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Asset Allocation Strategy: A Global Recovery Worth Waiting For

Our first quarter asset allocation strategy.

27 January 2021

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The Return to Economic Normality

Despite a resurgent virus in much of the world and recent signs of a renewed slowing in global activity, prospects for risk assets are quite good over the coming year.

The global vaccine rollout will allow global activity to normalise, and economic growth will improve quite markedly as we move through 2021. This will facilitate a strong global earnings recovery over the next couple of years.

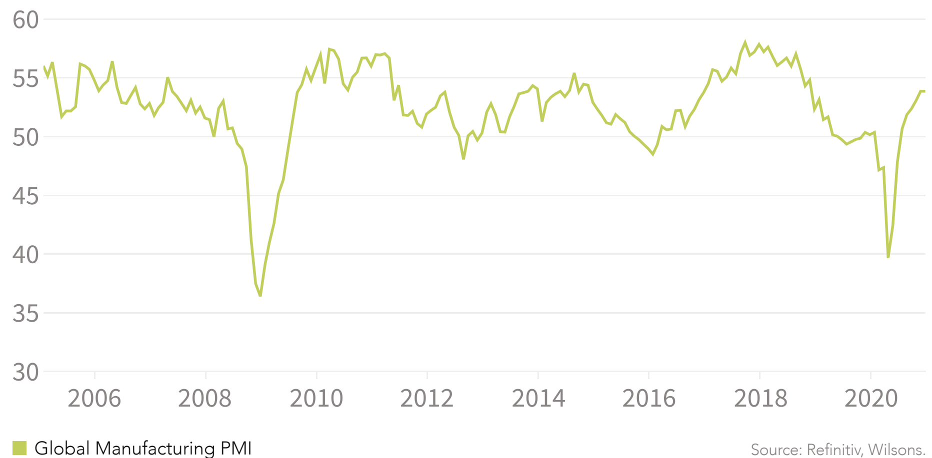
Near-zero rates, massive fiscal stimulus, and high household savings rates are laying the foundations for a synchronised global economic recovery that will likely surprise to the upside. Equities - particularly lagging cyclical and value names - should climb higher over the coming year as economic growth bounces back.

The belated shift to a Democratic-controlled US Senate has supported equities and other reflation trades this month. The equity market has focused on the more immediate prospect of additional fiscal stimulus rather than the (eventual) prospect of higher corporate tax and additional corporate regulation.

The pandemic and the near-term health of the US economy are likely to be the initial priorities of the new Biden administration. President Biden has proposed an additional US$ 1.9 trillion fiscal support package in addition to the US$ 900 billion package approved in December.

President Biden may hold off on pushing ahead with corporate tax hikes until the economy is on a firmer footing (perhaps in 2022). The razor thin majority in the Senate also suggests that (unpopular) tax hikes may be put on the backburner at least for now. However, the market may begin to fret about regulation and tax hikes later in the year.

Exhibit 1: Global Manufacturing Purchasing Managers' Index (PMI) - activity rebound likely peaked for now

