KENNAS

Asset Allocation Report

December 2020

/ Chartered Accountants

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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

Capping off a volatile year

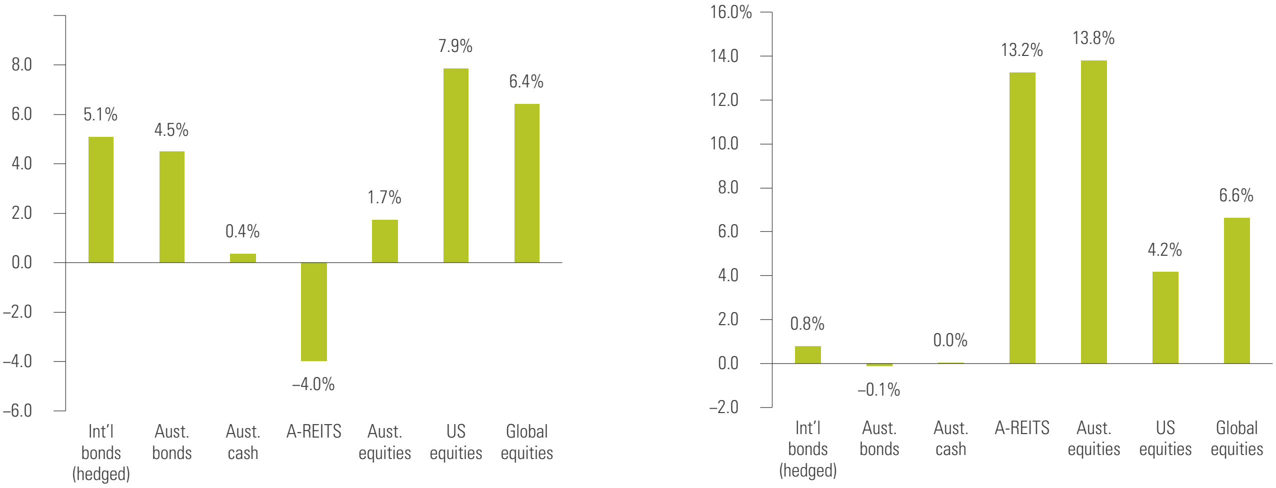
Quarter in review

Market volatility was ever present during the final quarter of 2020, driven by the controversial U.S. election in November, the looming Brexit deal deadline in December, escalating China trade tensions and the ongoing global spread of COVID-19. Yet, despite these and other unsettling factors, investment returns over the December quarter as a whole were relatively strong. At the final 2020 trading bell, the U.S. share market closed at a record high, spurred by positive sentiment around economic stimulus measures and the impending rollout of COVID-19 vaccines. The Australian share market, although still well off the record high it reached in February, closed off the final quarter more than 10% above where it started on 1 October. The bulk of that gain occurred during November, when the S&P/ASX 200 Index notched up its best return since 1988.

Figure 1. How asset classes performed

2020 returns

Q4 2020 returns



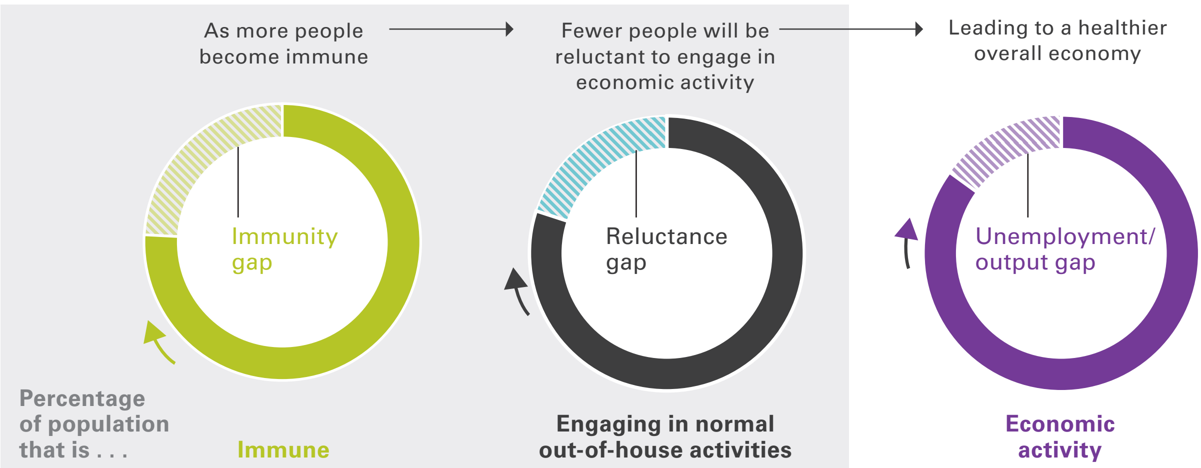
Notes: All returns except Q4 2020 are annualised. Global equity represented by MSCI AC World in AUD, US equity represented by S&P 500 in AUD, Australian equity represented by S&P/ASX 300 Index, Australian property represented by S&P/ASX 300 A-REIT Index, Australian bonds by the Bloomberg Ausbond composite 0+ Yr Index, International bonds by Bloomberg Barclays G obal Aggregate Index Hedged in AUD, and AUstralian cash by the Bloomberg Ausbond Bank Bill Index. Data through December 2020.

