KENNAS

Asset Allocation Report

June 2021

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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

A BETTER BUT STILL BUMPY ROAD AHEAD

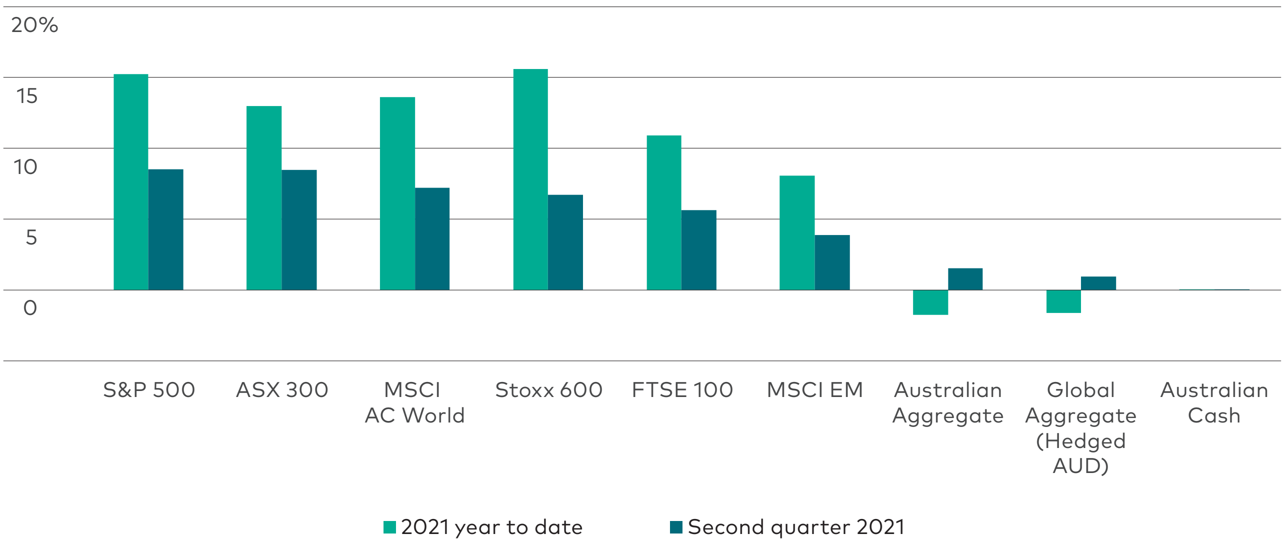
Quarter in Review

Despite concerns about rising inflation, global equity markets capped off the financial year with yet another strong quarter as economic activity rebounded, corporate earnings strengthened, and policy support remained accommodative **(Figure 3)**. The rollout of vaccinations remains critical to the reopening of economies and continued to gain pace over the quarter, particularly in the euro area. The percentage of its population receiving at least one dose of the vaccine increased from just 12% at the start of the quarter to 53% in June.

The progress on health outcomes saw European equity indices retain their year-to-date lead, while the U.S. outperformed in its Q2 performance as economic optimism continued to be fuelled by a strong earnings season and the Biden administration's announcement of an additional USD 1.2 trillion infrastructure stimulus plan. Meanwhile, strong economic data in Australia saw the S&P/ASX 300 reach new highs, closing the quarter 8.5% higher as investors cheered on the quick normalisation in the labour market and gross domestic product (GDP). A dovish Reserve Bank of Australia (RBA) helped to support a weaker Australian dollar, which ultimately saw international equity investments outperform the local market in AUD terms.

In fixed income markets, total returns for most bond classes were positive as yields declined modestly by 29 bps, marking a reversal from the first quarter. The decline in yields was driven by the market's view that recent increases in inflation are likely to be temporary and should moderate once pent-up demand fades and supply-chain issues are resolved. Australian yields also ended the quarter around 26 bps lower after an 81 bp rise in Q1 as real yields were capped by the RBA's commitment to keep the cash rate on hold until 2024.

