WILSONS

Cycle Maturing but Still Plenty of Life

Our fourth quarter asset allocation strategy.

11 October 2021

Quarterly Asset Allocation Outlook

Global growth has peaked, but the global economy will continue to grow at an above-average rate over the next 12 months at least.

Central banks are now beginning to withdraw policy support, but they are likely to remove this support at a very gradual pace.

With this backdrop, equities are likely to deliver solid returns over the next 12 months, driven by above-average earnings growth. However, returns should be more "normal" than over the past year and with the potential for higher volatility. We retain our overweight to both domestic and global equities though we have edged Australia up to +3 and edged global down to +1.

Globally, we favour the cheaper and more cyclical non-US-developed equity markets over the coming 12 months. Emerging markets (EM) look very cheap, but significant near-term uncertainty around China policy decisions suggests a neutral position.

We remain underweight fixed interest. We continue to see government bonds as expensive, particularly against the backdrop of an improving global and domestic economy. Credit should continue to outperform government bonds.

We retain a 4% tactical overweight tilt to alternatives. We are attracted to the diversification and return enhancement potential within our alternatives opportunity set.

Exhibit 1: Asset allocation weightings

Asset Class	Tactical Tilt	Movement	Wilsons View
Cash	Neutral	1%	Neutral weighting reflects some residual risk that recent correction extends, balanced by relatively positive 6-12 month view on risk assets.
Fixed income (Domestic & Global)	Underweight -8%	-1%	We retain a significant underweight in fixed interest due to very low yields and our view of a developing global and domestic recovery over the coming year. Moderate increase in underweight position into tapering. Absolute return fixed interest strategies not reliant on duration gains or running yield are preferred over traditional fixed interest strategies. Credit preferred over government debt.
Equities - Domestic	Overweight +3%	1%	Increase in weighting reflects recent pullback combined with potential for strong economic re-acceleration as lockdown ends. Prospect of renewed A$ strength over next 6 months adds to Australian equity markets "relative" appeal.
Equities - International	Overweight +1%	-1%	While we are still constructive on global equities we see better relative upside in Australain equities near-term while (long duration) US equities may need to digest a further rise in bond yields and a potential corporate tax hike. We retain our 40% hedge back to the A$ as we still believe the A$ has medium-term upside, particularly against the US$.
Alternatives	Overweight +4	No change	We retain our tactical overweight given a) above average economic and policy uncertainty b) unattractive valuations in govt. bonds and full absolute valuations in equities. A range of growth and defensive alternative strategies appeal i.e. private equity, infrastructure, real property, long short global hedge funds and private credit. Gold still appeals as a long-term portfolio hedge against inflation and heightened geopolitcal tensions but could be cyclically vulnerable to a rise in global real interest rates.

Our tactical tilts represent our view over the next 6-12 months though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments. See exhibit 17 for additional asset allocation detail.

The Core of our View

While market volatility has picked up lately, the central tenant of our investment view remains that the global economy will continue to grow at an above-average rate over the next 12 months and that central banks (and governments) will withdraw policy support relatively slowly.

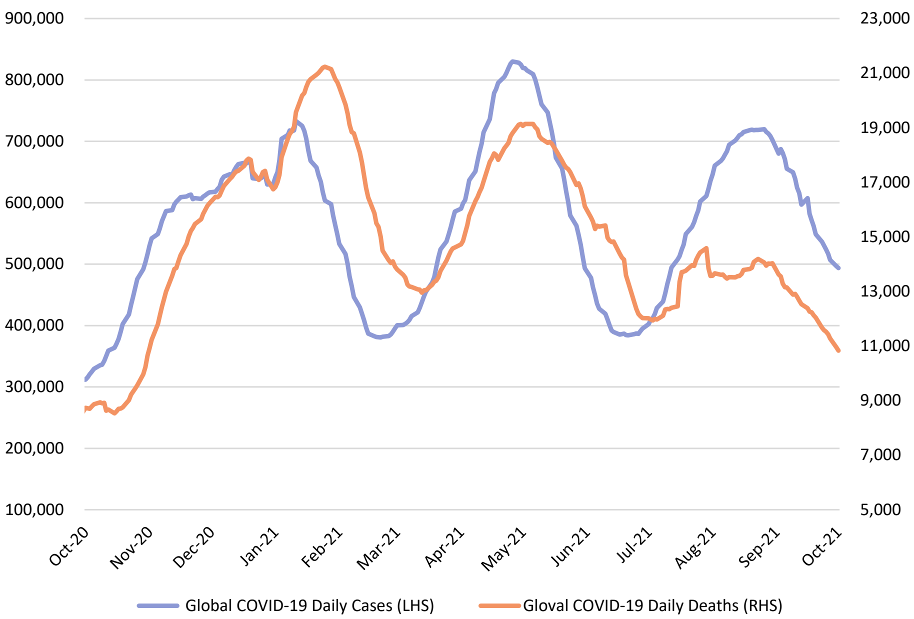
This justifies the continuation of at least a moderately pro-risk stance, with overweights in equities, credit and growth alternatives, balanced by a significant underweight in government bonds.

Importantly, we attach a relatively low probability to a recession on a 12-18 month time horizon. This does not preclude volatility, but risks of a bear market style drawdown appear relatively low in our view.

