



# Asset Allocation Report

*March 2021*



- / Chartered Accountants
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*A history of shaping financial success*

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# Improving conditions, but challenges remain



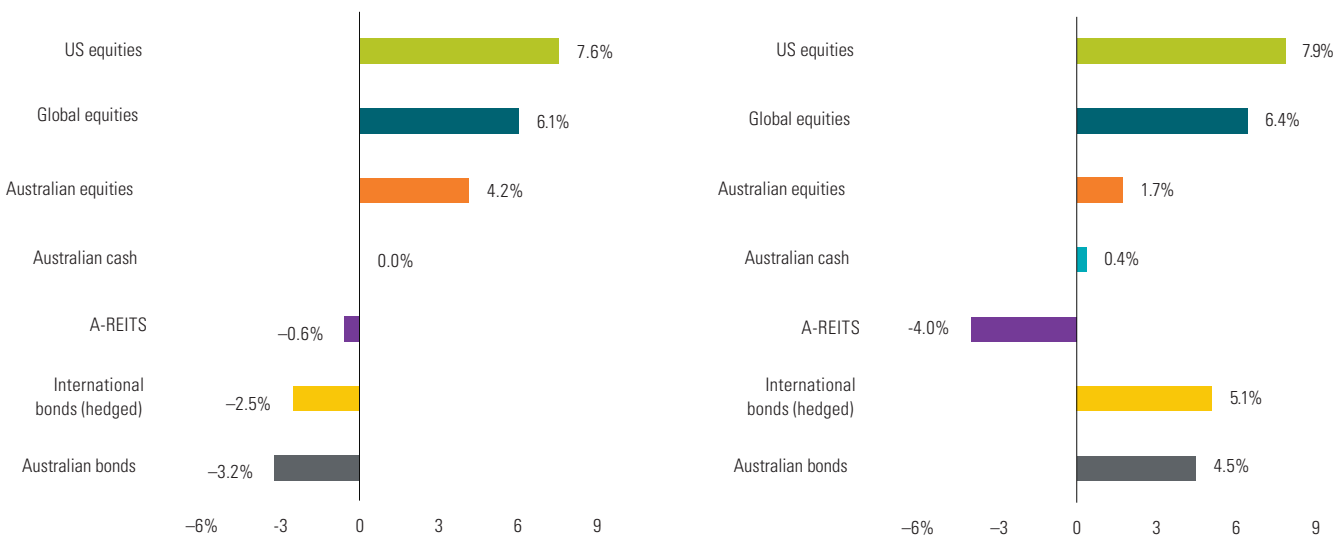
## Quarter in review

Global investment markets continued to build momentum from the 2020 year over the first quarter of 2021. U.S. Treasury yields rose 86 basis points over the quarter to 1.7%, a level not seen since January 2020, and global equity indices closed 17% above their pre-COVID highs. Within equities, the U.S. market outperformed its peers, coming in at 8% year-to-date compared to the global return of 6% (**Figure 2**), after the passing of a larger-than-expected USD 1.9 trillion fiscal stimulus package and with the aid of accelerated COVID-19 vaccine rollout program. The Australian share market lagged behind the global market, but nonetheless closed off the quarter 2.5% above its return in 2020 as value stocks recovered and as investors welcomed a return to relatively normal conditions. Fixed income, on the other hand, suffered as yields rose across the world on concerns around a potentially overheated economy and inflation scares.