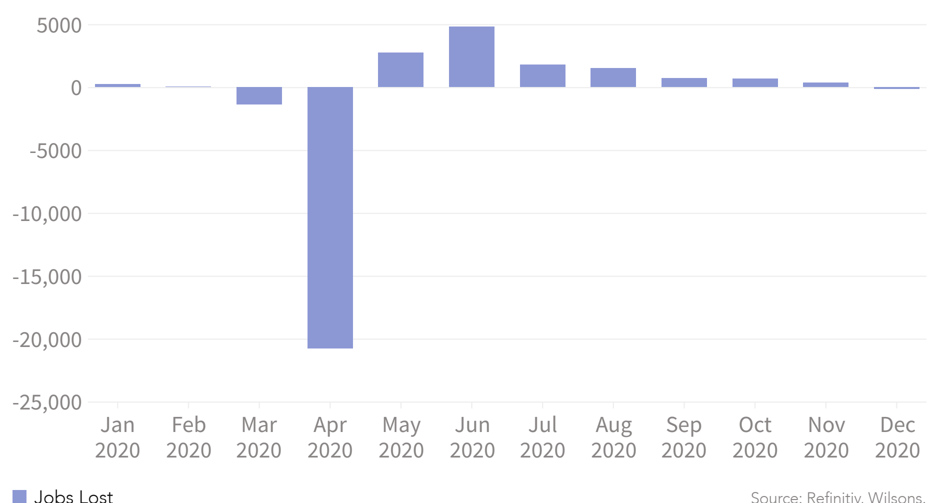


Source: Refinitiv, Wilsons.

Exhibit 2: US Economic Surprise Index - disappointing data recently as COVID-19 weighs

Source: Citibank, Refinitiv.

Exhibit 3: US employment rebound has faded with 10 million jobs still lost



Source: Refinitiv, Wilsons.

Key Asset Allocation Views

Asset Class	Tactical Tilt	Movement	Wilsons View
Cash	Underweight -1%	Decreased	We have decreased cash to fund an increased allocation to international equities.
Fixed Interest (Domestic & Global)	Underweight -6%	No change	We retain a significant underweight in fixed interest due to very low yields and our view of a developing global recovery over the coming year. Absolute return fixed interest stratagies not relient on duration and long-term inflation protection are preferred over traditional fixed interest strategies.
Australian Equities	Overweight +2%	No change	We remain moderately overweight Australia. Economic performance continues to beat expectations and reporting season should reflect this. Australia is outperfoming the rest of world in terms of virus control but should still participate in a global recovery rally, so we think the risk return trade-off for the Australian equity market is still appealing.
International Equities	Overweight +1%	Increased	We edge up our global equities (UK/Europe) despite the rise in COVID-19 infection rates due to the prospect of a significant (vaccine-led) economic recovery later in the year. We retain our 40% hedge back to the A$ rally as we still believe the A$ has medium-term upside, particularly against the US$. We continue to overweight emerging markets.
Alternatives	Overweight +4	No change	We retain our overweight given above average economic and policy uncertainty and unattractive valuations in govt. bonds. A range of growth and mid-risk alternative strategies appeal i.e. private equity, private credit, infrastructure, long short global hedge funds. Gold still appeals as a long-term portfolio hedge but could be cyclically vulnerable to a rise in global real interest rates.

* Our tactical tilt represents our view over the next 6-12 months though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments.

EQUITIES - OVERWEIGHT

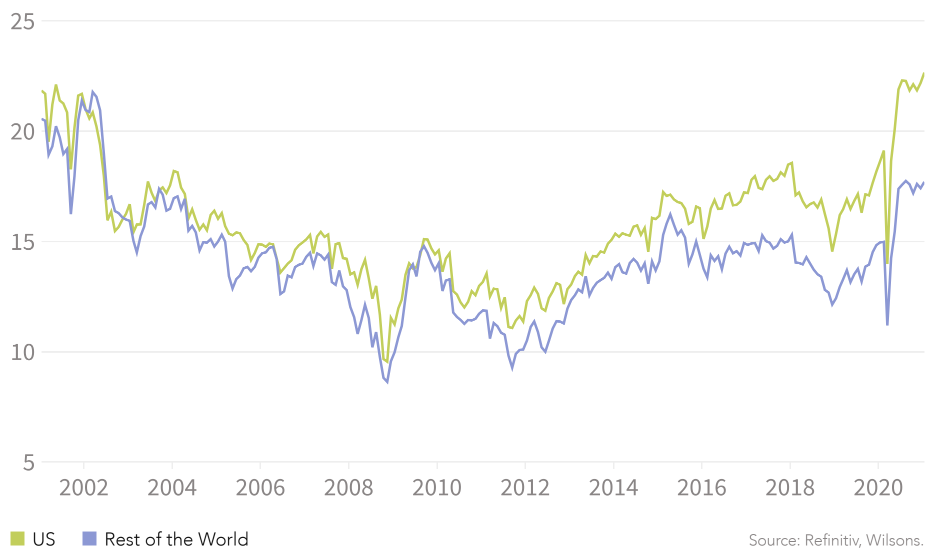
Equity Valuations to Stay Elevated but Earnings Growth to Drive the Next Leg of Market Recovery