Exhibit 2: Global Manufacturing PMI - growth momentum has peaked but at a high level

Source: Wilsons, Refinitiv.

Exhibit 3: Global COVID cases and deaths are falling



Source: Wilsons, Refinitiv.

Global Growth has Peaked but at Very High Levels

Over the next 12 months progress on the global vaccination rollout coupled with accommodative monetary and fiscal policies should keep global growth ticking along at a very solid pace.

Indicators of economic momentum such as purchasing managers indexes (PMIs) are coming off their highs. However, they are falling from abnormally high levels and generally still well above 50, indicating that the expansion is not at risk of stalling any time soon.

There has been a degree of commentary regarding the peaking of the global growth cycle. When growth peaks, investors (and market commentators) can start to worry about the risk of a phase of below-trend growth, or at worst, a recession. Given that growth is coming down from exceptionally high levels and policy is still very supportive, neither is a major risk at the moment in our view.

Reopening not without challenges but still proceeding fairly well

While we are positive on the growth outlook, we continue to assess how our view could be wrong. An unexpected twist in the global pandemic still presents as the major risk to our positive 12-month growth outlook in our view. A more virulent COVID strain cannot be completely discounted, but our expert discussions suggest virus mutations tend to become less dramatic over time. As a result, we still see a progressive global reopening against a fading pandemic as the most likely central case scenario.

Close to 50% of the world's population have now received at least one vaccine shot. While vaccine availability in many emerging markets remains an issue, the situation is improving quite rapidly. Lower case counts, along with increased vaccinations and lower hospitalisations, have allowed most countries to loosen lockdown measures. So, while the reopening has had its challenges, we still see it as prudent to forecast further social and economic normalisation, which translates to a supportive growth backdrop.

Policy Support Still Significant

As the impact of pandemic eases and signs of economic recovery build central banks are now starting to edge back monetary support. The Fed has signalled that it will formally announce the tapering of asset purchases in November.

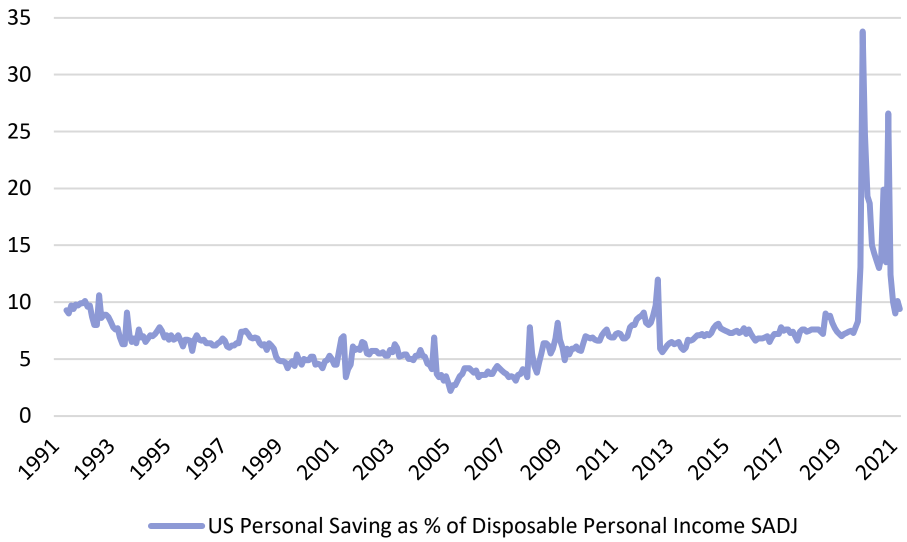
The RBA has also begun to taper, albeit gradually, while retaining very dovish guidance around the official cash rate (no rise until 2024).

The prospect of Fed tapering has led to some discussion around a repeat of the 2013 Taper Tantrum. We think a repeat market tantrum ahead of the upcoming tapering kick-off is unlikely.

Tapering implies a slower pace of easing rather than outright tightening. This is an important distinction. The Fed has gone out of its way to separate its tapering actions from its cash rate policy with a much tougher economic health test around raising the cash rate.

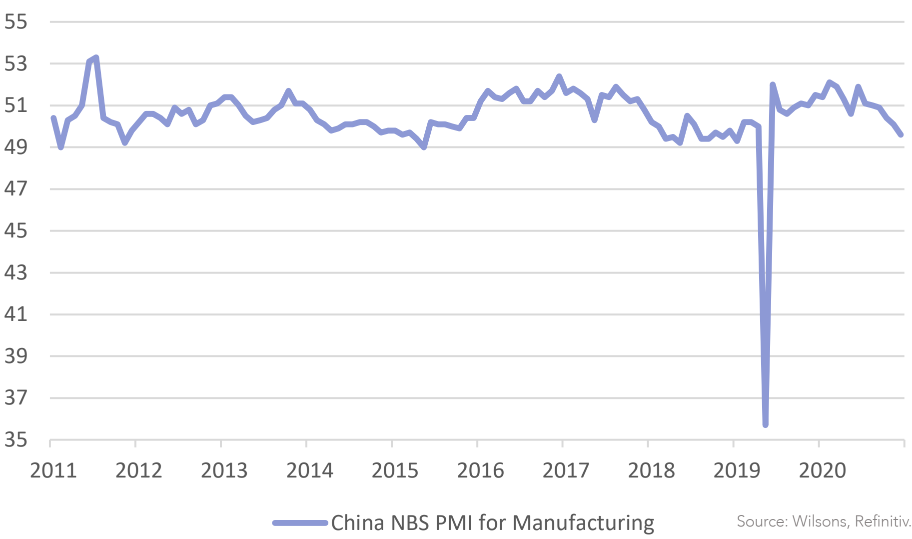
The Fed is unlikely to start hiking rates until late 2022 or early 2023. It will probably take another year or two (at least) for interest rates to then move into restrictive territory. So there still appears a decent runway for the current expansion.