Figure 3. Local currency returns for global indices

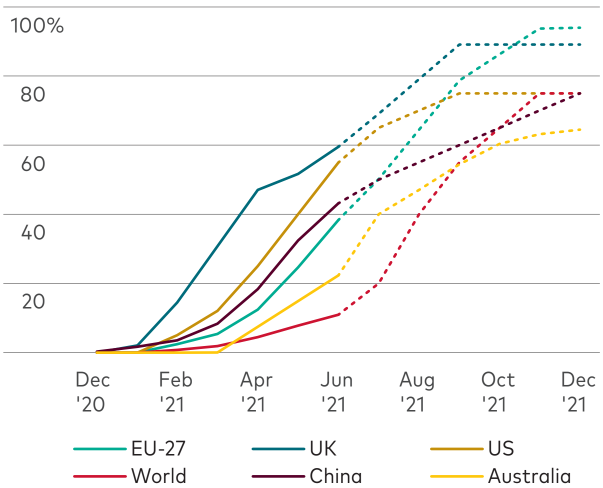


Notes: Returns are cumulative total returns. Global Aggregate hedged to AUD, other indices in local currency terms. **Source:** Vanguard, July 2021 using data from FactSet, Refinitiv

Economic Outlook

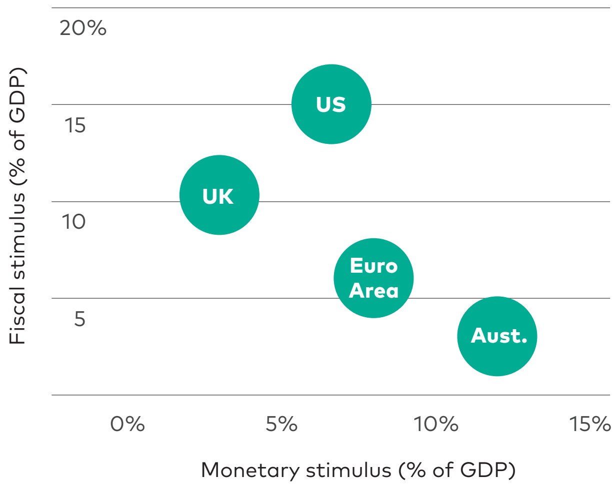
As vaccinations ramp up across the world, health risks are expected to gradually decline over the next few months, which could pave the way for a more robust recovery in face-to-face service sectors. Vanguard note, however, that differences in vaccination rates and varied levels of policy support **(Figure 4a and 4b**) are likely to produce a bifurcation of economic results in the near term. The U.S., for instance, with its leading vaccination efforts and strong fiscal support, is likely to lead the global economic recovery with full-year growth of at least 7%. By contrast, China, which was first to enter and first to emerge from the pandemic and an outperformer in 2020, is likely to experience a sequential deceleration in economic momentum in the second half of the year as support from the export sector wanes and consumption growth normalises gradually given sporadic virus outbreaks and an initially slow vaccination rollout.

Figure 4a. % of population with at least one dose



Source: Vanguard,July 2021 using data from Vanguard's World in Data.

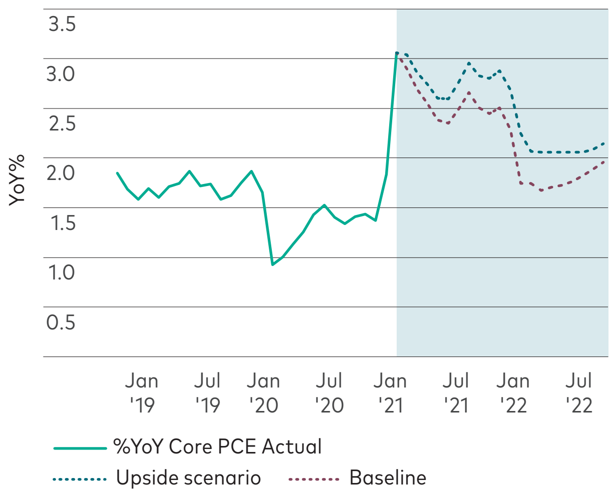
Figure 4b. US is expected to deliver the most fiscal support in 2021



Notes: Monetary stimulus refers to the expected change in central bank balance sheets, as a % of 2019 GDP.
Source: Vanguard,July 2021 using data from the Congressional Budget Office, European Commission, UK Government and Australia's Federal Budget.