Equity valuations are already buoyant by historical standards, but do not look overly demanding versus low interest rates. Valuations outside the US also look considerably cheaper.

Price to earnings (PE) expansion drove the sharemarket recovery in 2020. 2021 will be about the re-emergence of earnings growth with PE ratios likely to edge down (crimping capital gains) but stay elevated versus history due to the low interest rate backdrop.

Consensus expects the US market to deliver 23% earnings per share (EPS) growth in CY21 with mid-teens growth expected in CY22 (assuming no change in the US corporate tax rate). EPS growth outside of the US is likely to be even higher (30-40% for CY21). Countries and sectors leveraged to economic recovery will likely gain further support as the earnings recovery begins to manifest.

Exhibit 4: PE Ratios are high and should edge down, though ex US levels are less demanding



Source: Refinitiv, Wilsons.

Exhibit 5: Global earnings should recover strongly in 2021 after the 2020 downswing

Source: Refinitiv, Wilsons.

FIXED INTEREST - UNDERWEIGHT

The Bond Market will be Key to the Equity Bull Market's Longevity

Bond yields have pushed up in recent months but remain very low in a historical context.

The US 10-year yield has risen around 50 basis points in the last 6 months with a particularly sharp bounce seen earlier this month as the Democrats gained control of the US Senate. The rise in bond yields has not posed a problem for stocks given the low starting point for yields and the expectation that more US fiscal stimulus will aid economic and profit recovery. The impact has been more important for relative performance (rotation) than absolute equity performance.

At 1.1% the US 10-year yield is still well below the Pre-COVID-19 levels of around 1.5% 12 months ago, and way below the longer-term average (the 10-year average is 2.2%). The Australian 10-year yield is sitting at similar levels, while sovereign yields in Europe remain firmly in negative territory.

These very low yields do not appear to be an imminent threat to either stock market valuations or the real economy. However, we view the medium to longer-term path of interest rates as a crucial story to monitor the longevity of the current equity upswing.

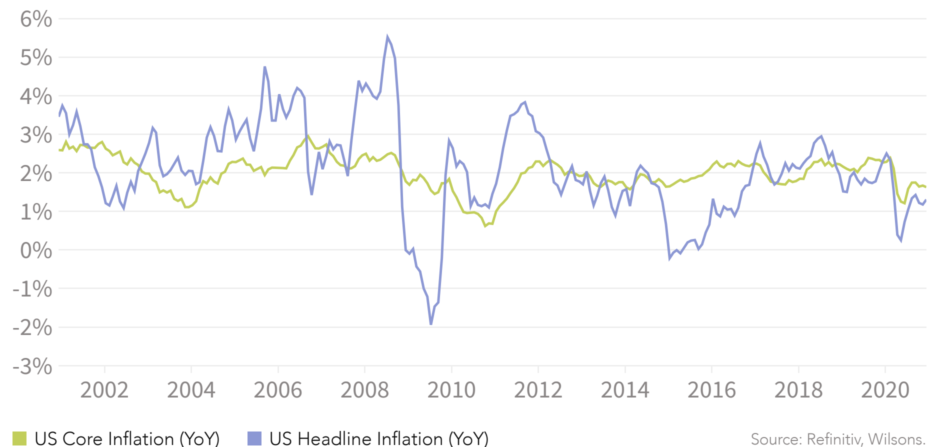
Higher bond yields may well become a problem at some point in this new economic expansion cycle, but the inflection point is likely to be some way off. It is possible that the pinch-point could be later in 2021 if the global economic bounce back is especially sharp, but it is more likely to be a risk factor for 2022 or 2023.