Exhibit 4: US Consumers still have plenty of spending firepower



Source: Wilsons, Refinitiv.

Exhibit 5: China's growth has slowed but is within the typical range



Source: Wilsons, Refinitiv.

There has also been some angst around the fading of fiscal stimulus. While the absolute size of budget deficits is set to fall (from 70-year highs), governments are in little hurry to reign in deficits. Post-pandemic fiscal policy is likely to end up being significantly more expansionary than it was following the post-global financial crisis years.

It is also very important to note that a large portion of the fiscal largesse has still not yet made its way into the economy. US households are currently sitting on close to $2.5 trillion in excess savings, equivalent to about 15% of annual consumption. About half of these excess savings stem from decreased spending on services during the pandemic. The other half stems from increased transfer payments such as stimulus payments and supplementary unemployment insurance benefits. This should bolster consumption over the coming year.

In conclusion, the monetary and fiscal backdrop should still provide a decent degree of support to the global growth outlook for some time to come.

China is a Risk we Continue to Watch Closely

China is, in our view, another potential risk to the global growth outlook that is important to monitor.

The Chinese economy has been slowing this year as a result of a combination of monetary tightening and its attempt to reign in a series of COVID outbreaks. China's economic slowdown may also be exacerbated by the fallout from the Evergrande situation. We believe the Chinese government has sufficient control over the domestic financial system to keep systemic risks in check, but balancing a property slowdown while achieving broader growth targets will be a tricky balancing act.

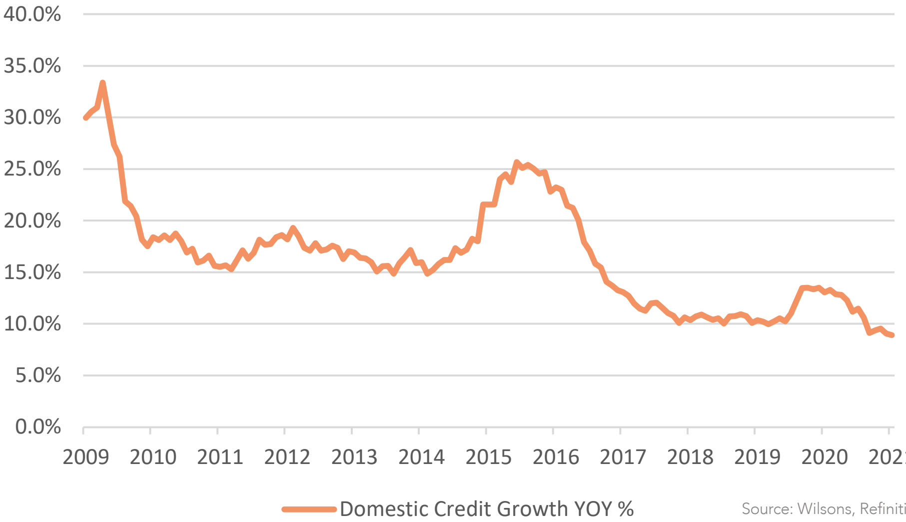
We do believe the Chinese authorities are likely to deliver a stimulus package and allow a targeted pick up in credit growth to offset the current slowdown. In contrast to previous cycles, the stimulus will probably be only moderate and targeted. It is unlikely that they will allow a renewed boom in real estate which has been a significant driver of Chinese growth in recent years. Commodities, which depend on Chinese demand, particularly iron ore, may be vulnerable to a secular slowing in the property sector, however, we expect the overall pace of China's economic growth (around 5% real GDP growth) to stay well ahead of developed word levels.

Over the medium to long-term, China will need to encourage consumer spending to allow for the continued slowing in the construction sector without depressing overall employment.

Infrastructure spending will also likely continue to be encouraged with investment broadening into a range of energy transition initiatives. So, our central case is that the Chinese growth cycle is still reasonable, albeit the key drivers are shifting at the margin.