**Figure 2. Market Review**

Q1 2021

2020

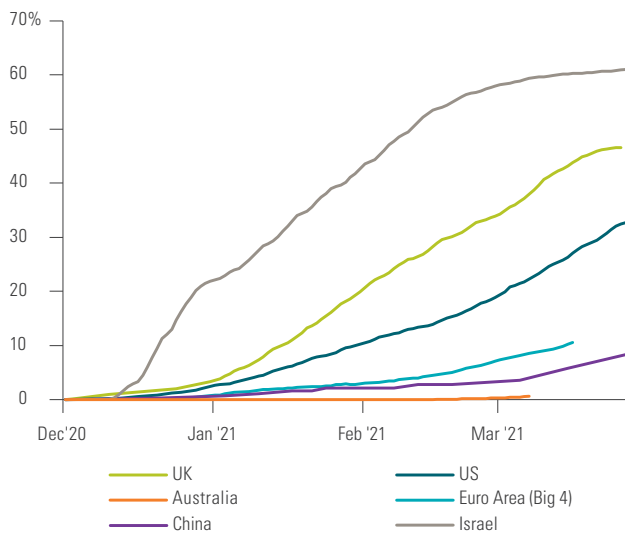


Notes: All returns except Q4 2020 are annualised. Global equity represented by MSCI AC World in AUD, US equity represented by S&P 500 in AUD, Australian equity represented by S&P/ASX 300 Index, Australian property represented by S&P/ASX 300 A-REIT Index, Australian bonds by the Bloomberg Ausbond composite 0+ Yr Index, International bonds by Bloomberg Barclays Global Aggregate Index Hedged in AUD, and Australian cash by the Bloomberg Ausbond Bank Bill Index. Data through March 2021.  
Source: Thomson Reuters Datastream and Bloomberg.

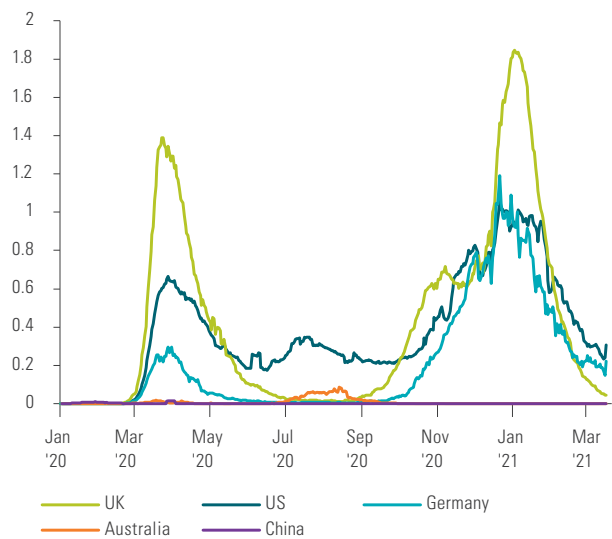
With vaccinations underway, the number of COVID-19 cases, hospitalisations and deaths in developed economies have been much lower than at the start of the year, paving the way for a significant pickup in economic activity in the second half of the year. This is especially the case for countries like the U.S. and U.K., which have accelerated the number of vaccinations over recent months. As **Figure 3** illustrates, over 30% of the U.S. and 50% of the British populations have now received at least one dose of vaccine, compared to only 1% and 2% respectively at the start of the year. Closer to home, vaccination progress in Australia and China has proved to be much slower, though the effective containment of the virus to date has meant the pace of economic normalisation is less sensitive to vaccine developments.

**Figure 3. Vaccine prospects remain key to closing the immunity gap**

Vaccination progress (% of population vaccinated with first dose)



Daily deaths per 100,000



Source: Vanguard, using data from Refinitiv and John Hopkins University.

## Economic outlook

Looking ahead, Vanguard expect economic normalisation to pick up across the world, particularly in the U.S. and U.K. In the U.S., the passage of the USD 1.9 trillion fiscal stimulus package has led Vanguard to upgrade their growth forecast by around 2–2.5 percentage points to a range of 7–7.5% for 2021. Some investors have worried that the size of the U.S. stimulus, combined with pent-up savings, could lead to an excessive pickup in inflation, and trigger a tightening of policy to an extent that could be damaging for equity markets. However, despite the upgrade to Vanguard's growth forecast for this year, Vanguard expect the direct effect on inflation of the U.S. government's recently enacted stimulus package to be relatively modest, at around 7–10 basis points for all of 2021 (**Figure 4a**). Additionally, the long-term structural trends that have kept inflation low for more than a decade will continue to limit price rises. As **Figure 4b** illustrates, these structural forces will have to experience a significant move of around 15–20 standard deviation on average in order for inflation to be sustainably higher, a situation Vanguard think is quite unlikely in the near term. Modest, rather than high inflation, alongside the Fed's increased tolerance for inflation risks is why Vanguard only foresee a potential third-quarter 2023 lift-off for the Fed's rate target.

