation have been lagging. We see the potential for value focused funds to have at least a cyclical renaissance over the coming year.

4

Infrastructure

Typically seen as a mid-risk or defensive growth exposure, COVID-19 saw many formally defensive assets (for example airports) coming under unprecedented revenue pressure. Recovery in revenue may take some time, but if the market can see a path to economic normalisation, many of these growth defensive assets have considerable valuation upside. We continue to see infrastructure investments as having attractive long-term prospects.

5

Physical Gold (ETFs)

Gold has been our largest overweight within the alternative basket; however, we see the potential for a cyclical pullback in gold if the scenario of a vaccine led recovery comes to pass in coming months. Medium to longer-term we continue to see plenty of reasons to hold gold.

The Appeal of Gold

We tend to see gold as a portfolio hedging alternative to very low yielding fixed interest, but with the option value to generate strong capital gains under certain (quite plausible) macro conditions. Gold has shown a tendency to do well in an environment of very low (real) interest rates. This relationship is supported by the low opportunity costs of holding gold in an environment of very low or negative real interest rates. A very low interest rate regime also typically coincides with very easy money growth (as we are currently experiencing). Gold appeals in this type of environment as a store of value relative to Fiat currencies (particularly an under pressure US$) and as a hedge against the potential long term inflationary consequences of ultra-easy monetary policy.

Read The Case for Gold in Multi-Asset Portfolios.

Asset Allocation Summary

Asset Class	High Growth			Growth			Balanced			Moderate			Defensive		
	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt
Cash	1%	2%	-1%	1%	2%	-1%	5%	5%	0%	10%	10%	0%	19%	20%	-1%
Fixed interest	2%	5%	-2%	10%	15%	-5%	19%	25%	-6%	29%	35%	-6%	43%	50%	-7%
Equities - Domestic	44%	42%	2%	40%	38%	2%	33%	31%	2%	27%	25%	2%	15%	13%	2%
Equities - International	41%	41%	0%	37%	37%	0%	31%	31%	0%	24%	24%	0%	13%	13%	0%
• United States	23%	24%	-1%	21%	22%	-1%	17%	18%	-1%	13%	14%	-1%	7%	8%	-1%
• Europe/UK	11%	11%	0%	10%	10%	0%	9%	9%	0%	7%	7%	0%	3%	3%	0%
• Emerging Markets	6%	2%	4%	6%	2%	4%	5%	1%	4%	4%	1%	3%	3%	1%	2%
• Japan	1%	4%	-3%	0%	3%	-3%	0%	3%	-3%	0%	2%	-2%	0%	1%	-1%
Equities Total	85%	83%	2%	77%	75%	2%	64%	62%	2%	51%	49%	2%	28%	26%	2%
Alternatives	12%	10%	2%	12%	8%	4%	12%	8%	4%	10%	6%	4%	10%	4%	6%
Growth Assets	97%	93%	4%	89%	83%	6%	76%	70%	6%	61%	55%	6%	38%	30%	8%
Defensive Assets	3%	7%	-4%	11%	17%	-6%	24%	30%	-6%	39%	45%	-6%	62%	70%	-8%
Cash + Fixed + Equities + Alternatives	**100%**	**100%**		**100%**	**100%**		**100%**	**100%**		**100%**	**100%**		**100%**	**100%**	

Commentary references our Balanced Portfolio.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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