Inflation is unlikely to revive quickly given the amount of spare capacity in labour markets. An environment of improving growth and a gradual rise in inflation from low levels is typically supportive for growth assets.

Exhibit 6: US Bonds yields are rising but from very low levels

Source: Refinitiv, Wilsons.

Exhibit 7: The Fed will allow Inflation to rise above 2% given current undershoot



Source: Refinitiv, Wilsons.

An additional consideration is that central banks will be slow to react even if inflation does pick up over the next 2-3 years. The Fed (and the RBA) has signalled that it is willing to see inflation spend some time above its central target of 2% given the current extended phase of below-target inflation.

While in the past Fed officials might have begun preparations for rate hikes in anticipation of inflation potentially exceeding 2%, the new average inflation target implies the Fed will be much more patient and be prepared to let the economy run quite hard to best achieve its target of full employment.

The shift in thinking underscores the US central bank's determination to keep rates near zero, possibly for years, to help the economy recover from the COVID-19-induced recession. The Fed is likely to remain squarely focused for some time on boosting growth and reducing unemployment via near-zero cash rates and ongoing quantitative easing (QE). At the moment the market is pricing the first Fed rate hike in mid-2023. While pricing can change, we doubt expectations will shift much over the coming year, so the monetary backdrop is likely to stay supportive.

An interesting counter-argument to the view of structurally low interest rates is that the supply of bonds has increased massively this year with budget deficits blowing out around the world. There seems little appetite to reign in these deficits anytime soon, so the supply of government bonds will continue to build as fiscal support continues. Sluggish growth, very low inflation, zero policy rates and ongoing central bank buying are all combining to help keep government bond yields low at present. Yet these supports for the low interest rate regime may shift over the next few years. A strong recovery will eventually put upward pressure on real yields and likely lead to an eventual pick-up in inflation, all at a time of burgeoning bond supply. While it is likely to be a few years away, central banks may eventually struggle to hold back the tide of significant upward pressure on yields.

Though we remain underweight fixed interest (particularly traditional fixed interest), we think it is too early to aggressively position for a scenario of significantly higher rates in terms of being underweight equities and other risk assets. However, a material bear market in bonds remains the biggest medium-term threat to the equity bull market in our view.

We remain moderately constructive on credit despite the significant fall in spreads to below long-term average levels. Moving forward, we do not expect too much in terms of further spread compression, but better economic conditions and the insatiable thirst for yield should lead to at least a modest further tightening.

Exhibit 8: High yield credit spreads have continued to tighten to below average levels

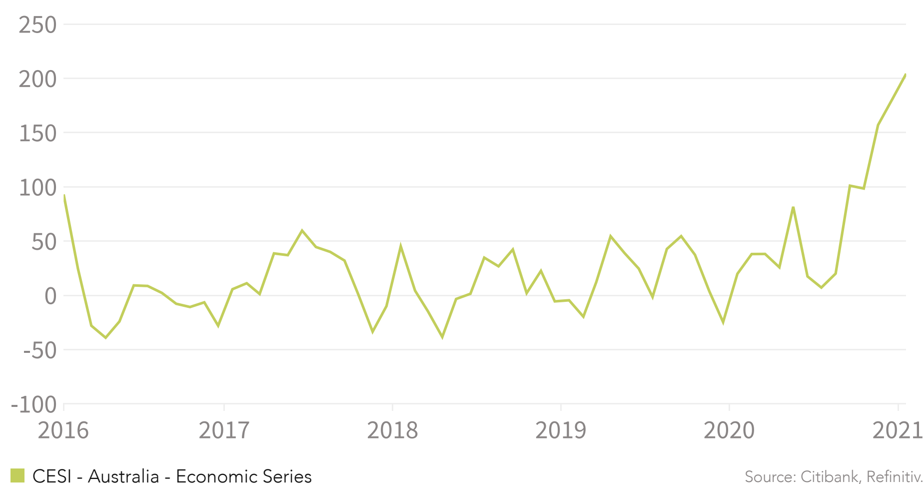
Source: Refinitiv, Wilsons.