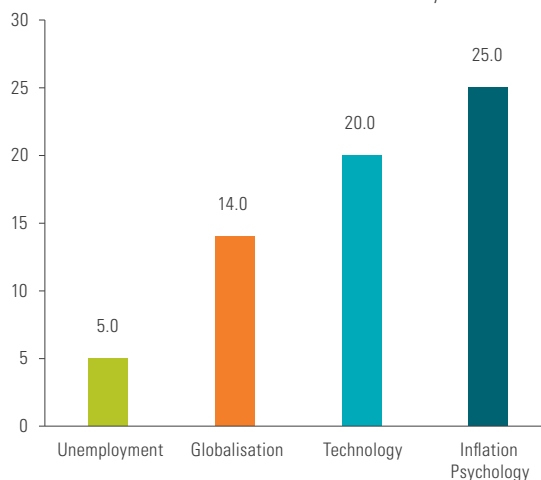
**Figure 4a & 4b. Modest U.S. reflation "yes"; High inflation "no"**

Core PCE forecast



Structural factors containing inflation

Standard deviation move needed for inflation consistently above 3%

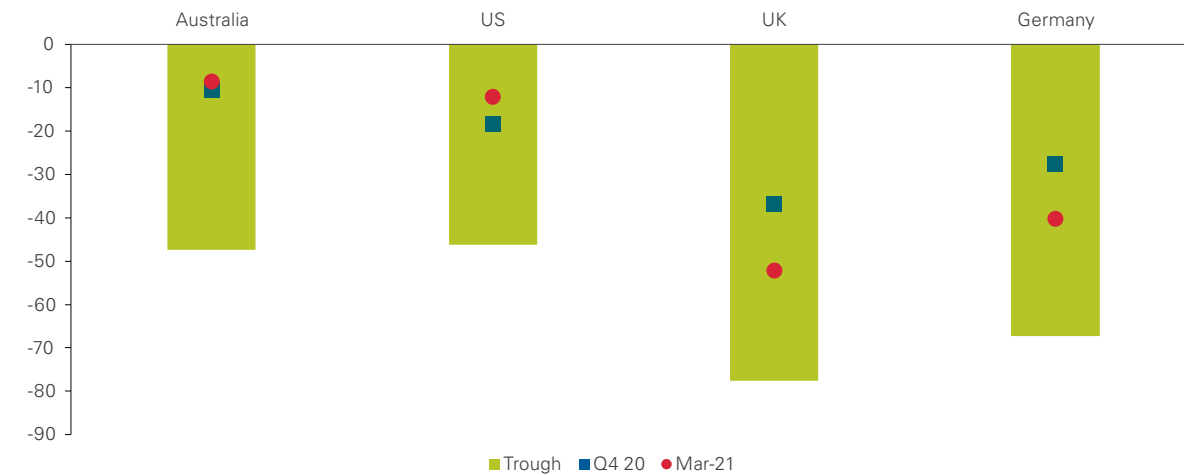


Notes: The globalisation factor is proxied using the ratio of import price deflator to overall GDP deflator, while technology is represented by a technology price input factor. Inflation psychology reflects 10 year inflation expectations.

Source: Vanguard, using data from Data Buffet.

In Australia, the economic recovery is well underway thanks to more effective virus containment measures. Mobility indicators for retail and recreational activities, for example, are much closer to their pre-COVID levels than in countries such as the U.K. or Germany (**Figure 5**). Against this backdrop, Vanguard expect output to reach its pre-virus level by the end of the first half of this year, compared to later in 2021/ 2022 for most of its developed peers.

