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Quarterly Commentary

June 2020

Entrust
WEALTH MANAGEMENT

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June 2020 Quarter

Pleasingly the June 2020 quarter saw a sharp snap back in performance with positive contributions from all asset classes.

Australian and International Equities rallied strongly though a 12.45% rise in the Australian dollar was a significant headwind for unhedged International Equities.

Clawing back some of the weakness in the previous quarter, Real Estate Investment Trusts (REITS) were the standout although the sector remains well off its previous highs.

Alternative's had a strong quarter with a sharp turnaround in performance from one of our long short managers whilst a strong run in the USD gold price saw the portfolio's exposure to a USD gold bullion ETF continue to add positively to performance.

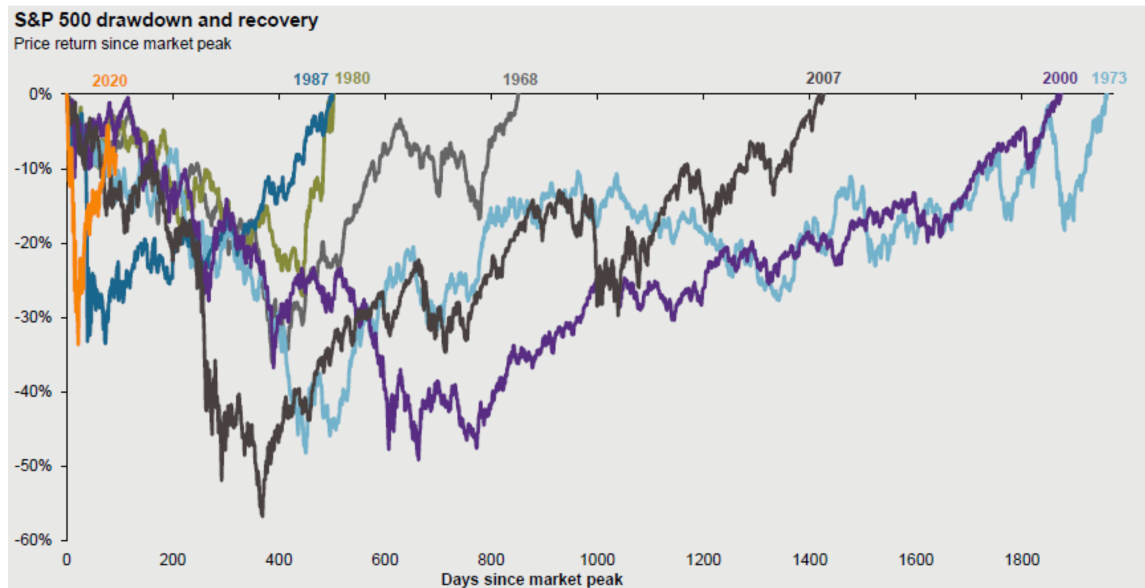
Both Domestic and International Fixed Income portfolios joined in on the re-rate with a fall in credit spreads leading to a strong rally in credit instruments, including hybrid securities. Yields on global bonds fell as bonds rallied on the back of interest rate cuts and increased purchases from central banks.

If the March 2020 quarter highlighted the benefits of a diversified high-quality approach to managing portfolios, the June 2020 quarter highlights another point we made in our last note about remaining largely invested through these volatile periods.

As can be seen in the chart below, the Covid-19 sell off and rebound has been one of the shortest and sharpest in history. Understandably, there were many reasons for investors to be concerned as markets reached their lows in March, but as discussed in our last quarterly most asset classes at that time were in a 'valuation discovery' mode due to the highly uncertain nature of near-term cash flows. Essentially, investors just didn't know how to price for a pandemic.

We suggested, however, that as information on that became more apparent, markets would adjust quickly and if you were not invested and missed that turn you may have left a significant amount of your medium term returns on the table. Increased volatility is the trade-off but in an environment of stubbornly low growth, missing these turns can prove costly.

June 2020 Quarter



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – Australia. Data as of 30 June 2020.

Model Portfolio Movements

As highlighted in our March 2020 quarterly, our approach to portfolio management through this period can be broken down into two stages; firstly, risk management and secondly, looking for opportunities to allocate available capital. The June quarter was focused on the latter.