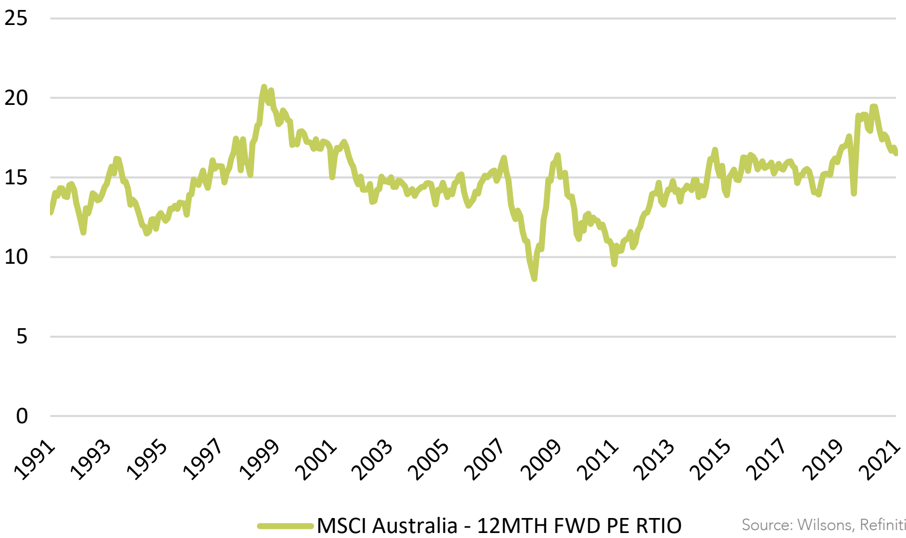
We do not believe China represents a major risk to the global (or Chinese) financial system. There is a risk that the property workout drags on the Chinese and global economic recovery, though we think some incremental policy easing to support the growth cycle is the most likely scenario in the coming months. While the Chinese outlook is beset by a number of competing cross-currents, the downside risks at the moment are, in our view, not severe enough to warrant turning bearish on either developed world equities (overweight) or indeed EM equities (neutral).

Exhibit 6: The China central bank has slowed the economy via tighter credit but we expect some easing soon



Source: Wilsons, Refinitiv.

Exhibit 7: The Australian multiple has eased back somewhat



Source: Wilsons, Refinitiv.

The Australian Economy and Sharemarket - Poised for Reopening

The current NSW and VIC lockdowns have weighed heavily on the Australian economy in the third quarter, with market estimates putting the economic contraction at somewhere around 4.%. In comparison, this is not as severe as the 7% contraction experienced in the Q2 national lockdown last year, but it is a significant hit.

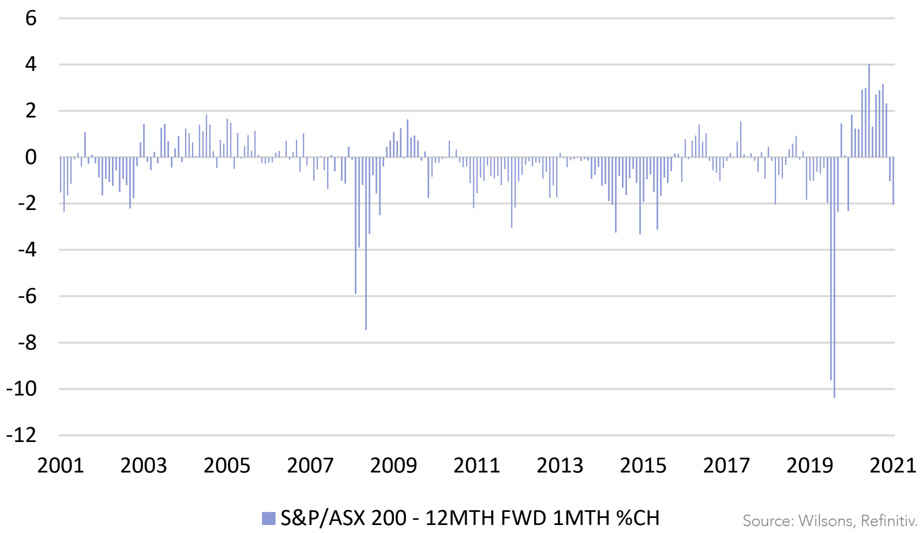
With NSW now set to exit lockdown and VIC a few weeks behind, we see good prospects for a solid growth rebound in the fourth quarter which will likely extend through 2022.

A very large consumer savings war chest will likely ensure a relatively strong rebound in growth as the NSW and VIC economies are allowed to progressively reopen. The household savings ratio would have moved up to well in excess of 10% in the current quarter. This is well above pre covid levels of 4-5%

This huge pool of excess household savings should support a reopening driven acceleration in growth beginning in Q4. This release of pent-up demand will likely take several quarters to work through the economy, suggesting a well above average growth outlook for 2022.

The local sharemarket has, in aggregate terms, appeared to "look through" the Q3 lockdown dislocation. Recent weakness appears most linked to global concerns. Internal sharemarket rotation is showing renewed interest in COVID recovery plays after a couple of months of underperformance. While global factors will be important, the prospect of a strong recovery year ahead for the Australian economy should be a relative plus for the local sharemarket. We have edged up our weighting to Australia in response.

Exhibit 8: Australian earnings revisions have slipped to negative recently due to falling iron ore and lockdowns but should rebound on reopening



Source: Wilsons, Refinitiv.