**Figure 5. Mobility indicators suggest uneven recovery across countries**  
Google Mobility Index.

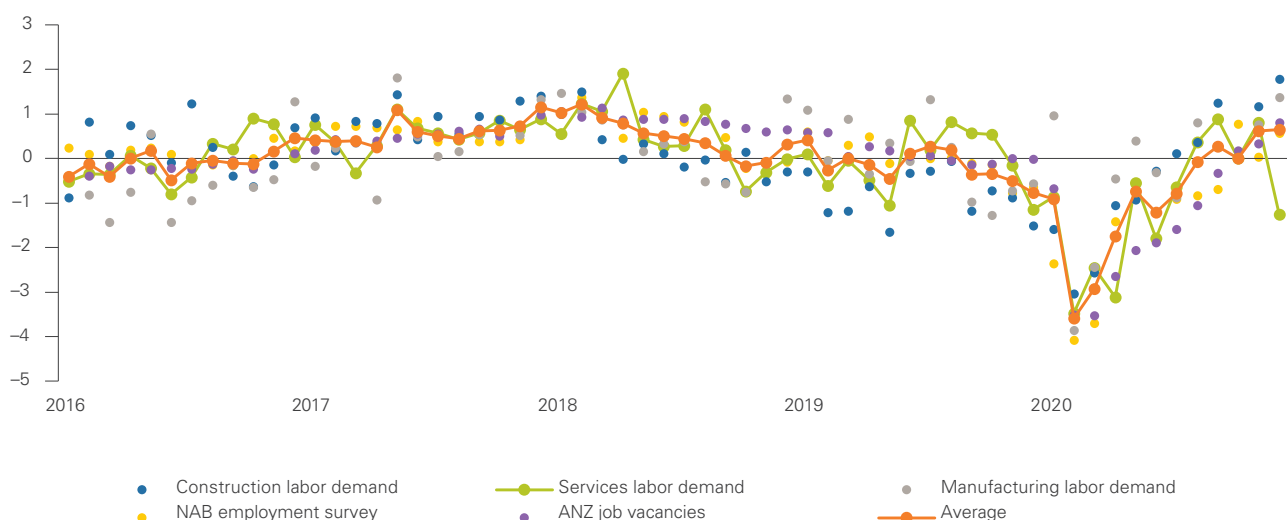


Source: Vanguard, using data from google

A key risk to the Australian outlook lies with the roll-off of the JobKeeper Payment scheme at the end of March, which to date has benefitted millions of Australians. Without the JobKeeper scheme, Vanguard estimate job losses in Australia could have been 700,000 higher and the unemployment rate at its peak would have been around 12% instead of 7.5% last year. The key challenge ahead is how the labour market situation will fare now that the 1.1 million people that were participating in JobKeeper have rolled off the scheme. Should all of these people lose their jobs, the unemployment rate could rise to around 13.8% in April/May (assuming labour force participation rates remain unchanged).

However, this assumption vastly overstates the workers “at risk” because those benefitting from JobKeeper in the last quarter of 2020 or the first quarter of 2021 will not necessarily lose their jobs. Given Australia’s minimal COVID-19 restrictions, many companies that qualified for JobKeeper in 2020—particularly those in Victoria—won’t feel the need to lay-off employees in the second quarter. In fact, forward looking indicators of aggregate labour demand are showing signs of strength at the moment (**Figure 6**), especially in sectors such as construction and manufacturing. Thus, even if some people in the service sector do lose their jobs, Vanguard think this will be partially offset by people getting jobs in other sectors that are doing well.