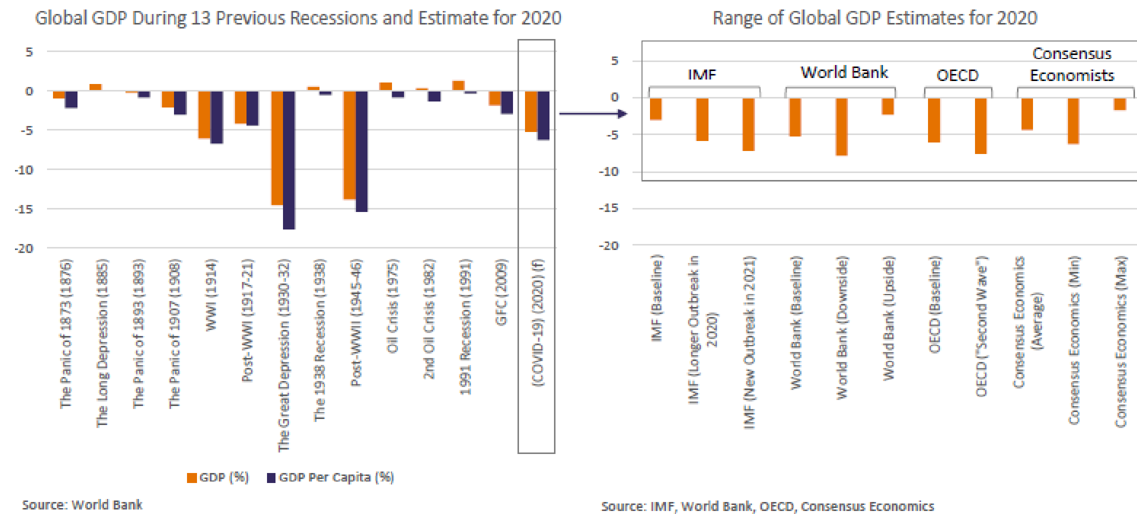
The starting point was a general reallocation at the asset class level by shifting some exposure from Alternatives to Australian Equities. Driving this decision was a sharp pullback in equity markets, the underperformance of Australian versus unhedged International Equities and the better outlook for the Australian economy given the reduction in infection rates and active Covid-19 cases at the time. Also, the fiscal headroom available to the Australian Government to support the economy was an important factor.

Within an overall lift in the Australian equities weighting other portfolio changes included; adding exposure to energy via Woodside Petroleum (WPL) on the back of a sharp sell off in the oil price; added to Property via a top up of GPT Group (GPT) and initiating a new position in Dexus (DXS); added to Australian banking exposure on valuation grounds and a reduction in CSL as momentum started to work against the 'safe haven' stocks.

For more detail on changes to the model portfolios please refer to our monthly Portfolio Trade Updates.

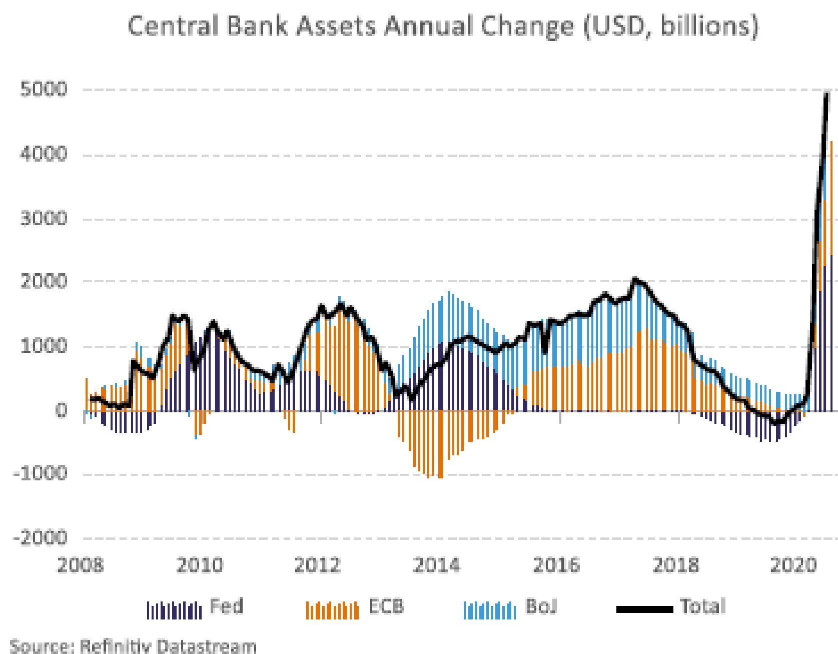
Outlook

From an economic perspective there is little doubt that we are in the midst of one of the deepest recessions in the post war era. What is less certain is how large the hit to growth will be and how long the recovery phase is likely to take. As can be seen below the range of current global GDP estimates is large.