We continue to like hybrids. The Australian banking sector is well capitalised and likely over-provisioned and we anticipate further spread compression in the years ahead as the RBA policy intensifies the search for yield. Hybrids will also not suffer from yield curve steepening given they are floating rate instruments.

Australian Economy and Sharemarket Still Relatively Well Placed

The Australian economy is performing relatively better than the majority of developed economies due to a much more benign virus backdrop – notwithstanding recent restrictions and border closures.

Exhibit 9: Australian Economic Surprise Index - positive data trends continue



Source: Citibank, Refinitiv.

The trend of better than expected data has continued with the labour market and consumer spending both showing continued strength. The relative health of the economy is being reflected in a strong recovery in the banking sector in recent months, as well as selected consumer discretionary names and of course the resource sector on the back of strong commodity price rises. Of course, life is still a long way from normal and there are still pockets of weakness in the economy as reflected by renewed weakness in travel-related stocks.

Market valuations are not cheap in an absolute sense (19x expected earnings), but as has been our view for some time, low interest rates will continue to put a floor under market valuation with earnings growth (20%+ in CY21) allowing 5-10% capital gains alongside a still attractive 4% dividend yield. Ultimately, there is likely to be more cyclical recovery potential in global equities, however superior near-term economic and earnings performance and the risk of some additional upside in the A$ keeps us moderately overweight Australia.

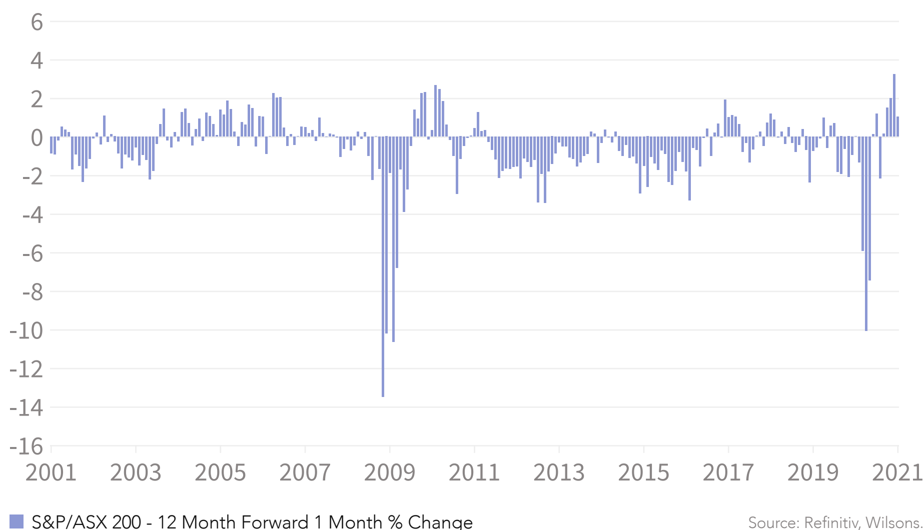
The uptrend in the A$ is leading to some softness in globally orientated sectors such as healthcare. However, in aggregate, the impact of better global and domestic growth as well as commodity price strength should more than make up for the impact of the dampening effect of a higher A$. While we see some residual upside risk for the A$ over the coming year, we think we are now a fair way through its appreciation. Our year-end target remains 0.80, albeit with risk skewed to the upside (0.85). We think the risk of a renewed surge in the A$ to 0.90 or higher is relatively low. Iron ore prices will likely ease back over the coming year (as Brazilian supply revives) which may act to crimp further A$ gains. In addition, Australia does not have the attractive interest rate spread advantage that was evident when the A$ charged through the parity level 10 years ago.

