Asset Allocation Report

September 2020

/ Chartered Accountants

/ Business & Tax Consultants

/ Financial Planners

A history of shaping financial success

P **07 4924 9100** / E **kennas@kennas.com** / **www.kennas.com**

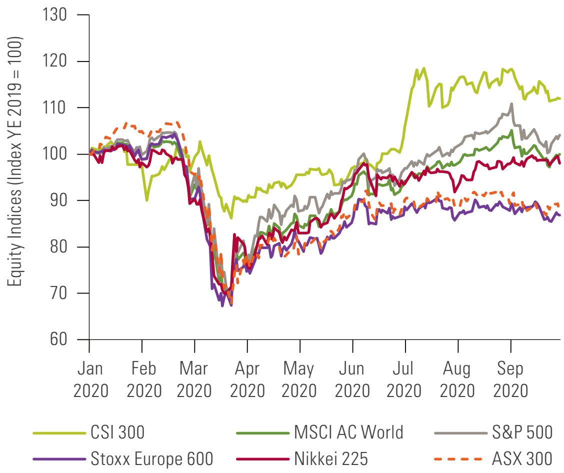
ROCKHAMPTON / 5th Floor Capricornia Electricity Centre Cnr Fitzroy & Alma Sts / PO Box 201 Rockhampton Qld 4700
YEPPOON / 1st Floor, 21 James Street / PO Box 1187 Yeppoon Qld 4703

Hypothesising a post-COVID world

Quarter in review

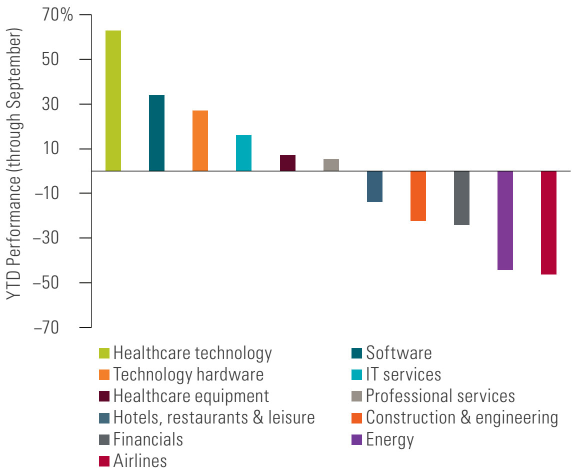
Markets oscillated between risk-on, risk-off mode in Q3, with investors whipsawed by policy announcements, economic data and changing COVID-19 case counts. The picture across regions (**Figure 1a**) was mixed, with China outperforming the rest of the world owing to its first-in-first-out (FIFO) experience with the pandemic, and the U.S. dwarfing most developed markets on the strength of gains in tech-heavy indices, which benefitted from favourable network effects during the pandemic. Australia, on the other hand, appeared to lag most markets given the renewed surge in new COVID-19 cases and stringent re-imposition of lockdowns in Victoria, which accounts for around a quarter of national GDP.

Figure 1a. Significant dispersion across countries...



Notes: Index returns are stated in local currency.
Source: Vanguard, using data from Bloomberg.