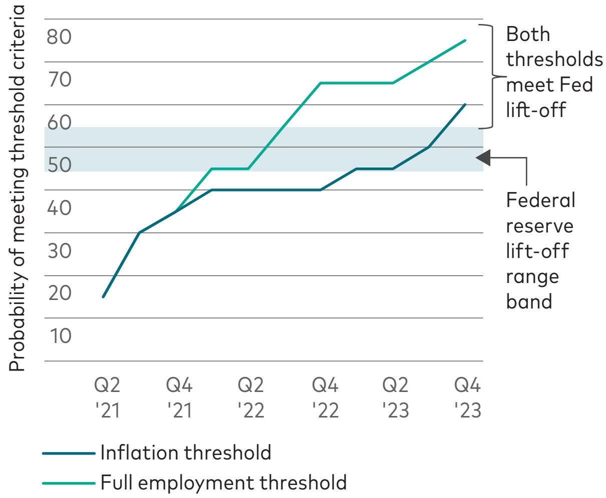
A strong U.S. economic recovery, coupled with ongoing supply constraints, has in Vanguard's view increased the likelihood of moderately higher inflation in the coming years. In Vanguard's baseline scenario of USD 500 billion in additional fiscal spending (above the existing USD 1.9 trillion American Rescue Plan Act), a 10 bp increase in inflation expectations, and 7% GDP growth in 2021, core PCE would average 2.4% in 2021 and 1.9% in 2022 (Figure 5a, overleaf), both of which are higher than the pre-COVID five-year average of 1.6%. Sustained inflationary pressures will eventually call for the Federal Reserve to taper stimulus and raise interest rates from near zero. Figure 5b, overleaf, illustrates Vanguard's outlook for monetary policy in the U.S., where Vanguard foresee conditions for an interest rate lift-off—namely full employment and the inflation outlook sustainably above 2% - to be met in the second half of 2023. Notably, while Vanguard expect labour market dynamics to normalise by the second half of 2022, the fading of base effects and eventual normalisation of supply-demand imbalances mean that modest reflation, rather than runaway inflation, is more likely in the near term.

Figure 5a. U.S. Core PCE forecast



Source: Vanguard, July 2021

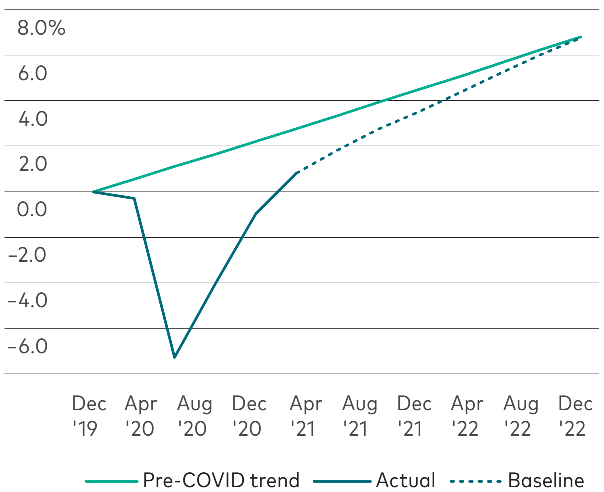
Figure 5b. U.S. is expected to deliver the most fiscal support in 2021