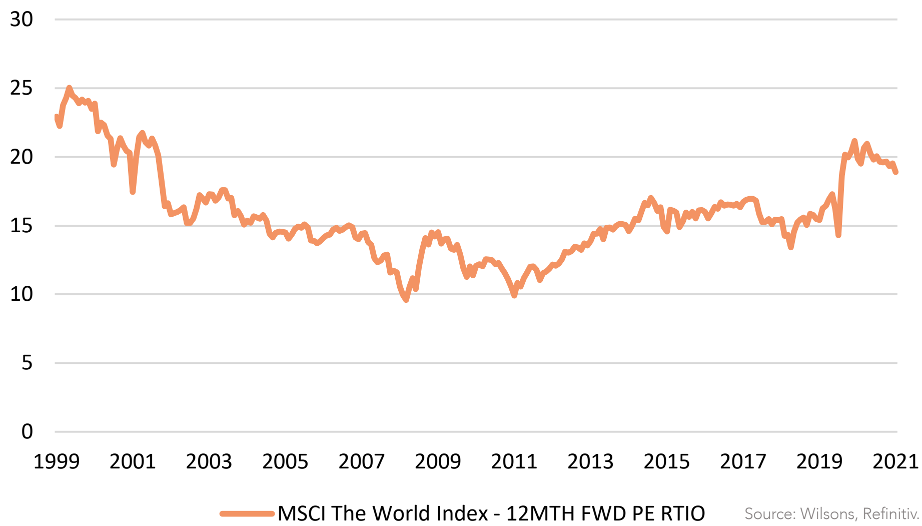
Global Equities - Economic Cycle Still Supports Stocks Despite Turning Bond Market

As we noted earlier, global growth is peaking but at very high levels. This suggests that earnings growth and stock returns should still be reasonably solid over the next 12 months, although not as strong as they were over the preceding 12 months.

While absolute equity valuations are not cheap by historical standards, they are not at extreme levels either. The MSCI World Index currently trades at 19x expected forward earnings. Indeed, non-US stocks appear quite reasonably priced, trading at a forward price-to-earnings (PE) ratio of around 15x. Analysts have been revising up earnings estimates for over 12 months across virtually all sectors. The pace of upgrades is easing, but we still see scope for more upgrading in the coming months. This suggests the market is a bit cheaper than suggested by currently quoted forward PE ratios.

In addition, the equity risk premium, as proxied by the gap between the earnings yield and the government bond yield, suggests equities remain relatively attractive. This is particularly the case for non-US equities.

Exhibit 9: The global PE multiple is high but growth is good and rates are very low



Source: Wilsons, Refinitiv.

Apart from notionally cheaper valuations, stock markets outside the US have more of a cyclical/value tilt. Hence, they tend to fare best when global growth is strong. Probable tax changes in the US could also dint the relative performance of US stocks over the coming year, albeit it should be at least partially priced in.

Emerging market equities look especially cheap. They currently trade at a forward PE ratio of 12x. The EM discount to the global index is back at post GFC lows, while earnings continue to come through solidly. As discussed, China uncertainty complicates the EM trade. Signs of additional policy support would likely be a signal to become more tactically bullish on EM stocks, but for now, our preference remains the developed world ex the US. Given our current preference for Australia over the US, we have edged back our weighting to global equities at the margin but remain broadly constrictive.

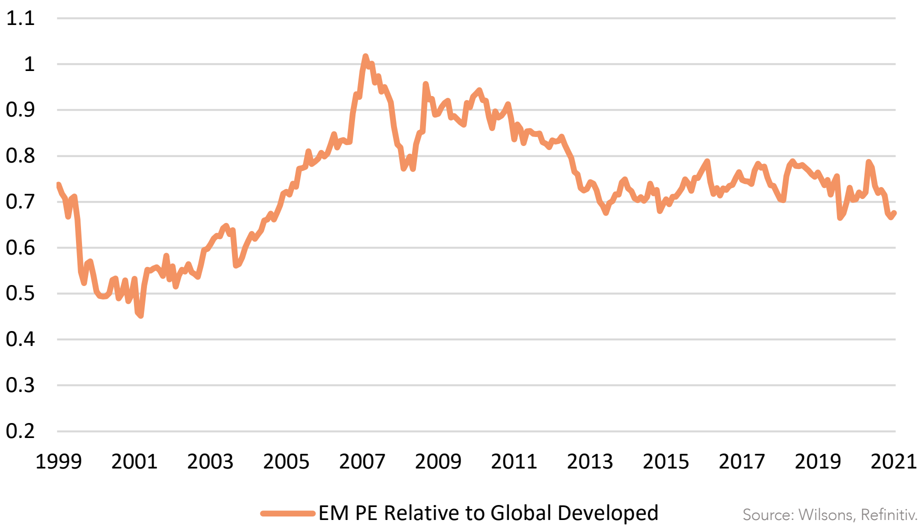
The expected rise in bond yields a reason to underweight bonds but (yet) not stocks

Treasury yields have moved up quite sharply since the conclusion of the Fed's last meeting just over 2 weeks ago. Our sense is that the rise in bond yields reflects the Fed's confirmation that QE tapering is set to begin, along with the realisation that the pandemic-induced rise in inflation may be a bit stickier than previously believed. Angst around the US debt ceiling stalemate may also be contributing to the lift in US yields.

Equities can come under pressure in periods when bond yields rise quickly. However, history suggests that as long as yields do not increase enough to choke off the economy, stocks usually end up recovering and pushing on to new highs. This is particularly the case if the official cash rate remains supportive, i.e. the yield curve slope remains positive.