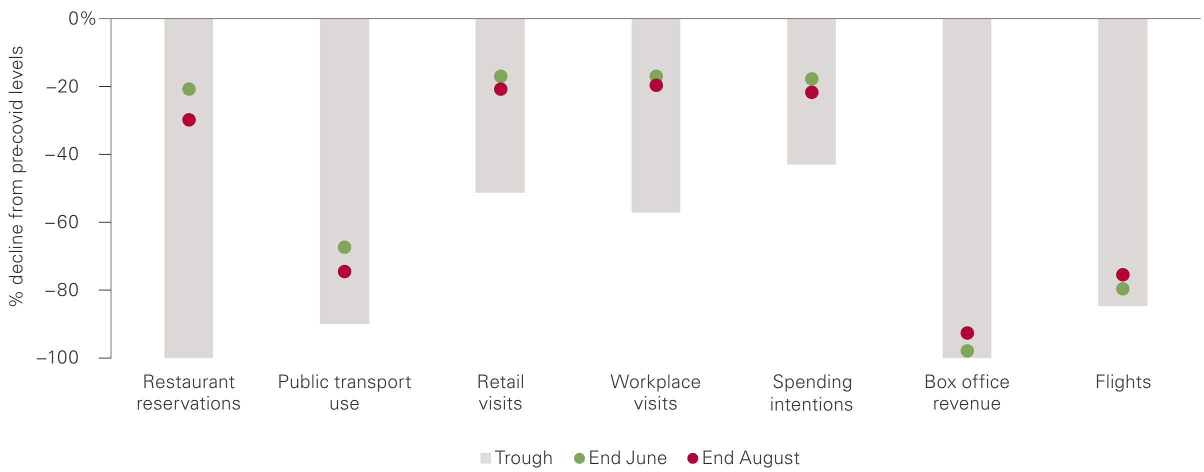
Figure 1b. ...and across sectors



Notes: Inter-industry performance for MSCI AC World Index in local currency
Source: Vanguard, using data from Bloomberg

As **Figure 2** illustrates, high frequency indicators used to track activity locally have experienced a pullback over the past two months, with most retail, labour and recreation mobility indicators falling below the levels seen in June. With the extension of direct fiscal support and bank payment holidays until March, 2021 is positive for Australian businesses and households. The lack of a meaningful economic reopening in Victoria until later in Q4 may increase the likelihood of more permanent job and business losses in the state. In the U.S., the negative effects of having the economy in hibernation for a prolonged period of time are evident, with the proportion of temporary unemployed workers permanently losing their jobs steadily increasing over the course of the last quarter (**Figure 3**).

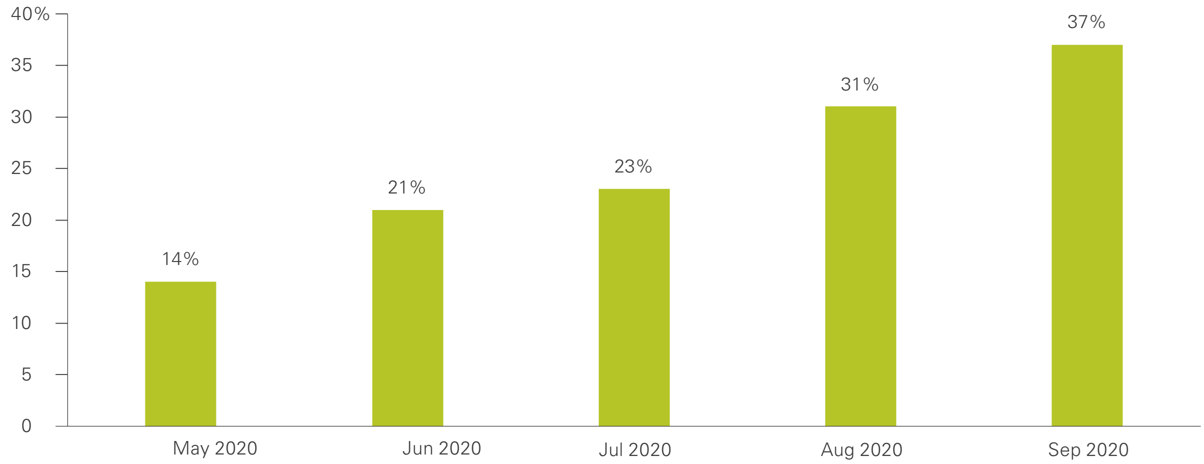
Figure 2. Real time tracking shows stalling recovery in recent months given VIC lockdowns



Source: Vanguard, using data from OpenTable, CityMapper, Apple, Google, Box Office Mojo, OAG and ANZ.

As past crises have taught us, a high proportion of permanent unemployment could prove detrimental to the shape and strength of the recovery, given its spillover effects on consumer confidence and spending. With the labour market unlikely to be as tight as it had been before 2021, and consumer sentiment weighing on face-to-face (F2F) consumption, Vanguard do not expect global output to return to its pre-pandemic levels in the very near-term, and quite possibly beyond, should permanent scarring effects intensify.