As unsettling as the prospect of a deep and possibly protracted global recession is it would be wrong not to consider the power of what has become the largest global monetary and fiscal response in modern history.

In addition to large cuts in interest rates, the US Federal Reserve has enacted numerous policies designed to bring confidence and liquidity back to bond and credit markets. This has driven a sharp expansion in the Fed's balance sheet and has successfully reduced credit spreads and kept funding markets operational.

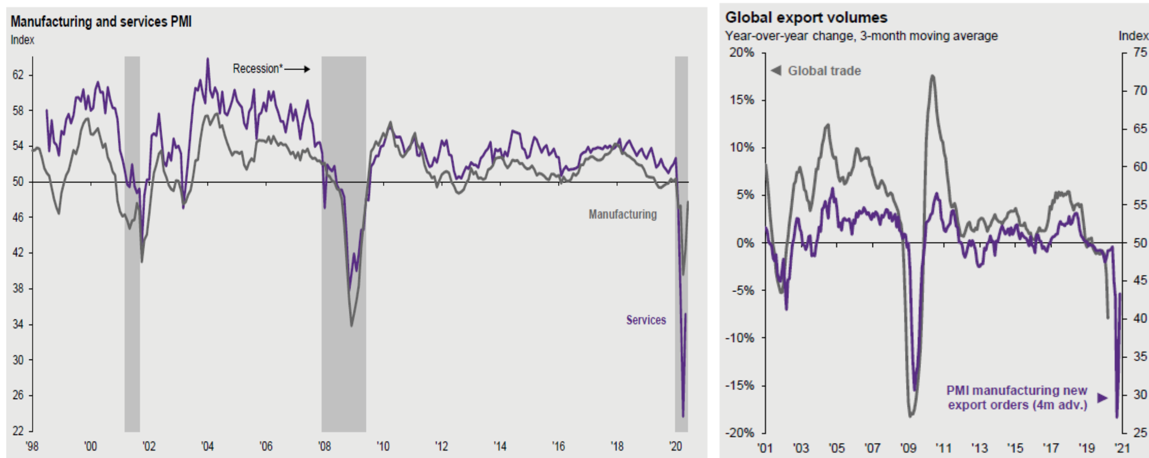


Outlook

In Australia, the Federal Government has provided financial support to individuals and businesses and has announced new stimulatory spending measures. On the monetary front, the RBA has announced a number of measures including cutting the cash rate to 0.25% whilst targeting a 0.25% rate for the 3-year government bond via purchases of government bonds in the secondary market. However, at this point the RBA has ruled out the use of negative interest rates and broader Quantitative Easing (QE) measures.

Importantly, the common message from central banks is that low interest rates are likely to be in place for an extended period or at least until growth, employment and inflation come back into more normalized ranges.

As a result of these measures and some easing around the Covid-19 restrictions, the data points to an increase in economic activity off the March / April lows. New orders have bounced, which has historically been a positive leading indicator for global trade.



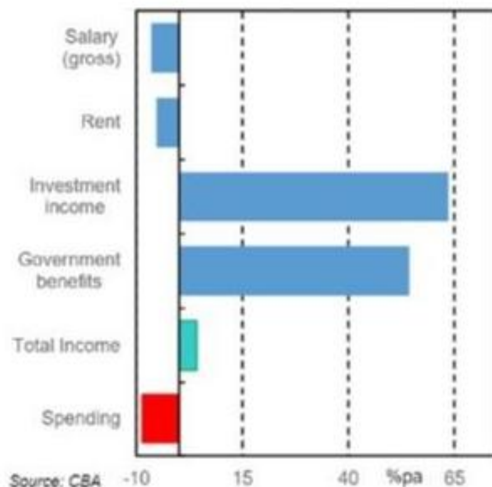
Source: Markit, J.P Morgan Asset Management. 'Recession is U.S economic recession' Guide to the Markets – Australia. Data as of 30 June 2020.