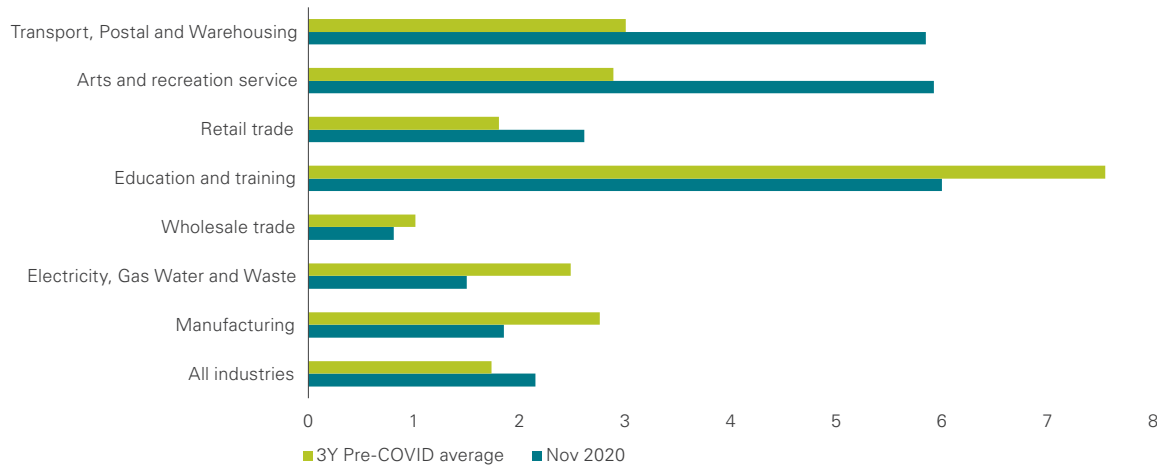
**Figure 6. Aggregate labor demand remains strong**



Source: Vanguard, using data from Refinitiv.

Within the more vulnerable service industry, Vanguard estimate that there are around 300,000 workers in high-risk sectors. These include the Aviation industry, Hotels and Accommodation, and in Arts and Recreation given ongoing international border closures and restrictions on large-scale public gatherings in some locations. As **Figure 7** illustrates, many of the more vulnerable sectors have not yet experienced a meaningful reduction in the unemployment/job vacancy ratio, which remains much higher than pre-COVID levels and more elevated than heavy industries such as manufacturing and utilities.

**Figure 7. Unemployment still outweighs job vacancies in the most virus-sensitive sectors**  
Unemployment to job vacancies



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

One way to estimate the number of job losses in these sectors post JobKeeper is to look at the number of employees currently working zero hours for economic reasons, as this group is most vulnerable to layoffs once the scheme rolls-off.

In Vanguard's baseline scenario, they assume around 90% of this group of workers within the Arts and Recreation as well as the Accommodation sector will likely lose their jobs in April/May. The Aviation industry, on the other hand, faces a lower risk given the government's recent announcement of the extension of the wage subsidy scheme<sup>1</sup> for workers in this industry. Meanwhile, Vanguard assume the other less vulnerable sectors will recover at least 50% of jobs given the ongoing reopening and normalisation of activity nationally, with a lower risk of the "fear factor" deterring activities. Under these baseline assumptions, unemployment will likely rise by about 60,000–80,000 in April/May, and the unemployment rate by around 0.4–0.6 percentage points.

On the downside, however, if all employed workers currently working zero hours for economic reasons across industries were to lose their jobs, then the unemployment rate could rise by close to 1 percentage point. However, this seems less likely given the ongoing loosening of restrictions nationwide and the normalisation of activities.