Read Is the Rising A$ a Threat to the Australian Equity Market Outlook.

Exhibit 10: Equity risk premium (EY-BY) suggest stocks are still not expensive versus bonds

Source: Refinitiv, Wilsons.

Exhibit 11: Australian market earnings estimates are being revised up



Source: Refinitiv, Wilsons.

INTERNATIONAL EQUITIES - OVERWEIGHT

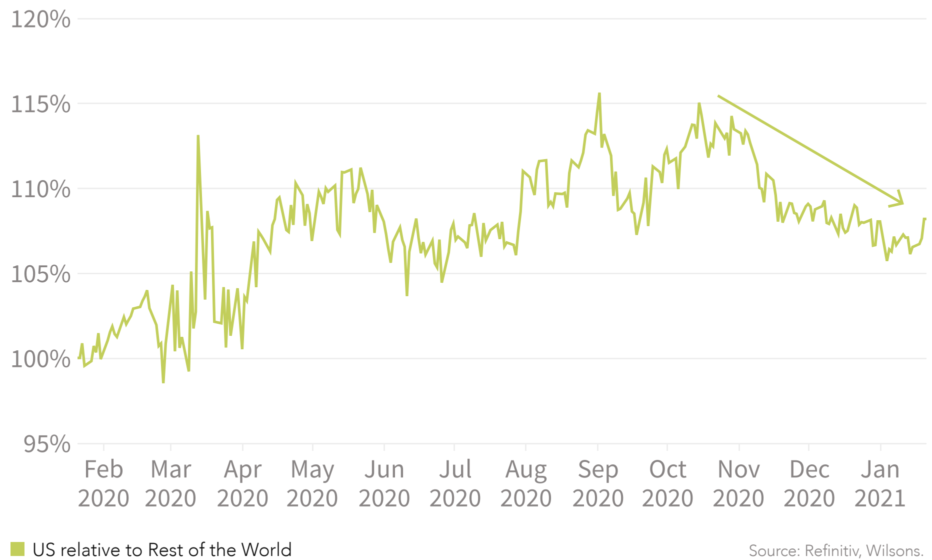
Non-US Equity Market Comeback to Continue

While equities have continued to do well globally, we are seeing some notable leadership shifts.

The US market has continued to rise over the past 3 months, but it has lagged the rest of the world as the market rotates towards the value and recovery leverage on offer outside the US. This is in line with our existing portfolio positioning to have a significant overweight to emerging market (EM) equities and a moderate preference for ex-US markets over the US. We are not US market bears at this stage, but think US leadership is at least due for a cyclical pause.

Improved performance from the world ex the US is reflected in the outperformance of value over growth stocks in the past 3 months and is clearly evident at the sector level by the outperformance of previous laggard's energy and financials. The high flying tech sector continues to track higher, though it has not been leading the global market over the past few months with the recovery in value and recovery trades favouring outperformance from the rest of the word.

Exhibit 12: US equity outperformance is taking a breather



Source: Refinitiv, Wilsons.