The 10-year Treasury yield at 1.55% is still well below the 1.7% highs at the end of March. We expect bonds yields can make a new high this year, but this is likely to be only incremental. Any further upward move is likely to be more gradual than the move seen over the past few weeks. As such, we expect the pressure on stocks to ease.

Exhibit 10: Emerging market valuations are back at post GFC relative lows



Source: Wilsons, Refinitiv.

Exhibit 11: Regional table - global equities, consensus valuation and earnings growth outlook

	PE (12 Mth expected EPS)	CY20 EPS growth	CY21 EPS growth	CY22 EPS growth
World	18.9	-18	48	8
US	20.6	-14	46	9
Europe	15.2	-28	58	8
UK	12	-40	84	4
GEM	12.8	-13	46	9
Japan	15.4	-29	33	11
Australia	17.5	-20	33	4

Source: Refinitiv.

We expect the ultimate high for US ten-year bonds yields is likely to be in the 2.5%-3.0% at least. This is based on an expectation that the Fed's guidance of a neutral cash rate of around 2.5% proves to be correct. This is higher than current pricing and most market surveys of just under 2%. So, we think the market is a little too complacent on the equilibrium or neutral interest rate for the US economy.

However, as this year has demonstrated, we will not get there in a straight line. Stocks can likely cope with this shift in bond yields if it occurs over a couple of years (or quite possibly longer). At the margin, it is likely to be more supportive for value skewed markets and sectors relative to growth. However, a sharper adjustment or an eventual shift to an outright restrictive policy rate to reign in inflation would be a negative for equities in general.

Will inflation bring both the bond and equity market undone?

Inflation outcomes will, of course, be important to the path of bonds yields, cash rates (and equities) over the next 1-2 years.

We have written previously that we believe the recent US (and global) inflation spike as somewhat transitory.

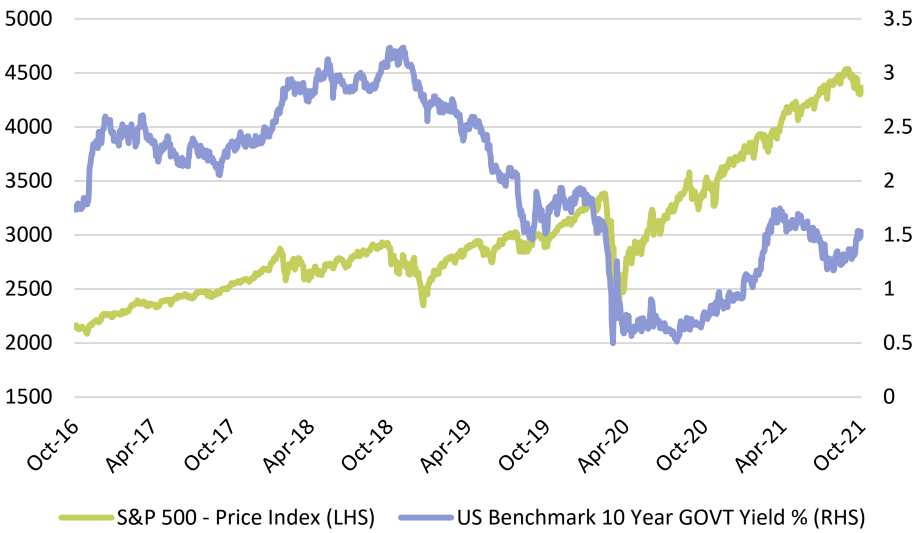
The recent spike in US CPI inflation has been contained to only a few categories, and encouragingly, these pressures are now starting to ease.

Read US Inflation Pressures Ease for Now

There are, however, some other signs of inflation in the system. Various input costs have risen sharply, i.e. shipping costs and a variety of commodity input costs. US wages growth is also perking up.

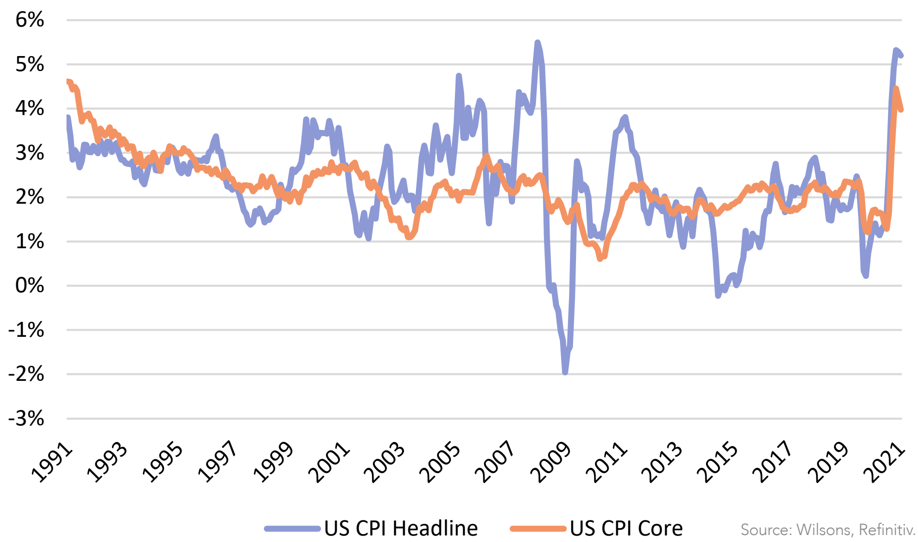
Our base case view continues to be that a fair portion of these upstream inflationary signals are also transitory, often linked to COVID disruption. There is a risk that these upstream pressures do not fade as quickly as the market expects while the inflationary pressures within the core CPI basket actually build across more categories (e.g. the housing component) rather than just fade in the current hot areas. So, we are watching developments closely.