Source: Thomson Reuters Datastream and Bloomberg.

Global economy in 2021: Closing the immunity gap

It should come as no great surprise that the global economic outlook and the likely behaviour of financial markets remain hinged to COVID-19, and more specifically to health outcomes and responses. As **Figure 2** illustrates, the pace of the next phase of recovery is a function of immunity and the degree of consumer reluctance, where greater infection immunity and reduced reluctance to engage in economic activities will drive a sharper recovery

Figure 2. Health outc omes drive consumer behaviour and, in turn, recovery



Notes: The immunity gap is the proportion of the population that remains susceptible to COVID-19, and it's calculated as the difference between herd immunity threshold (around 65% of the population) and the percentage of population with acquired immunity. The reluctance gap is the proportion of the population that continues to refrain from normal out-of-house activities in fear of catching the virus. This is directly related to the immunity gap. The higher the immunity gap, the higher the proportion of the population that is fearful of engaging in normal activities. The unemployment/output gap is the gap between what economic activity was before COVID-19 and what economic activity is today. That is directly related to the reluctance gap. The bigger the reluctance gap, the lower economic activity is. That translates to a bigger economic activity gap and a bigger output gap. `Source: Vanguard.

Under Vanguard's more optimistic scenarios for vaccine effectiveness and coverage, output is likely to reach its pre-pandemic levels by the middle of the year, while a persistently large immunity gap—possibly a result of a less effective vaccine or an elongated distribution cycle—leaves economies with only marginal progress from current levels. Vanguard's central case projects a positive recovery path that will see global economic activity normalising by the second-half of the year and output reaching pre-pandemic levels by the end of 2021 **(Figure 3)**.