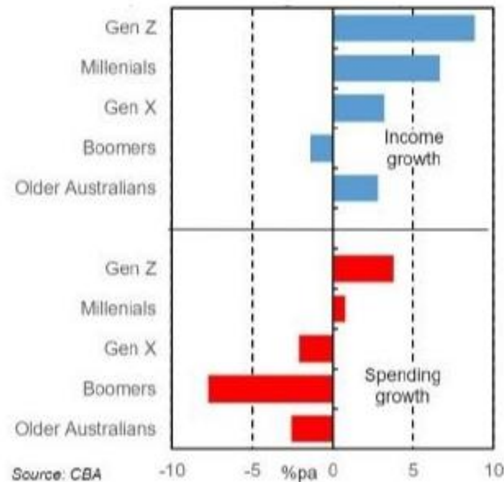
Perhaps surprisingly, during this crisis, consumption has been a reasonably supportive part of developed economies as lost incomes have been replaced with government support programs. This combined with perhaps shorter than expected lockdown periods has driven some parts of the population to spend rather than save.

The following charts highlight this in the context of the Australian economy. The first shows that as at the end of June 2020 households have had a slight rise in incomes when compared to the 12 months prior. This is despite a cut in salary and rental income, which have been offset by an increase in investment income (early access to Super) and government benefits such as job keeper and job seeker.

Overall, spending has fallen but as the second chart shows there has been a clear difference in spending patterns across generations. Being major beneficiaries of the government support and early super access scheme, the younger cohorts have stepped up to do their part for the economy!

Outlook



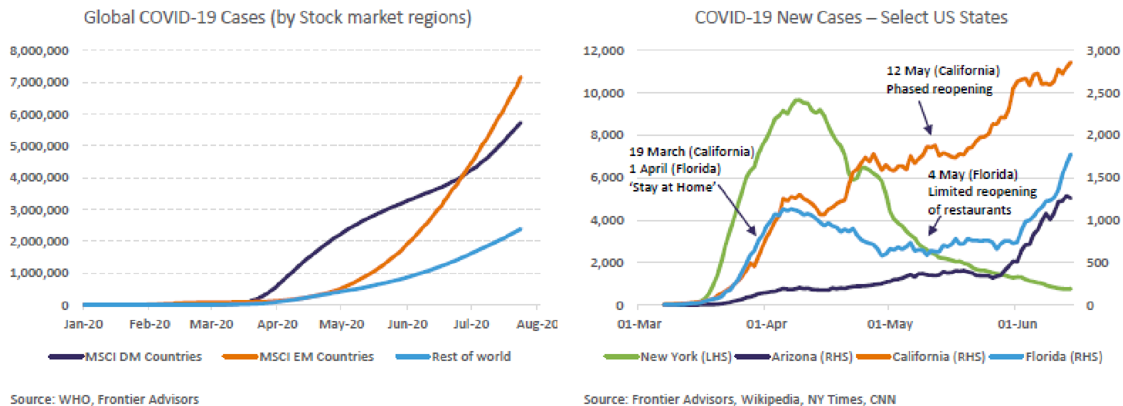


Unquestionably, as a short-term stimulus mechanism these government policies have worked well. As we move forward a risk is the transition from government support back to employment income and what if any, long-term impacts emerge in relation to wages expectations and productivity.

Rising Covid-19 infection rates remain a key risk to some of the improving trends in the economic data. As discussed in our last quarterly, any outbreaks leading to the reintroduction of economic restrictions could impact growth and confidence as well as potentially test the limits of governments capacity and willingness to provide the necessary support.

Globally, the number of Covid-19 cases continues to rise. In developed economies we have seen second waves of infection in countries that have eased restrictions. The concerning situation in Melbourne is one such example. In the US, where they arguably began the reopening process prematurely, we have seen what might be described as a 'Mexican wave' as the infection rolls from the early hotspots, such as New York to other regions. In emerging markets (EM), Covid-19 cases are continuing to rise with many regions less equipped to mount an effective health response. Capital outflows from these EM regions could also be a headwind in providing the necessary fiscal support, particularly for countries that rely on external capital to finance their deficits.

