KENNAS

Asset Allocation Report

March 2021

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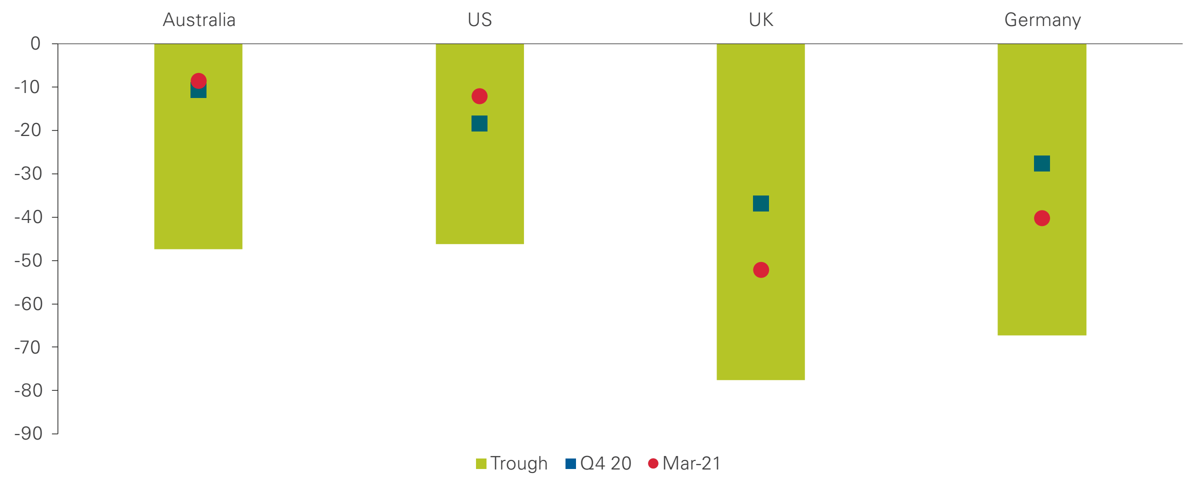
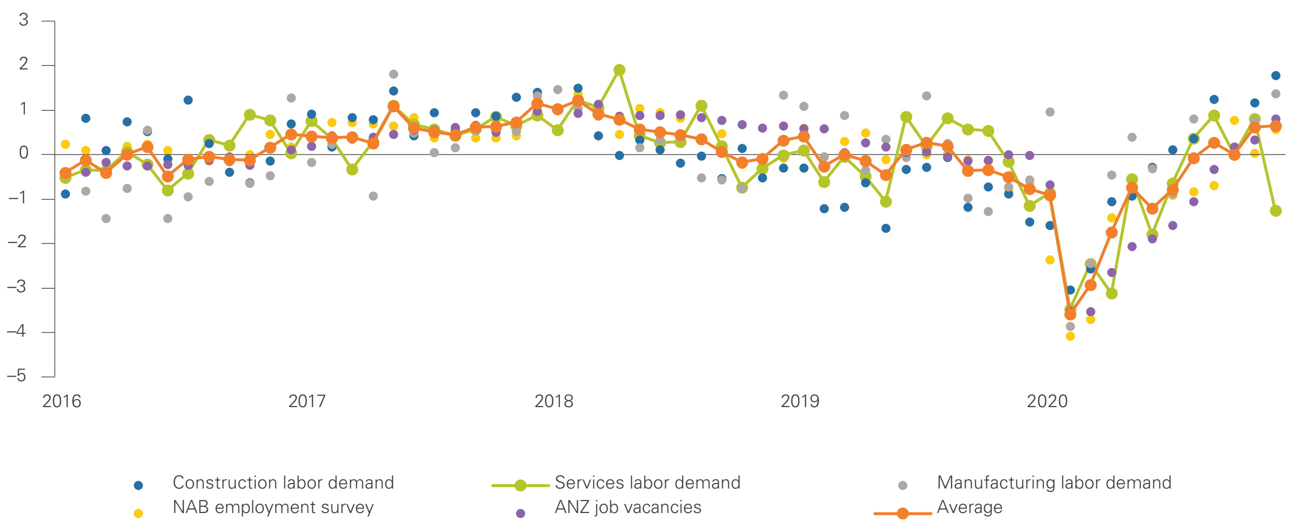


Source: Vanguard, using data from google

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, we 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, we 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.

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.