Figure 3. Economic scenarios for 2021

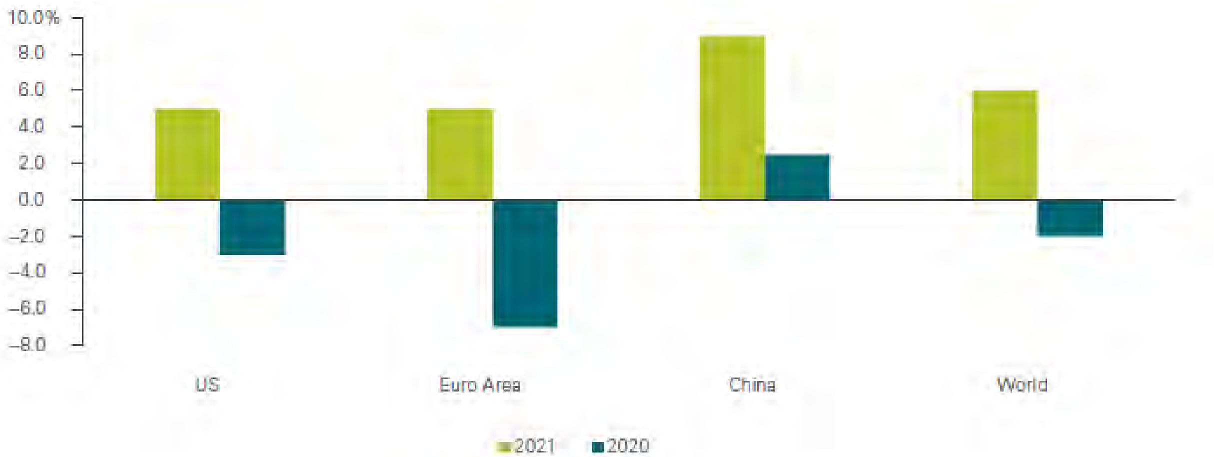
Vanguard assessment of risks

Downside risk	Base case	Upside surprise
10%	60%	30%
Little progress on infection immunity by end of 2021	Major economies achieve infection immunity by second half of 2021	Major economies achieve infection immunity by first half of 2021
Social and business activity hampered through 2021	Social and business activity normalizes by the second half of 2021	Social and business activity normalises in the first half of 2021
Labour market scarring possible given persistently high and long-term unemployment Inflation persistently below target Pre-pandemic level of output not achieved in 2021	Unemployment rate falls through year-end 2021 Inflation moves toward target in 2021 Pre-pandemic level of output reached by second half of 2021	Unemployment rate falls and full employment is achieved by end of 2021 Inflation overshoots in 2021 Pre-pandemic level of output reached by first half of 2021

Note: The odds for each scenario are based on the assessment of members of Vanguard's Global Economics and Capital Markets Outlook Team.
Source: Vanguard, as of November 30, 2020.

Country-specific economic growth rates will be varied, with some economies returning to their pre-COVID levels of employment and output faster than others. In China, where control of the pandemic has been more effective, output has swiftly returned to its pre-pandemic trend growth by Q4 of last year, and Vanguard see the recovery extending with growth of 9% in 2021 **(Figure 4)**. Elsewhere, the virus's prevalence has been less well-controlled, implying a sharp rebound in growth from a lower base in 2020 once vaccines become widely available. Vanguard expect growth of 5.4% in the U.S. and 4.5% in the euro area, with those economies still falling short of full employment levels in 2021. In emerging markets, Vanguard expect a more incomplete recovery, with growth of 6%.

Figure 4. Global growth—better in 2021

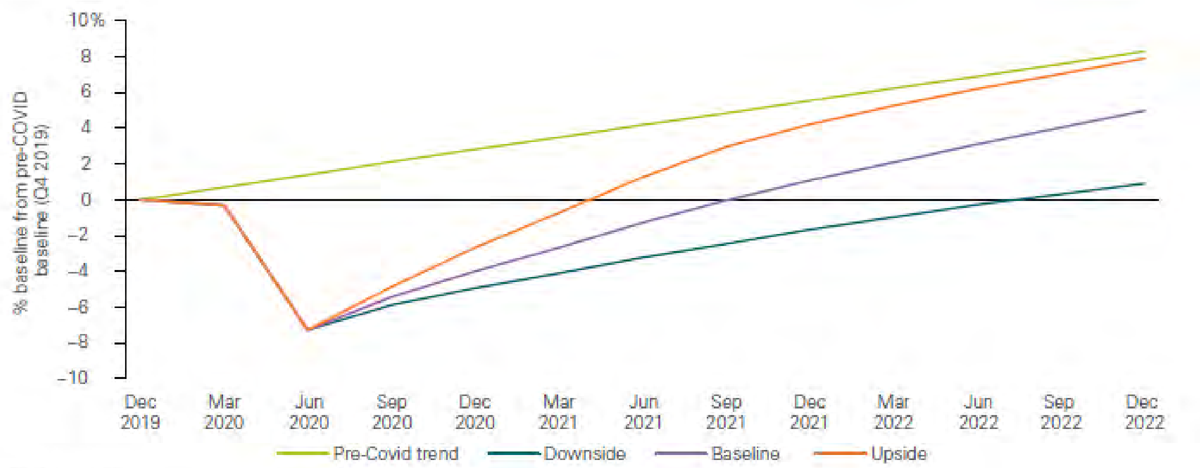


Notes: 2020 annual growth rates includes Vanguard estimates for Q4 2020.
Source: Refinitiv, Vanguard

Australia: A brighter summer to look forward to

The effects of the 'one, two punch' simultaneous supply and demand shock brought about by COVID-19 led Australia to experience its largest contraction since WWII and its first technical recession in close to 30 years. More effective containment measures to date, however, imply that normalisation of economic activity may prove to be slightly faster than countries facing higher rates of community transmission. Specifically, with annual growth of around 4.3%, Vanguard expect output to reach its pre-virus level by around the middle of 2021 (vs. end of year for global) on the back of a sequential lift in momentum as restrictions ease and state and territory borders are re-opened **(Figure 5)**.