Exhibit 13: Outperformance of growth over value looks to be peaking for now

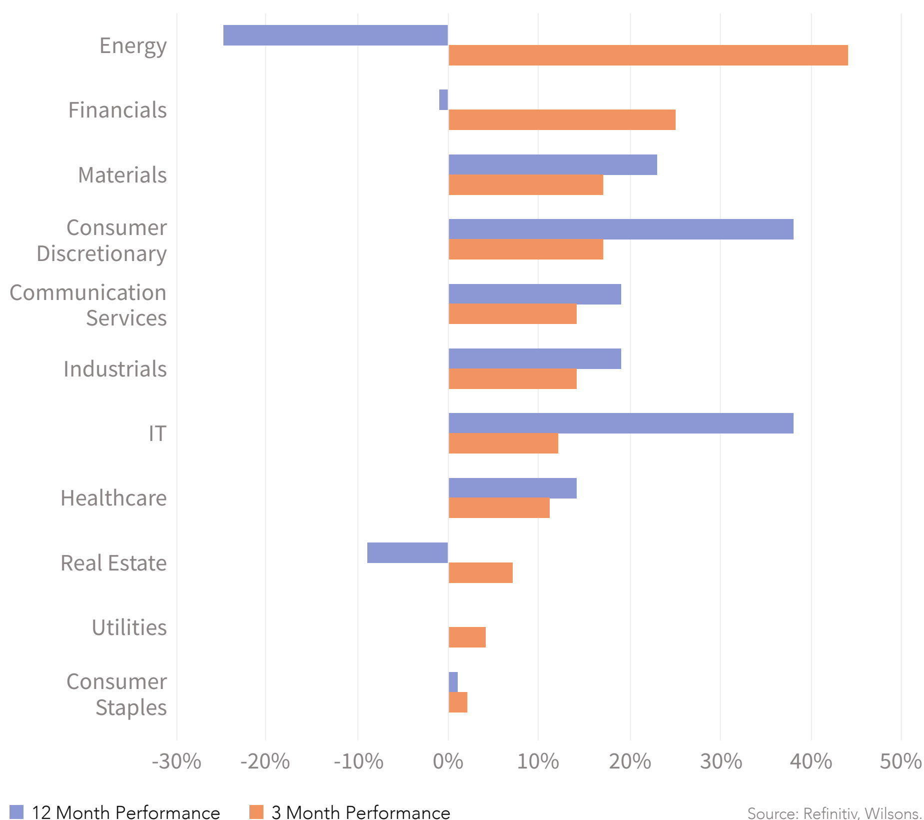
Source: Refinitiv, Wilsons.

Emerging markets have been the strongest area within international equities of late. We continue to be overweight EM due to the following positive supports:

1. Significant leverage to a medium-term global economic recovery as growth rebounds in 2021 and 2022.
2. Strong secular (5 years +) growth potential beyond the near-term cyclical rebound driven by relatively better demographics, superior productivity gains, and growing addressable markets.
3. More attractive valuations relative to developed market equities.
4. A likely tail-wind for EM from progressive US$ depreciation.

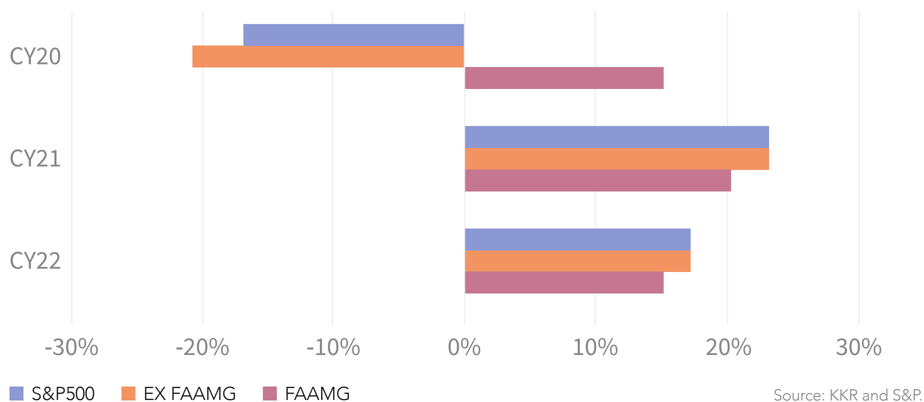
We see total returns for global equities in the order of 9%-15%, albeit some residual A$ strength may crimp performance. We continue to think a partial currency hedge makes sense given our view of upside risk to the A$ (0.80-0.85).

Exhibit 14: 2020's laggard cyclical sectors are beginning to outperform globally



Source: Refinitiv, Wilsons.