Figure 3. Increasing percentage of unemployed not on temporary layoffs



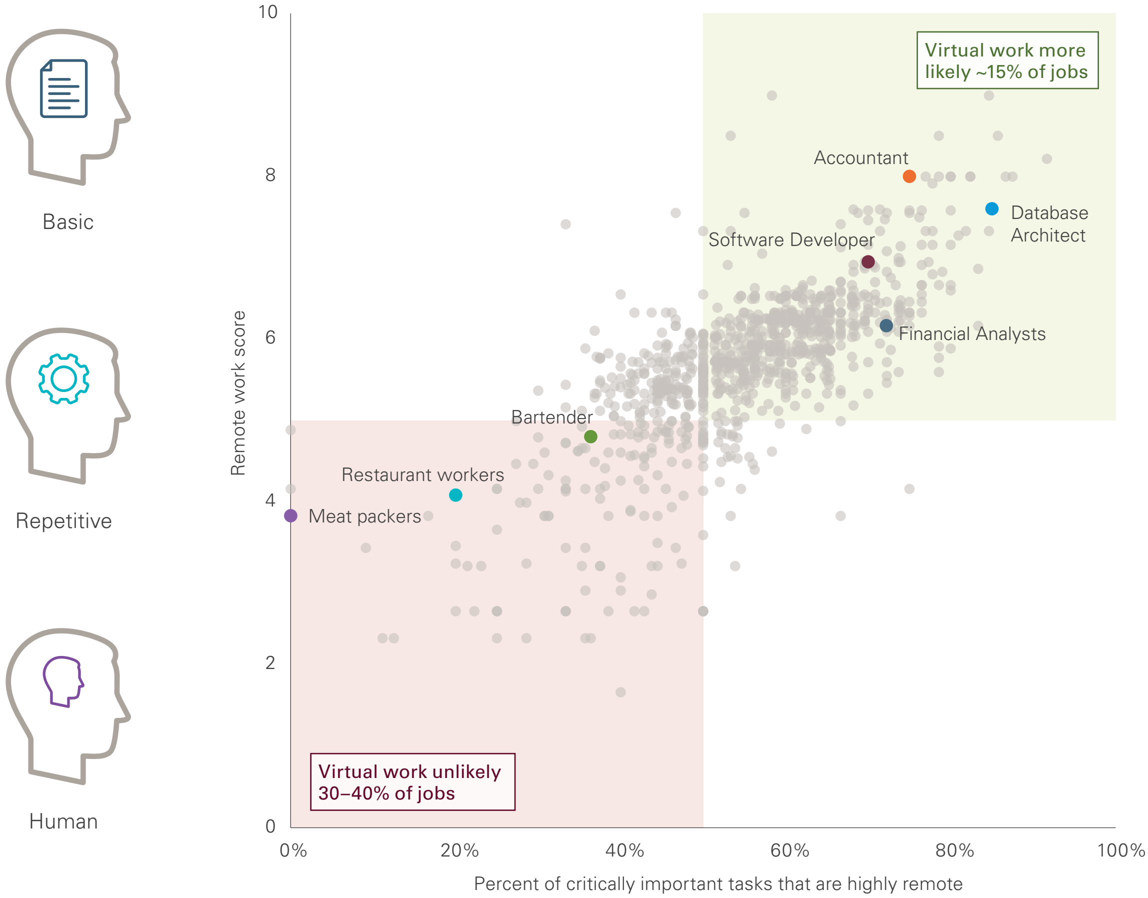
Source: Vanguard, using data from the U.S. Bureau of Labor Statistics

1 It has been well-documented that large financial crises or deep recessions can cause productive potential to ratchet down to a trajectory below its previous trend or even that the trend growth rate will be lower; for example, productivity growth in many developed economies still has not recovered from the 2008 global financial crisis.