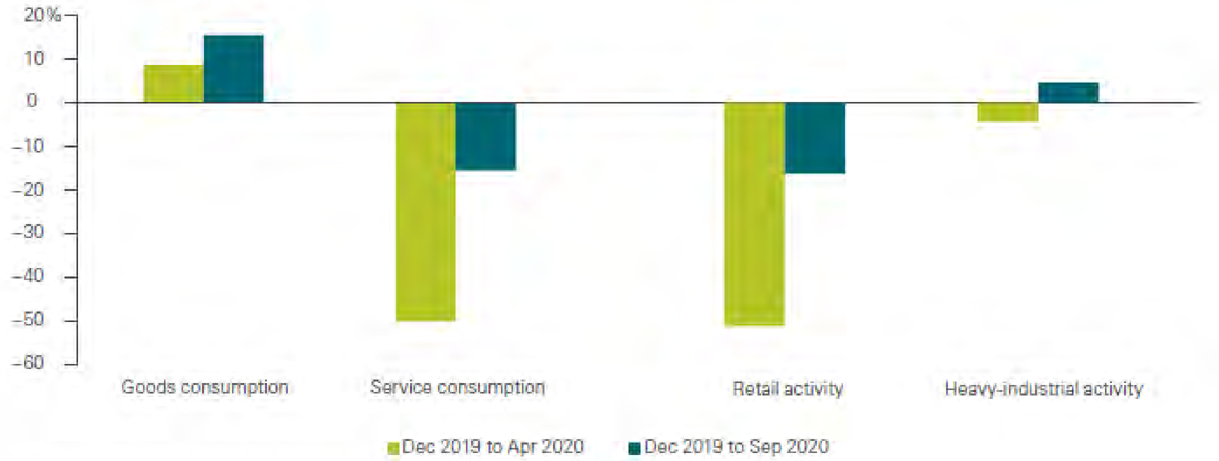
Figure 5. Reaping the rewards of harsher lockdowns upfront



Source: Vanguard

That said, the composition of the recovery in the near-term, barring widespread distribution of a vaccine, will continue to be rather uneven, with the consumption of goods and normalisation of heavy industrial production likely to outperform that of the services and highly face-to-face intensive sectors **(Figure 6)**.

Figure 6. Multispeed recovery across demand and supply



Source: Vanguard, using data from the Australian Bureau of Statistics.

Risks to the economy and markets could shift as 2021 progresses. Between now and widespread vaccine distribution, health-related risks to economic growth and sentiment should prevail. However, as growth and inflation firm in 2021 and immunity to COVID-19 increases, an "inflation scare" is possible. Ultimately, Australia's inflation could cyclically bounce higher in the middle of 2021 from current lows owing to base effects and an ongoing economic recovery, before plateauing back to the mid to low 1% levels, but such a move could introduce market volatility.

Meanwhile, the tapering of Australia's fiscal relief measures poses a risk to the consumption and financial stability outlook, but Vanguard take comfort in the resilience and speed of the initial recovery to date, and expect the household savings buffer to be used to smooth spending.

Against a fragile and uncertain backdrop, the RBA is likely to maintain its dovish pivot, with any additional adjustments to policy done through its new QE program rather than its price targets on the cash rate and the three-year yield. The choice of instruments may help to alleviate market concerns around the potential impact of negative rates, and expand the RBA's balance sheet to be more in line with global peers, the latter of which could help to push down Australian long-term bond yields to be more in line with global peers.