Outlook



Offsetting some of these concerns is perhaps the prospect that any new infection hotspots can be dealt with in a more localised and targeted approach. As time moves on governments and health authorities are no doubt learning more about COVID-19 and the strategies that are most effective in managing it.

The search for an effective vaccine also moves on at pace with around 164 candidates in total and 25 in clinical trials. The usual timeline for developing and producing a vaccine for general use is being dramatically reduced given the urgency of the situation with some estimates of a vaccine being available late 2020 or early 2021. Of course, we must keep in mind that there is no guarantee that an effective vaccine will ever be developed.

Implications for Portfolios

A key pillar of our investment philosophy is a preference for high quality investments but with a firm eye on valuations.

There is no doubt that attempting to make an accurate assessment of valuation over the past two quarters has been challenging. On one hand, macroeconomic fundamentals look poor but on the other, the swiftness and shear size of the fiscal and monetary support cannot be underestimated and those with an eye on fundamentals only have been caught short.

Ultimately markets remain in a valuation discovery phase with the range of potential outcomes wider than normal but expectations around the outlook for corporate earnings and cashflows has improved somewhat at least from the information vacuum we were in the midst of the March 2020 sell-off.

Outlook

Given the snap back from their lows and based on current earnings expectations, equity market valuations on face value look stretched so we enter this new quarter in a more defensive mindset. However, when compared to bond yields the earnings yield on offer from equities continues to look relatively attractive (see below), which suggests there is likely to be ongoing support on any meaningful sell offs. It must also be remembered that one of the potential outcomes is a continuing improvement in the economic data that moves us into some form of a cyclical recovery phase, an environment that tends to be very positive for equities.

Despite the low yields paid on government bonds we continue to see them as offering liquidity and diversification benefits for portfolios although we remain underweight our long-term target allocations. To remove some of the interest rate risk that comes with owning low yielding bonds we have recently introduced a relative value manager into portfolios that looks to benefit from any mispricing between high quality government bonds to deliver low volatility returns irrespective of the level or direction of interest rates.

Thanks, in no small way to central bank buying, the yield spread above government bonds for credit investments have moved back to their long-term averages. Credit defaults are rising and have the potential to increase further so we maintain a preference for higher quality investment grade exposures. We feel Australian major bank hybrid securities offer an attractive risk reward pay off and maintain the view that Australian banks remain well capitalised. We also suspect there will be an increasing level of demand for these securities as income investors switch their focus from owning bank equity to owning bank hybrids given the ongoing pressure and uncertainty around bank dividends.

Outlook

Benefiting from a rebound in commodity prices and in particular the iron ore price the AUD is enjoying some positive momentum at the moment. No doubt the AUD is also being supported by the increasing yield differential between US and Australian bonds and Australia's relatively attractive Covid-19 experience and fiscal balance sheet. Arguably the AUD looks to be around fair value but with some upside momentum. We reduced our exposure to a rising AUD in the March 2020 quarter, which has helped reduce this drag on our International Equity portfolio, however, we are happy to maintain some foreign currency exposure due to the uncertain outlook and the valuable downside protection this can provide to portfolios.

The gold price has been on an absolute tear! Since lifting exposure back up around the US$1450 mark the gold price so far has found little resistance upon reaching our targeted range of $1800-$1920. There are some very compelling reasons to own gold at present but ultimately, gold is a very difficult commodity to value and more often than not, momentum drives returns. As such we recently reduced our exposure to US gold when it hit the top of our targeted range. We continue to assess the momentum for the balance of the holding.

In summary, we are pleased that most assets classes have moved well off their March lows. After being a net buyer of assets over the last quarter we enter the new quarter in a more defensive mindset based on current valuations. However, given the larger that normal set of potential outcomes from here we do not believe it is appropriate to be making any binary asset allocation calls at the moment so remaining invested in quality assets, diversified across assets classes remains a sensible approach.

As part of this, we feel it continues to be prudent to maintain higher than normal cash levels due to the ongoing uncertainties. As well as providing a cushion against higher volatility this extra cash allows us to participate in appropriate opportunities that arise from the volatility itself or from a lessening of the uncertainty around the economic outlook.

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