Longer-term consequences of the pandemic

As economic activity gradually re-emerges, attention shifts to some of the longer-term consequences of the pandemic, some of which are more evident than others. Significant trends such as the shift to new ways of working, for example, will become more entrenched as a result of the pandemic. For many companies, arrangements such as working from home and virtual business meetings that had previously been the exception have now become the rule. Similarly,
e-retail and food delivery, already growing in popularity before the pandemic, have become essential to consumers worried about F2F interactions. As with office work and air travel, restaurants and retail may not overcome heightened consumer reluctance until an effective vaccine or treatment is developed - something Vanguard are not expecting before 2021. Under these circumstances, the damage on certain brick-and-mortar retailers could become permanent, and workers whose majority of tasks depend on physical interaction are also at a higher risk of not being able to resume their normal working hours in the near-term (**Figure 4**).

Figure 4. COVID and the future of virtual work

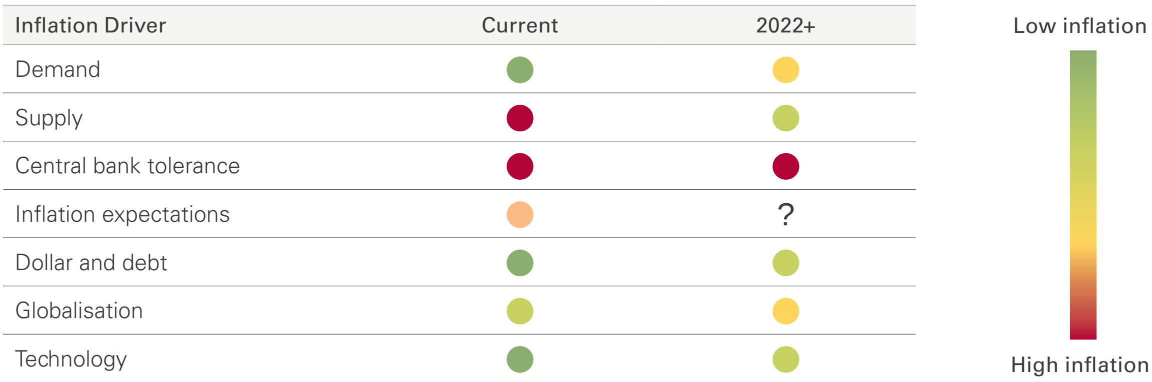


Source: Vanguard, using data from O*NET.

Interestingly, the second-order effects of remote working on commercial real estate, or at least how we invest in it, had already been occurring in plain sight even before the pandemic hit. Over the last decade, for instance, office and retail constituents have fallen from 39% to 19% of equity REIT assets, while residential, infrastructure, and data centres - sectors that are likely to benefit from the pandemic - now make up 45%[2]. The proliferation of digital technology will likely further accelerate this trend, although Vanguard expect the changes to occur gradually rather than overnight.

Meanwhile, inflation concerns have also re-surfaced against the backdrop of massive policy stimulus, supply-chain disruptions, and pent-up demand. While the effects of diminished demand imply a greater likelihood of disinflation (a slowing in the rate of inflation) in the near-term, virus-related supply shocks and increased willingness by central banks to tolerate above-target inflation could eventually push prices higher in the medium-term. In **Figure 5**, Vanguard list several cyclical and structural factors that could drive inflation outcomes, including higher inflation expectations, central bank tolerance, as well as de-globalisation.