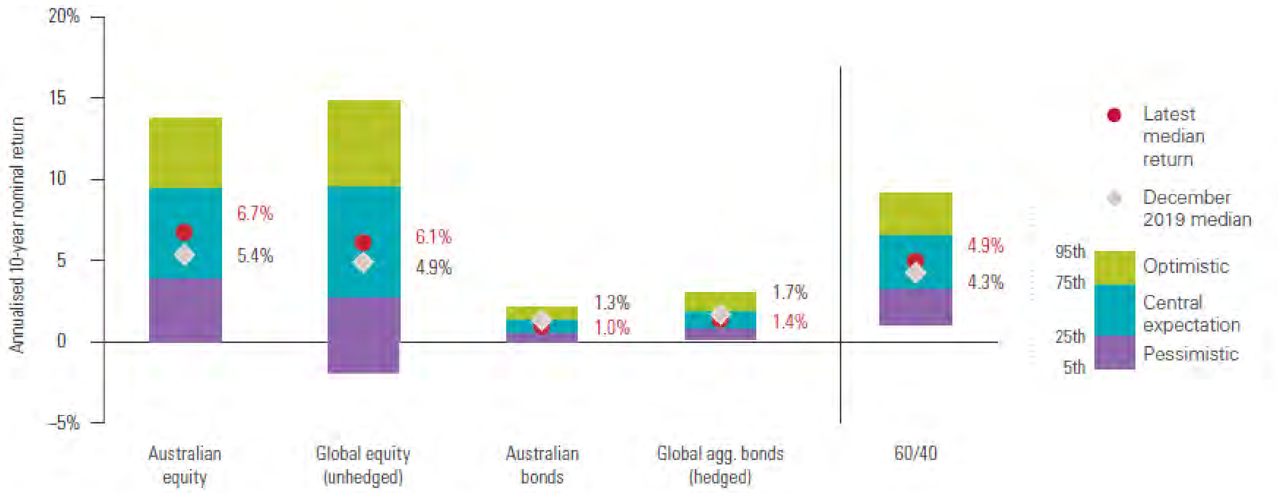
Global capital markets outlook

The path of global capital markets in 2020 can largely be described in three phases. The first phase occurred during the first month-and-a-half of the year and generally involved rising equity prices as lower rates and a reduction in trade uncertainty bolstered risk assets. The second phase occurred as the realities of the pandemic and related lockdowns set in during mid-February and March. Equity markets plummeted, credit spreads widened, central banks quickly cut interest rates and employed novel tools to stabilise markets, and fiscal policymakers unleashed a wave of support. The third phase began in April and has seen a more pronounced recovery in some regions than others.

For 2021 and beyond, Vanguard's outlook for global asset returns is guarded. High valuations and lower economic growth rates mean Vanguard expect lower equity returns over the next decade. Vanguard's outlook for global and Australian equities is in the 5%–7% and 5.5%–7.5% range respectively for returns over the next 10 years **(Figure 7)**, compared with the double digit returns experienced during prior decades. Despite the marginally higher expectation for local equity, Vanguard caution against excessive concentration risk and home bias, and underscore the benefits of a globally diversified exposure in managing risk, particularly given Vanguard's expectation for elevated risks in 2021 and beyond.

On the fixed income front, Vanguard expect interest rates globally to remain low despite a constructive outlook for firming global economic growth and inflation as 2021 progresses. While yield curves may steepen, short-term rates are unlikely to rise in any major developed market as monetary policy remains highly accommodative. Bond portfolios, of all types and maturities, are expected to earn returns close to their current yield levels.

Figure 7. Projected 10-year nominal return outlook



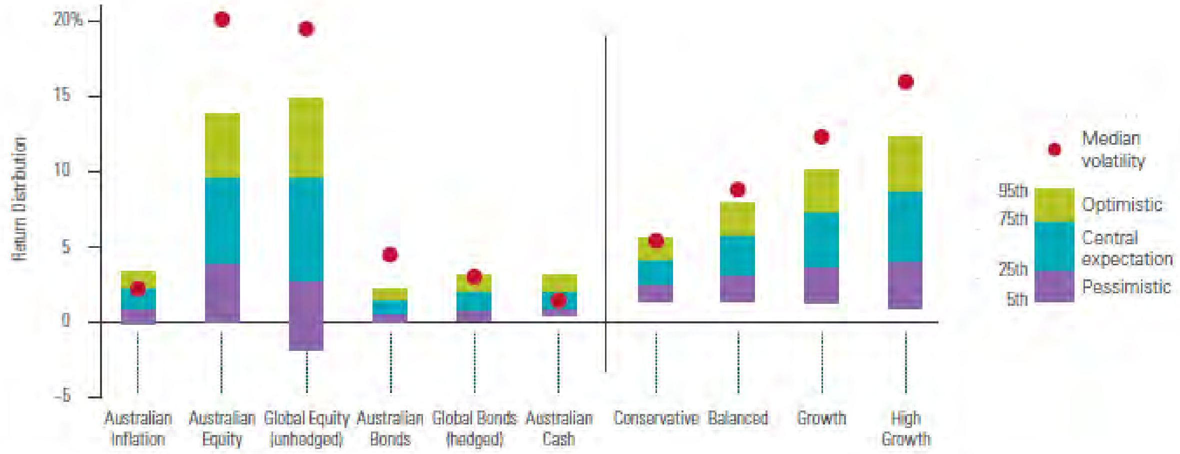
Source: Vanguard, November 2020. VCMM Simulation as of 30 September 2020 and 31 December 2019.