Exhibit 12: A sharp rise in bond yields has pressured equities recently but yields remain relatively low



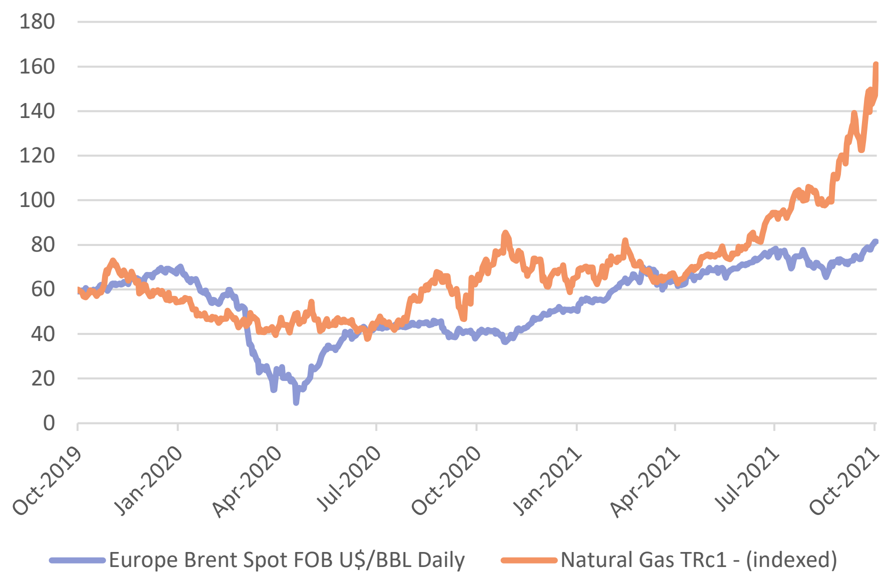
Source: Wilsons, Refinitiv.

Exhibit 13: US inflation has jumped sharply this year but appears to be moderating again



Source: Wilsons, Refinitiv.

Exhibit 14: Upstream Inflation? Oil continues to grind higher while the gas price has surged



Source: Wilsons, Refinitiv.

We have already taken some positions within our portfolio to hedge for the risk that our moderate inflation central case is too benign a view. We have exposure to real assets, gold and floating rate private credit in our alternatives portfolio. We are, of course, very underweight traditional duration-based fixed interest and are overweight value within equities. Clearly, being overweight equities, we are not positioned for a major inflation problem. We would describe our current position as being set for reflation with a watching brief around a more troublesome inflationary pulse. At present, we still see a more troublesome inflation scenario as more of a risk case than a central case.

Recent US Dollar Strength Should Fade

We continue to keep a partial (40%) hedge on global. This is meant to reflect a positive 12-month view on the A$ versus the US$ in particular.

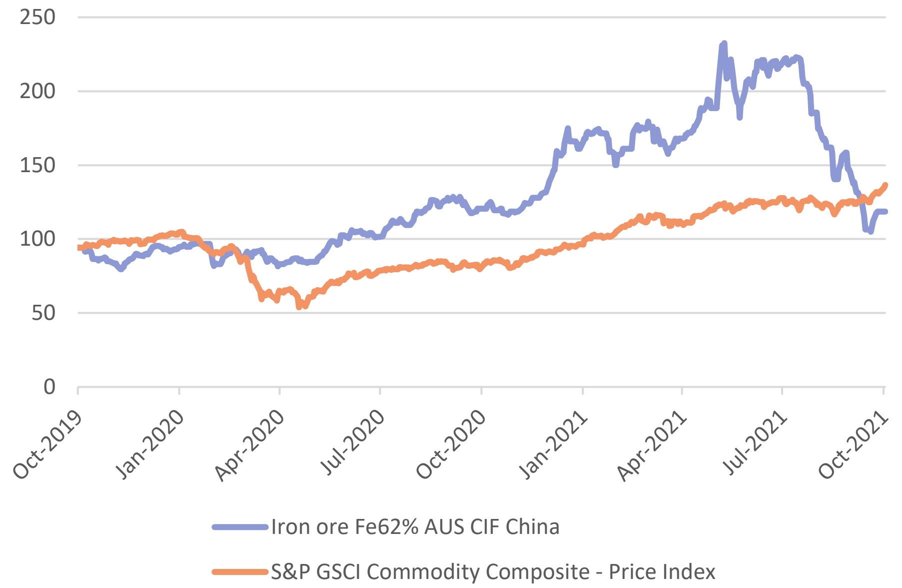
The US$ tends to be a countercyclical currency and a safe-haven currency. The US$ tends to be strong when the global business cycle is weak and softer when the cycle is strong. The US$ also tends to strengthen in risk-off phases. We believe that as global growth proves to be resilient and risk sentiment improves, the dollar should weaken; however, this will likely be a stop-start process.