Figure 5. The inflation machine: Factors driving inflation

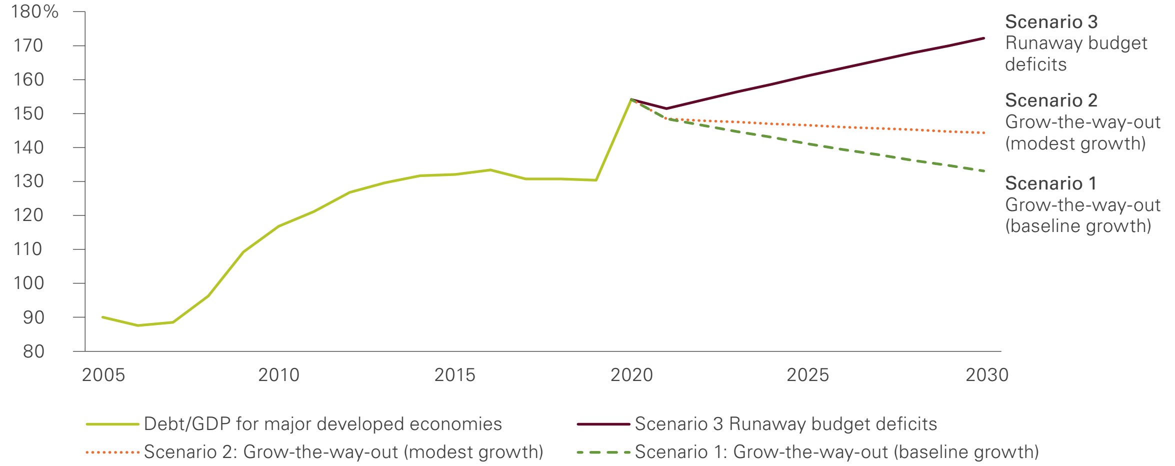


Some of these factors are more plausible than others in the near-term, such as the recovery in demand driving up consumer price inflation, particularly for goods inflation. Others, such as sustaining higher inflation expectations for an extended period of time, have proven to be more challenging, given central bank credibility in fighting inflation as well as the limited monetary ammunition to combat structural deflationary forces such as technology and globalisation. Indeed, while most central banks have a luxury of tools (such as raising policy rates) to combat higher inflation, it's on the downside where they've struggled, as interest rates have fallen toward or below zero even as the banks have implemented extraordinary measures to try to bring inflation to more reasonable levels. The adoption of the average inflation targeting (AIT) framework by the Fed in September is yet another unconventional tool used in hope of raising inflation expectations, but the not-so-successful experience of the Bank of Japan's inflation overshooting commitment in 2016 lead us to taper down our hopes for what this policy measure is able to achieve.

Should central banks finally achieve it, however, higher inflation could prove to be beneficial, especially against the backdrop of elevated debt levels taken on to fight against the monumental threat of the COVID-19 pandemic. In just two months after the initial shock, major developed economies saw their debt-to-GDP ratio surge by more than 20 percentage points, as policymakers spent trillions in spending, loans, and loan guarantees. In comparison, a similar increase in global debt in response to the 2008 global financial crisis took two years to play out.

2 Based on the FTSE Nareit All REITs Index. Data from 2010 are as of December 31, 2010, and data from 2020 are as of July 31, 2020. In 2010, residential infrastructure, and data centers made up 14%, 0%, and 0% of the index, respectively,

Figure 6. The fiscal math behind debt sustainability



Notes: Countries included in the calculation are Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States.
Scenario 1 represents 4% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit.
Scenario 2 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit.
Scenario 3 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 5% budget deficit.
Source: Vanguard calculations based on data from Thomson Reuters Datastream.

Under normal conditions, higher inflation doesn't help with debt reduction because bond markets eventually catch up through higher interest rates. But in rare circumstances like wartime spending or disaster responses, such as in this COVID-19 crisis, higher inflation can potentially erode the value of one-off debt. In addition, most policymakers and market participants understand that debt sustainability - the cost of servicing debt compared with economic growth - is far more important than the cold, hard headline number. In that respect, although the health shock led to unprecedented emergency spending, the low-interest-rate environment offers a favorable backdrop.

With growth rates also likely to rebound in coming years, as economies bounce back from pandemic-induced contractions, Vanguard could see developed economies "grow out" of their newfound debt. In scenario 1 of **Figure 6**, Vanguard suggest that an average nominal growth rate of 4% will be sufficient for debt in these major developed economies to return to pre-COVID levels by the end of the decade. Even more muted growth assumptions, as per scenario 2, are still enough to put debt on a sustainable downward trajectory, thanks to the sub-1% 10-year yields at which governments are issuing their debt. Of course, these scenarios are ultimately contingent on the shape of the initial recovery. A sooner-than-expected development of a vaccine or indications that we've achieved herd immunity would help accelerate recoveries and place us on a better path for debt sustainability. On the other hand, a second wave of infection that requires another round of national lockdowns is less likely but nonetheless a non-negligible risk - from both health and economic standpoints - that we unfortunately can't rule out.