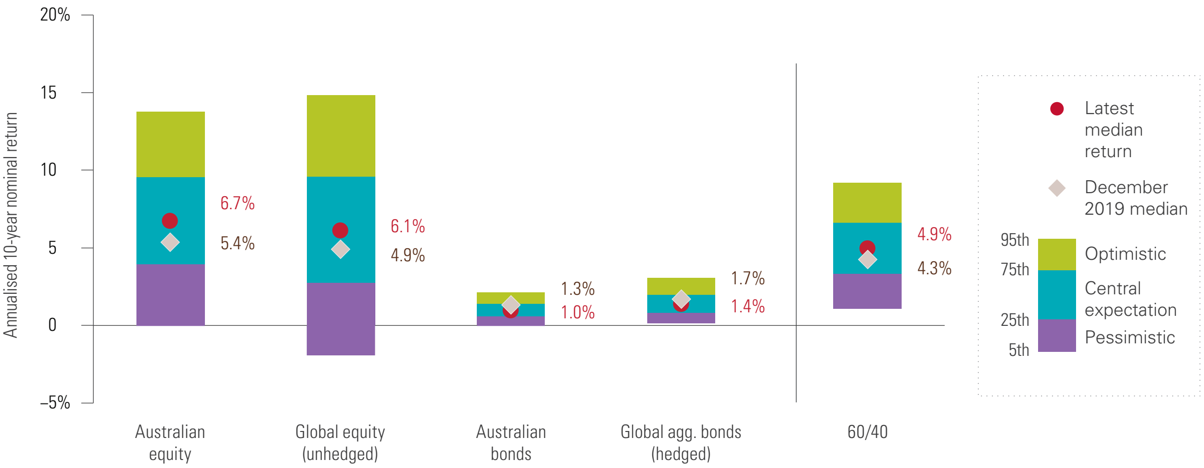
Global capital markets outlook

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



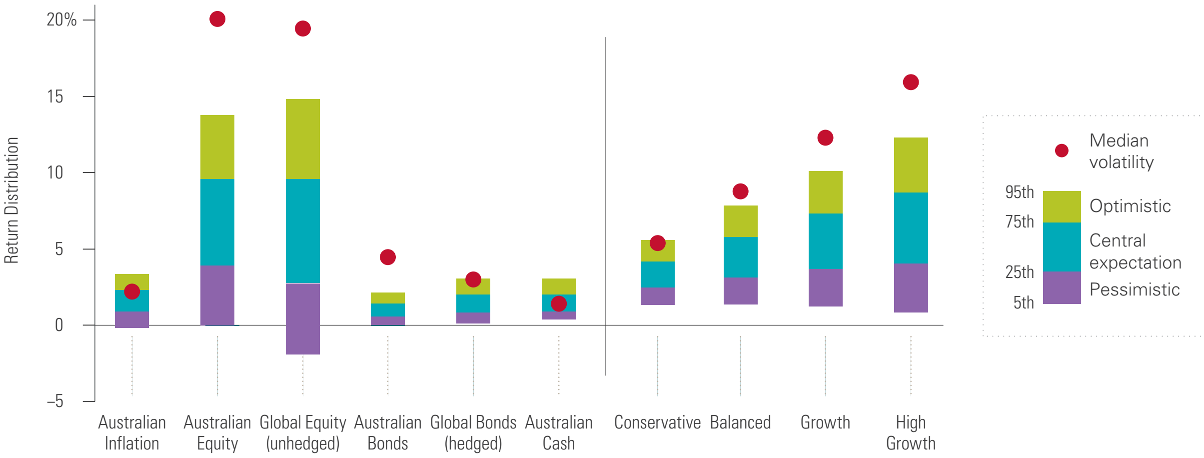
Source: Vanguard, November 2020. VCMM Simulation as of 30 September 2020 and 31 December 2019.

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

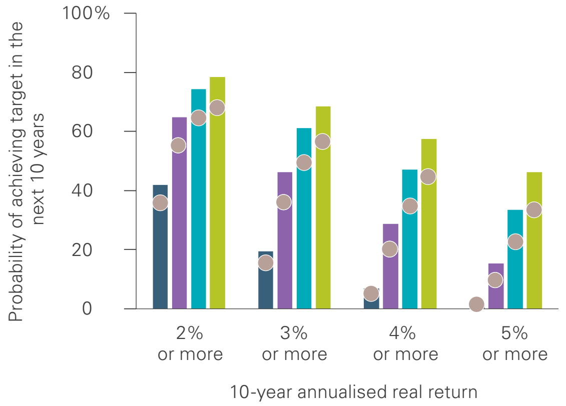
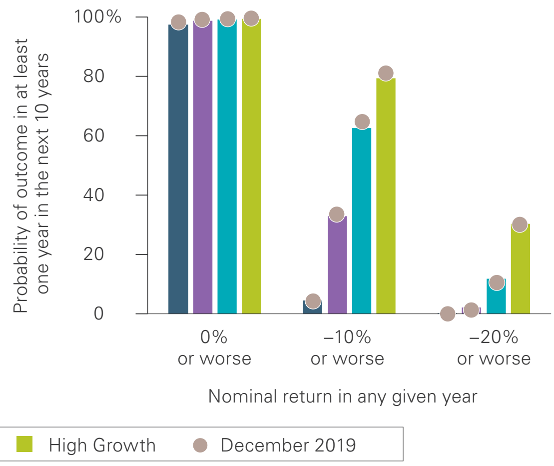


Figure 10. Downside risks



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

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