A consistent theme emerging from Vanguard's economic outlook of structurally lower interest rates across developed market economies supports Vanguard's view of a lower return environment. However, lower yield curves and still-not- overly-stretched equity valuations have also meant a modest steepening in the efficient frontier, which suggests an improvement in the equity risk premium or an increase in expected return for taking on marginal equity risk. Notably, equities are likely to continue outperforming most other investments and the rate of inflation, with returns expected to be 3 to 5 percentage points higher than that of traditional bond instruments over the next decade. That said, investors would still be encouraged to maintain a broadly diversified portfolio that is appropriately aligned to their goals and risk-tolerance, and to avoid over-reaching for yield or return at the cost of unintended risk exposures.

Long-term market outlook

The chart below shows the Vanguard Capital Markets Model (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds.

Figure 8a. Projected 10-year nominal return outlook



Source: Vanguard, 30 December 2020 VCMM Simulation.

It shows two concepts: the range of annualised 10-year nominal returns and the median volatility experienced.

The bars show the range of return outcomes over a 10-year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The red circles show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10-year period. The chart shows that equities are expected to produce a higher return over a 10-year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

Figure 8b. Projected 10-year nominal return outlook

	Return percentile					
	5th	25th	Median	75th	95th	Median Vol.
Australian Inflation	–0.2%	0.9%	1.6%	2.3%	3.4%	2.2%
Australian Equity	0.0%	3.9%	6.7%	9.6%	13.8%	20.1%
Global Equity (unhedged)	–1.9%	2.8%	6.1%	9.6%	14.8%	19.4%
Australian Bonds	0.0%	0.6%	1.0%	1.4%	2.2%	4.4%
Global Agg Bonds (hedged)	0.1%	0.9%	1.4%	2.0%	3.1%	3.0%
Australian Cash	0.4%	0.9%	1.4%	2.0%	3.1%	1.4%
Conservative	1.3%	2.5%	3.3%	4.2%	5.6%	5.4%
Balanced	1.4%	3.2%	4.5%	5.8%	7.8%	8.7%
Growth	1.2%	3.7%	5.5%	7.3%	10.1%	12.3%
High Growth	0.9%	4.1%	6.4%	8.7%	12.3%	15.9%

Source: Vanguard, 30 December 2020 VCMM Simulation

The next two charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way.

Figure 9. Probability of achieving real return target

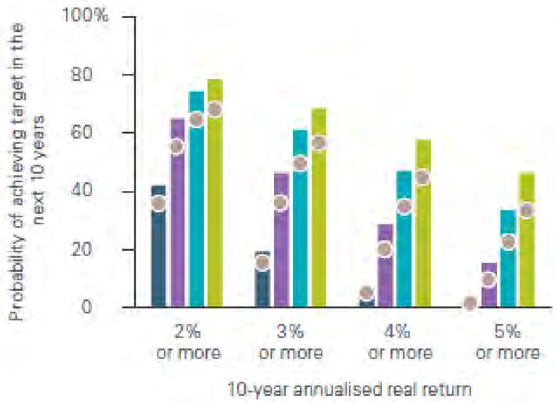
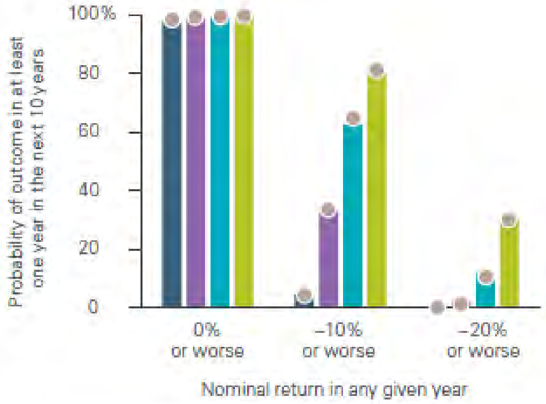


Figure 10. Downside risks



Note: The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modelled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, 30 September 2020 and 31 December 2019 VCMM Simulations.

Taking more risk means that an investor increases the probability that they will achieve their target over 10 years.

Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.

Source: Vanguard Asset Allocation Report, December 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