Given the high degree of uncertainty associated with both the near-term and medium-term outlook, Vanguard think investors will be well-advised, as always, to maintain appropriately diversified portfolios appropriate to their goals. Attempting to time the market is tempting but rarely profitable.

Market outlook

With equities continuing to rise in Q3, albeit at a more moderate pace, some investors have questioned the attractiveness of this asset class given current valuations. Although Australian equity valuations have risen by 20-per cent so far this year by traditional metrics, Vanguard maintain the view that Australian equity markets appear fairly valued. This is owing to the significant correction in valuations early in 2020, from which the market continues to recover, as well as the support of historically low interest rates. Looking abroad, the divergence in valuations persists, with the rapid rebounds from the U.S.'s tech-driven rally and China's first-in-first-out experience now slowing, but appearing to hold steady. This is in contrast to the U.K. and EU which have struggled to regain ground amidst uncertainty over the trajectory of the virus.

Vanguard's outlook remains similar to our midyear economic update, with expected returns of 5.8–7.8% for local equity and 5.4–7.4% for international equity annualised over the next 10 years for AUD investors. Central banks' positions on monetary policy look to continue to dampen fixed income yields with forecasts of 0.5-1.5% for domestic bonds and 0.9–1.9% for international.

The benefits of holding a globally diversified portfolio, with exposure to a variety of asset classes, sectors and regions, are likely to remain. The demonstrated unpredictability of markets and their varied paths towards recovery, as well as the role of high-quality bonds as ballast, reinforce the importance of not only a diversified portfolio that is aligned to your investment objectives, but also the discipline to stick to your plan and stay the course.

Figure 7a. Australian equity fairly valued

AUS Fair Value CAPE

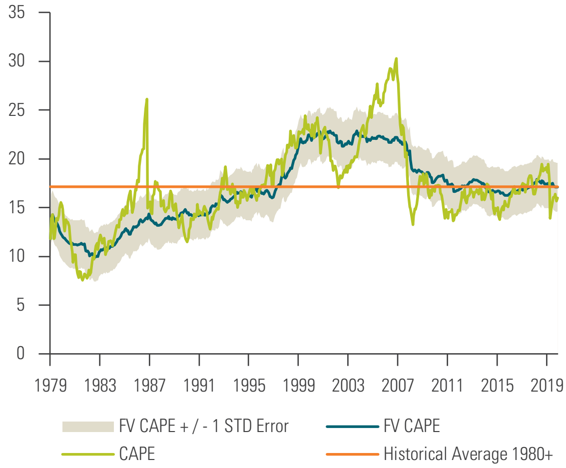
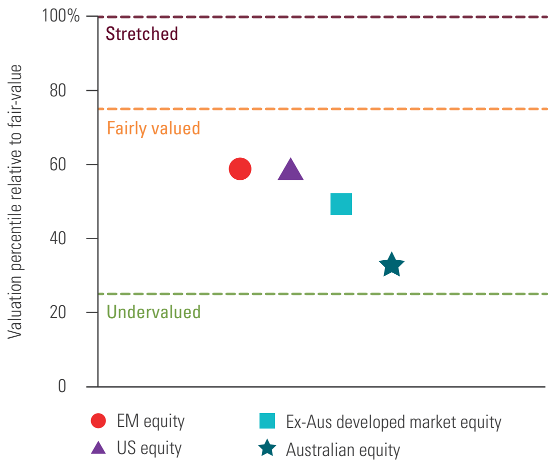


Figure 7b. International equities valuations are a mixed bag



Notes: "Fair-value CAPE" is based on a statistical model that corrects CAPE measures for the level of inflation expectations and for lower interest rates. The statistical model specification is a vector error correction (VEC), including equity-earnings yields, ten-year trailing inflation, and ten-year Govt. bond yields, and equity and bond volatility. Estimated over the period January 1970–October 2020.