Source: Vanguard, July 2021

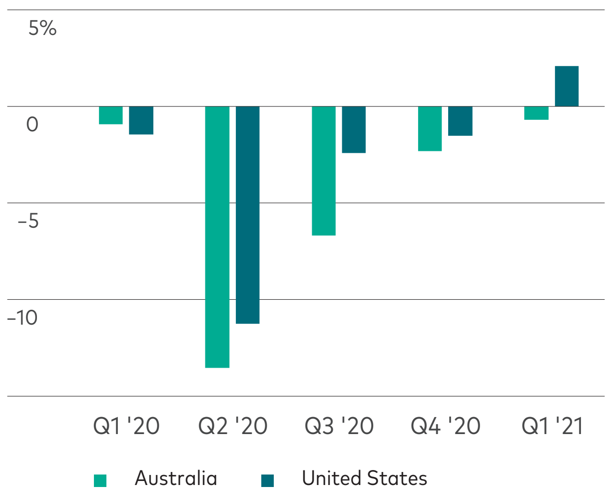
In Australia, the RBA has adopted a more conservative approach by committing to keep the cash rate on hold until 2024 given weaker inflation dynamics and a slower vaccination rollout. The latter increases the risks of sporadic outbreaks and lockdowns in the second half of this year and could further delay consumption normalisation. Despite a relatively faster economic recovery to date, with overall GDP having returned to its pre-COVID level in Q1 (**Figure 6a**), Australian household consumption is still below its pre-COVID level and weaker than that of other markets such as the U.S., where herd immunity is closer in sight (**Figure 6b**). The recent lockdowns in Victoria and New South Wales will only serve to delay normalisation and could detract around 0.2% from GDP, depending on the length of the lockdown and the strength of the subsequent rebound.

Figure 6a. Cumulative % GDP since Q4 2019



Source: Vanguard, July 2021using data from Refinitiv.

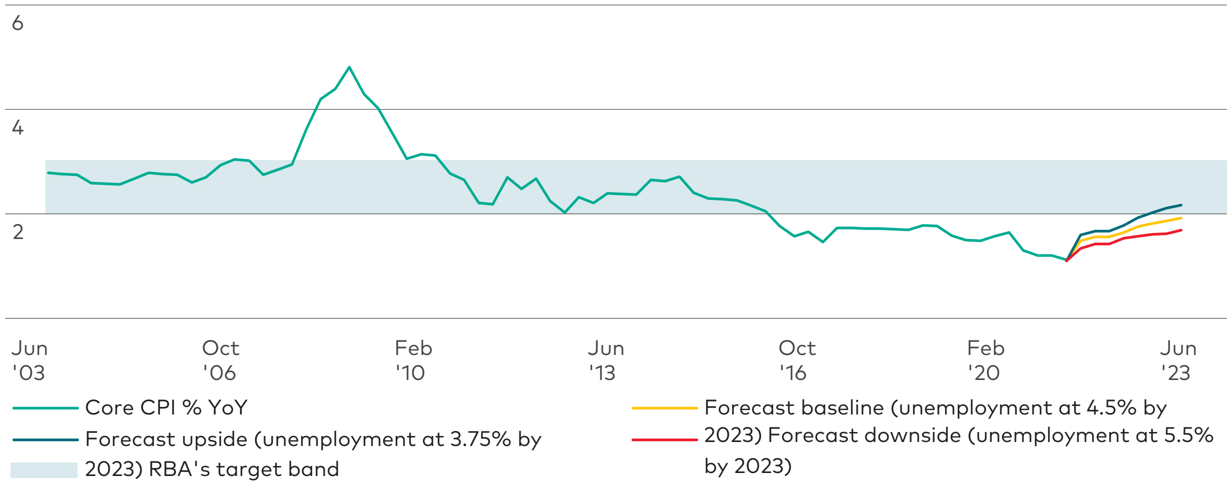
Figure 6b. % change from pre-COVID Q4 2019 levels, Australia vs U.S.



Source: Vanguard, July 2021using data from Refinitiv.

An unsustainable economic reopening, together with ongoing competitive cost pressures in the labour market depressing wage growth, suggests that inflation will continue to undershoot the 2% target in the near term (Figure 7). In Vanguard's baseline scenario, where unemployment falls to around 4.5% over the next two years, core inflation will average around 1.7% and end 2023 just slightly under the RBA's 2% target band. Against this backdrop, Vanguard expect the RBA to keep the cash rate at 0.1% until at least 2023 and maintain a tapered form of quantitative easing until the end of 2022.