Exhibit 15: US mega cap tech is set to lose its EPS growth advantage - at least for a while



Source: KKR and S&P.

A Mix of Alternatives Looks Attractive

We remain constructive on exposure to alternative assets.

High absolute valuations and near-zero interest rates are likely to keep investors looking for alternative portfolio hedges and alternative sources of both yield and growth. A mix of alternative assets continues to look attractive from this perspective.

Exposure to private equity continues to appeal due to low funding rates and improving economic conditions, alongside a continued wide dispersion of listed market valuations which provides scope for astute buying and selling of assets.

The Infrastructure space continues to appeal due to its yield plus growth potential and the scope to offer exposure to both cyclical recovery and steady long-term growth.

Commodities hold appeal as a play on recovery, alongside a number of structural trends (e.g. electric vehicle demand) and as a long-term hedge against higher inflation. We believe gold continues to warrant an allocation as an alternative tail risk hedge, particularly with interest rates so low. The 2021 outlook for gold is perhaps not as bullish as the 2020 backdrop. Higher real interest rates could pressure the gold price somewhat over the coming year, though the likelihood of further weakness in the US$ and the (difficult to time) prospect of higher inflation still suggests an allocation to gold has longer-term merit.

Exhibit 16: Wilsons Expected Asset Class Returns

	Long-Term Expected Returns	12-Month Expected Returns
Australian Equities	8.0%	9 - 14%
International Equities	8.0%	8 - 13%
Fixed Interest	1.7%	-2 - 0%
Cash	1.5%	0%
Alternatives	6.5%	6.5 - 9%

Long-term expected returns are 5 to 10 year passive expected returns based on both historical performance and current pricing/yields. 12-month expected (passive) returns are shown as a range due to the inherent volatility of financial market returns.

Performance and risk projections are subject to market influences and contingent upon matters outside the control of Wilsons Advisory and Stockbroking Limited and therefore projections may not be an accurate indicator of future performance and/or risk.

Source: Wilsons.

Asset Allocation Summary

Asset Class	High Growth			Growth			Balanced			Moderate			Defensive		
	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt
Cash	0%	2%	-2%	0%	2%	-2%	4%	5%	-1%	9%	10%	-1%	18%	20%	-2%
Fixed Interest	2%	5%	-3%	10%	15%	-5%	19%	25%	-6%	29%	35%	-6%	43%	50%	-7%
Equities - Domestic	44%	42%	2%	40%	38%	2%	33%	31%	2%	27%	25%	2%	15%	13%	2%
Equities - International	42%	41%	1%	38%	37%	1%	32%	31%	1%	25%	24%	1%	14%	13%	1%
• United States	23%	24%	-1%	21%	22%	-1%	17%	18%	-1%	13%	14%	-1%	7%	8%	-1%
• Europe/UK	12%	11%	1%	11%	10%	1%	10%	9%	1%	8%	7%	1%	4%	3%	1%
• Emerging Markets	6%	2%	4%	6%	2%	4%	5%	1%	4%	4%	1%	3%	3%	1%	2%
• Japan	1%	4%	-3%	0%	3%	-3%	0%	3%	-3%	0%	2%	-2%	0%	1%	-1%
Equities Total	86%	83%	3%	78%	75%	3%	65%	62%	3%	52%	49%	3%	29%	26%	3%
Alternatives	12%	10%	2%	12%	8%	4%	12%	8%	4%	10%	6%	4%	10%	4%	6%
Growth Assets	98%	93%	5%	90%	83%	7%	77%	70%	7%	62%	55%	7%	39%	30%	9%
Defensive Assets	2%	7%	-5%	10%	17%	-7%	23%	30%	-7%	38%	45%	-7%	61%	70%	-9%
Cash + Fixed + Equities + Alternatives	100%	100%		100%	100%		100%	100%		100%	100%		100%	100%	

Commentary references our Balanced Portfolio.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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