Source: Vanguard calculations, based on data from the Reserve Bank of Australia and Thomson Reuters Datastream

Budget timing leaves rates on hold

The release of the historic big-spending federal budget overshadowed another key piece of economic news on the same day: the Reserve Bank's monthly statement on monetary policy.

There had been some speculation leading up to the RBA's statement that Australia's official cash interest rate would be cut from 0.25 per cent (where it has been since March).

Doing so would have dropped Australian rates below those of the United States, Canada and New Zealand (all also at 0.25 per cent), and Singapore (at 0.21 percent).

Dropping rates to 0.1 per cent would place us on the same rung as the United Kingdom, Poland and Israel. Taking an even greater step down to zero per cent would put Australia in line with a host of other countries around the world.

In any event, a rate cut didn't happen. But another decrease is certainly not off the RBA's policy agenda either.

The federal government's budget measures, including investment incentives, wage subsidies and tax breaks for businesses, have largely been designed around creating one million jobs to short-circuit the large spike in unemployment caused by COVID-19.

In his statement, RBA governor Philip Lowe noted the central bank's board remains committed to doing what it can to support jobs, incomes and businesses in Australia.

And he said the bank's board would maintain "highly accommodative policy settings as long as is required."

The rates view for investors

What that means is that the RBA will not increase the cash rate target until progress is being made towards full employment and the board is confident inflation will be sustainably within its 2–3 per cent target band.

"The board continues to consider how additional monetary easing could support jobs as the economy opens up further," Dr Lowe said.

Additional monetary easing translates to even lower interest rates for investors, including those borrowing capital for investment purposes.

Of course, what happens at the policy level hasn't in any way stifled activity at the retail level across banks and other financial institutions.

Even though Australia's official interest has now been on hold for over six months, there has been considerable rate movement activity at the retail level.

This has included further cuts to bank term deposit rates, to investment property mortgage rates, and to other loan product rates.

Data from financial products comparison website Canstar shows the current peak one-year rate on bank term deposits is 1.41 per cent, with the bulk of rates at or below 1 per cent. This compares with the top 12-month interest rate in June of 1.7 per cent.

Locking away cash out to three years can currently attract returns between 1.1 per cent and 1.55 per cent. Back in June, some rate returns on two or three-year term deposit accounts were above 2 per cent.

On a borrowing level, rates on the bulk of variable and fixed investor property loans are now below 3 per cent. Many are hovering in the mid 2 per cent range.

In terms of fixed interest securities, bond yields are still around record lows.

Early in September, the RBA bought a further $2 billion of Australian government securities in support of its three-year yield target, bringing total purchases of government securities since March to $63 billion.

Over the past couple of weeks, 3-year bond yields have fallen to around 18 basis points as markets have priced in the probability of further monetary policy easing (a rate cut).

How low can rates go?

In a speech late last month, RBA deputy governor Guy Debelle also gave some further insight into the bank's current thinking on interest rates.

He spoke of the RBA having multiple options, including lowering rates further and even using negative interest rates to spur increased lending from banks to businesses and consumers in order to boost spending across the economy.

Germany, France and 20 other European countries currently have zero interest rates, with Japan, Denmark and Switzerland each having negative rates.

There's no clear picture on what the RBA will do next.

As at 7 October, the day after the federal budget, the ASX 30 Day Interbank Cash Rate Futures November 2020 contract was trading at 99.925, indicating a 78 per cent expectation of an interest rate decrease to zero per cent at the November RBA board meeting.

The future path for official interest rates in Australia is very much wedded to the stimulus measures unveiled in the latest federal budget.

Many of the government's announced jobs-growth measures will take a fair bit of time to filter through the macro economy, so the next move on rates comes down to how long the RBA board is willing to wait.

Source: Vanguard Asset Allocation Report, September quarter 2020

FOR MORE INFORMATION Contact

Brent Giles
Partner / Director
Certified Financial Planner and Aged Care Specialist
07 4924 9100
brentgiles@kennas.com

Andrew Landsberg
Partner / Director
Financial Planner
07 4924 9100
andrewlandsberg@kennas.com