The composition of global growth also matters. Growth momentum should rotate from the US to the rest of the world over the coming year. The dollar has a tendency to ease in these phases. Speculators are also now net long the US$, making the dollar vulnerable to a positioning reversal.

The A$ should also gain support from the reopening of the Australian economy. Australian vaccination coverage is set to easily surpass the US over the coming months, which should buoy the outlook for our economy and sentiment toward the A$.

Weakness in iron ore from a slowing Chinese real estate market could weigh on the A$ if iron ore weakness is particularly marked. However, we note that the currencies correlation tends to be closer with broader global commodity indices, where we remain quite constructive.

Exhibit 15: Iron ore massively outperformed the broader commodity complex but may now underperform



Source: Wilsons, Refinitiv.

Alternatives - Diversifying Risk and Supplementing Return

With yields likely to rise over the next 1-2 years because of the economic recovery broadening and QE support fading, we maintain a solid tactical overweight in alternatives (and a healthy strategic allocation).

We do not see cash as a particularly attractive alternative destination at present, with available cash rates at very close to zero. So, the opportunity cost of keeping some investing dry powder is relatively high at present.

Our alternative allocations compromise four major subcategories:

1. Private equity
2. Private debt
3. Real assets (infrastructure, real estate and commodities/agriculture)
4. Hedge Funds

Exhibit 16: Expected returns - Wilsons expected asset class returns

	Long-Term Expected Returns	12 Month Expected Returns
Domestic Equity	8.0%	8-12%
International Equity	8.0%	7-11%
Fixed Interest	1.5%	-3 - 0%
Cash	1.5%	0%
Alternatives	6.5%	6.5-9%

Long-term expected returns are 5-10 year passive expected returns based on both historical performance and current pricing/yields.
12 month expected (passive) returns are shown as a range due to the inherent volatility of financial market returns.
Total Returns have been assumed.
Performance and risk projections are subject to market influences and contingent upon matters outside the control of Wilsons Advisory and Stockbroking Limited and therefore projections may not be an accurate indicator of future performance and/or risk.

Source: Wilsons, Refinitiv.

We see good risk-adjusted return opportunities in growth alternatives such as private equity, and real assets such as infrastructure and active property strategies.

We also see the opportunity to earn attractive income streams in the order of 5-6% in relatively defensive alternatives such as private credit.

We retain some modest exposure to gold as a tail risk hedge – namely a hedge against unexpectantly high inflation or a significant spike in market risk aversion. Gold has been under a degree of pressure this year due to a combination of the US$ rebound (which we think is temporary), higher bond yields and general reflation optimism. Cryptocurrencies are also likely receiving flows that may have traditionally been directed at gold.

Gold is at a difficult juncture. Our central case macro view of higher real rates and positive sentiment toward further reflation may well act as a significant headwind for gold over the coming year. However, a re-emergence of a weaker US$ could offset this to some extent. While the outlook for gold is buffeted by a number of cross-currents, the tail-risk of inflation pressures re-emerging as a genuine threat at some point over the next couple of years as well as the potential for a rise in US-China geopolitical tensions suggest retaining some exposure. We remain sceptical of cryptocurrencies as either a store of value or an effective portfolio hedge in risk-off environments.

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	2%	2%	0%	2%	2%	0%	5%	5%	0%	10%	10%	0%	20%	20%	0%
Fixed Interest	0%	4%	-4%	4%	12%	-8%	14%	22%	-8%	24%	32%	-8%	39%	47%	-8%
Equities - Domestic	42%	40%	2%	40%	37%	3%	33%	30%	3%	27%	24%	3%	15%	12%	3%
Equities - International	39.0%	39%	0%	37%	36%	1%	31%	30%	1%	24%	23%	1%	13%	12%	1%
• United States	24%	25%	-1%	22%	23%	-1%	18%	19%	-1%	14%	15%	-1%	7%	8%	-1%
• Europe/UK	11%	8%	3%	11%	7%	4%	10%	6%	4%	8%	5%	3%	5%	2%	3%
• Emerging Markets	4%	4%	0%	4%	4%	0%	3%	3%	0%	2%	2%	0%	1%	1%	0%
• Japan	0%	2%	-2%	0%	2%	-2%	0%	2%	-2%	0%	1%	-1%	0%	1%	-1%
Equities Total	81%	79%	2%	77%	73%	4%	64%	60%	4%	51%	47%	4%	28%	24%	4%
Alternatives	17%	15%	2%	17%	13%	4%	17%	13%	4%	15%	11%	4%	13%	9%	4%
• Growth	13%	11%	2%	11%	8%	3%	11%	8%	3%	9%	6%	3%	8%	5%	3%
• Defensive	4%	4%	0%	6%	5%	1%	6%	5%	1%	6%	5%	1%	5%	4%	1%
Growth Assets	94%	90%	4%	88%	81%	7%	75%	68%	7%	60%	53%	7%	36%	29%	7%
Defensive Assets	6%	10%	-4%	12%	19%	-7%	25%	32%	-7%	40%	47%	-7%	64%	71%	-7%
Cash + Fixed Interest + Equities + Alternatives	100%	100%		100%	100%		100%	100%		100%	100%		100%	100%	

Commentary references our Balanced Portfolio.

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Recommendation structure and other definitions

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

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