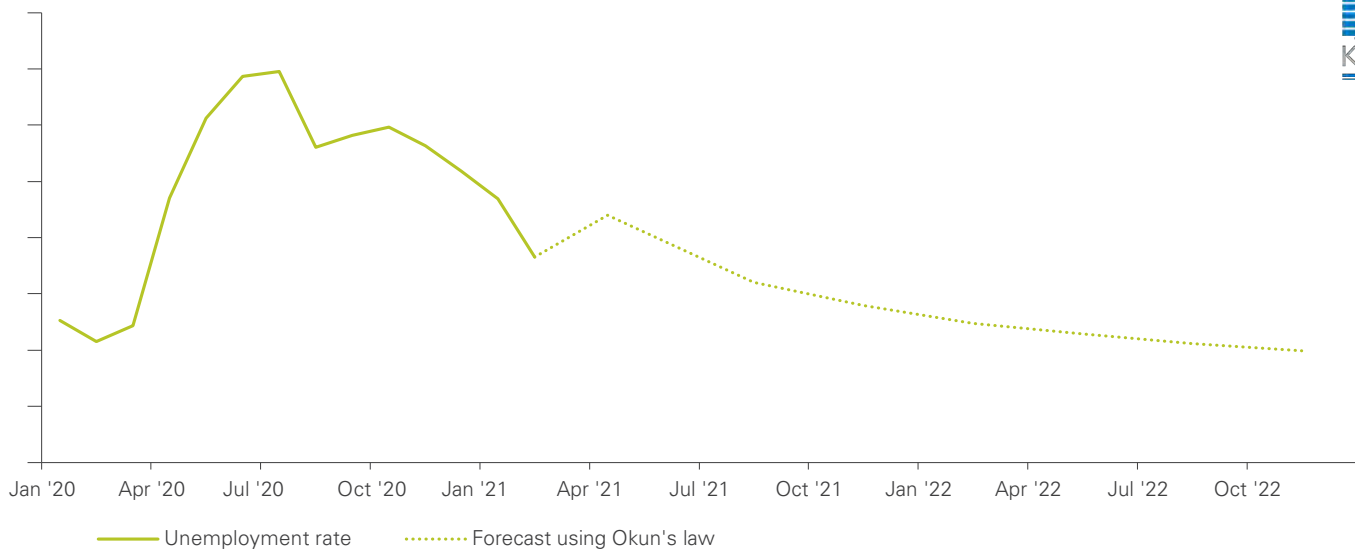
Beyond the second quarter, the labour market situation is slated to improve given the effective control of the virus in Australia as well as positive jobs growth expected in May and June. Using Okun's law<sup>2</sup>, which captures the relationship between unemployment and economic growth, Vanguard estimate the unemployment rate should end 2021 at around 5.3% and 4.9% at the end of 2022 given the ongoing economic recovery (**Figure 8**). While this is still slightly above the Reserve Bank's estimate of full employment (4–4.5%), it nonetheless marks a significant improvement in labour market conditions since the peak of the crisis last year.

In summary, temporary volatility in the unemployment numbers over the second quarter of 2021 can be expected, but this will not completely reverse the downward unemployment trend over this year.

<sup>1</sup> <https://australianaviation.com.au/2021/03/international-aviation-wage-subsidy-will-be-same-as-jobkeeper/>

<sup>2</sup> In Australia, Okun's law suggests that a percentage point increase in the output gap is estimated to decrease the unemployment rate by about a quarter of a percentage point.