Figure 7. Inflation likely to undershoot 2% target at the near-term



Source: Vanguard Investments Australia Ltd, July 2021, using data from Refinitiv.

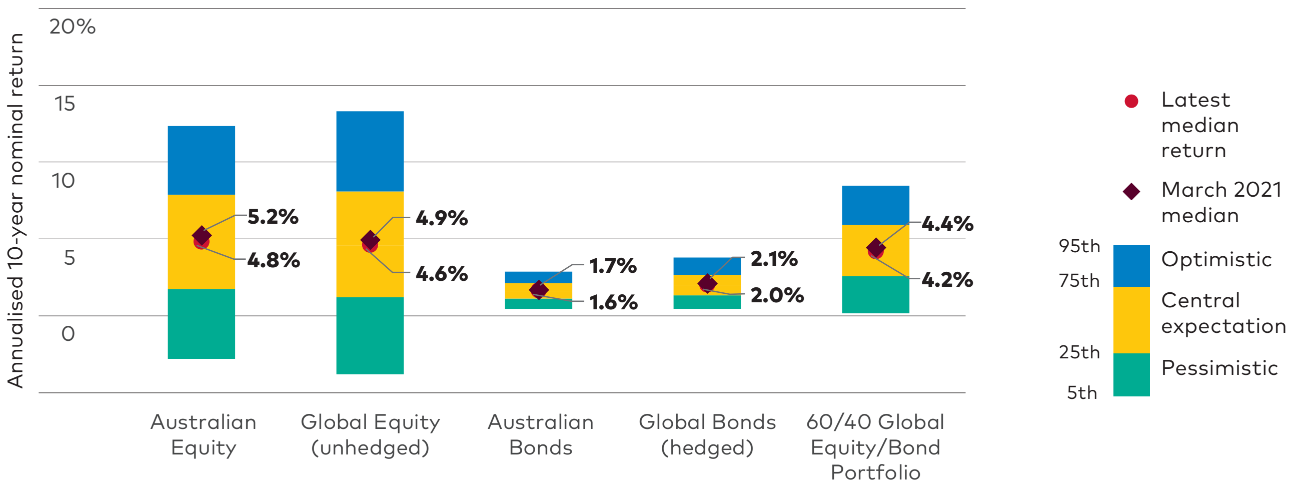
Market Outlook

The rally in global risk assets picked up where the previous quarter left off, seeing valuations continue to rise amid firming economic data, additional fiscal stimulus, and the assurances of central banks that they will keep interest rates lower for longer. Advancing valuations have led to a mild downgrade in the equity outlook moving forward, with expectations for global equities decreasing to a range of 3.6% to 5.6% over the next ten years, 30 bps lower compared to Vanguard's March projections **(Figure 8).** Meanwhile, the fixed income outlook remains in line with Vanguard's March forecast, as yields only retreated slightly towards the end of the quarter.

As a divergence in economic trajectories between regions is expected to persist over the near term, it is a timely opportunity to remind investors of the benefits of holding a globally diversified portfolio. Having exposure to a variety of asset classes, sectors and regions can help manage concentration risks and navigate the unpredictability of markets. Meanwhile, despite historically low yields, high-quality fixed income retains an important role in the portfolio as a ballast and diversifier of risk, as Vanguard show in Vanguard's recent paper Hedging Equity Downside Risk With Bonds in the Low-Yield Environment.

With volatility expected to remain elevated in the near term as economies continue to navigate the policy- and health-related uncertainties of the road ahead, investors would be encouraged to tune out the noise and focus on what they can control - keeping sight of long-term investment goals, appropriately aligning their portfolios, and maintaining the discipline to stick to their plans.

Figure 8. Ten-year outlook: setting reasonable expectations



Source: Vanguard, July 2021, using 31 May 2021 and 31 March 2021 VCMM simulations.

Source: Vanguard Asset Allocation Report, June quarter 2021

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