**Figure 8. Unemployment forecasted to resume downward trend post Q2 volatility**



Source: Vanguard

## Market outlook

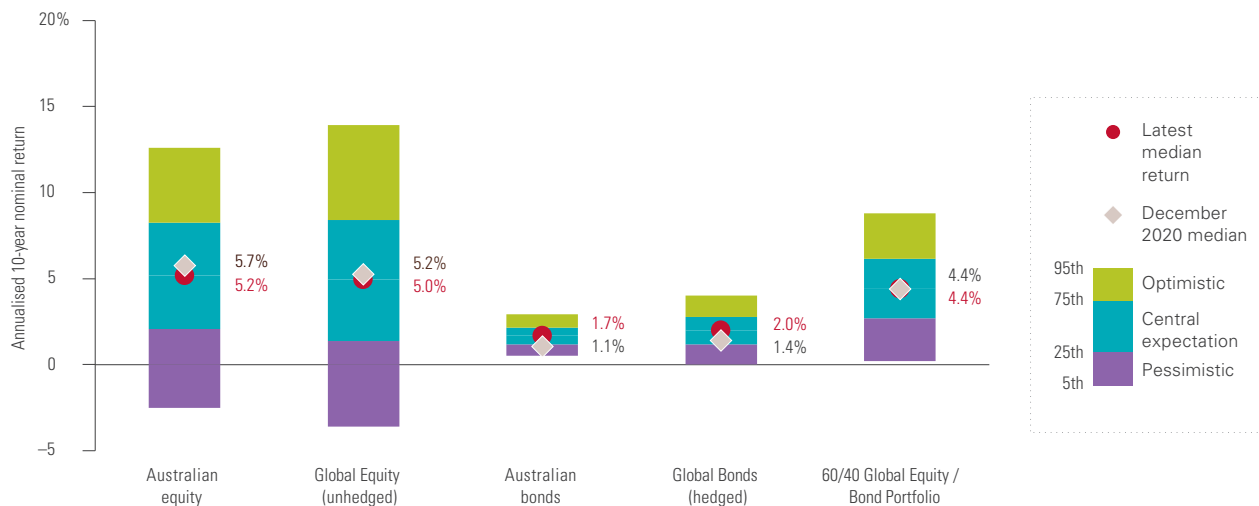
Global equity markets continued their climb in Q1, navigating a bout of bond market volatility to end at near all-time highs. Despite a repricing of inflation expectations that jostled equities, markets found comfort in the prospects of stronger economic growth, stimulus, and central banks' expectations for continued easy policy, although tail-risks still remain.

Rising yields combined with the strong gain in equities year-to-date contribute to a view on valuations that is broadly more elevated and less attractive than before, despite the support of near-term economic optimism. These movements are reflected in a decline in our 10-year annualised outlook for equities, with Australian and international equities expected to be in the range of 4–6% as of March 2021, modestly downgraded from December 2020 (**Figure 9**).

For some investors, elevated valuations have given reason for pause. As economies recover and return to trend, our equity return outlooks remain guarded and begin to resemble those from 2019 and 2020. Nevertheless, equities as part of a well-diversified portfolio are likely to continue outperforming most other investments and the rate of inflation over the long term.

Once again investors would be well advised to temper their expectations for returns over the coming decade, to ensure portfolios align with their investment objectives, and to focus on the factors within their control. Rebalancing can help to ensure that a portfolio aligns with its intended risk exposure, by responding to relative under and overvaluations within its asset allocation. However, Vanguard cautions against excessive concentration risk and market timing, where downside risks may be magnified and investment objectives compromised.

**Figure 9. 10Y annualised outlook: setting reasonable expectations**



Source: Vanguard, Interim 31 March 2021 and 31 December 2020 VCMM Simulations

On the fixed income front, recent rises in interest rates and inflation risks have left many investors questioning the appeal of bonds. However, a decomposition of fixed income returns suggest that rising rates are actually good news for long-term investors. While most have tended to focus on the price return (which falls as rates rise), many forget that a bond return consists of two other components – yield distribution and reinvestment income. Higher rates will not only result in a higher yield distribution, but investors reinvesting these distributions will also be able to reinvest at higher yields, thereby allowing them to benefit from the virtuous cycle of compounding interest at a higher rate.

While this concept is probably not top-of-mind when rates are rising and bond returns are depressed, it's a classic case of enduring short-term pain for long-term gain. As a rule of thumb, investors with time horizons longer than the durations of their bond holdings may be better off in the long term with a rise in rates today. In fact, as **Figure 9** illustrates, our long-term fixed income return outlook have actually improved since December 2020 given the rise in yields.

The mantras of discipline and long-term investing are never more important than when market volatility jumps. Instead of allowing emotions to drive your asset allocation, it is more prudent to let your investment goals shape decisions about your strategic asset allocation.

Source: Vanguard Asset Allocation Report, March quarter 2021

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