Duncan MacKintosh, CFA

DIRECTOR & AUTHORISED REPRESENTATIVE (458414)
SENIOR INVESTMENT ADVISER

Quarterly Commentary

September 2020

Entrust
WEALTH MANAGEMENT

DUNCAN MACKINTOSH, CFA
DIRECTOR & AUTHORISED REPRESENTATIVE (458414)
SENIOR INVESTMENT ADVISER
Dir: +61 8 9476 3945 | dmackintosh@entrustwealth.com.au
ENTRUST WEALTH MANAGEMENT PTY LTD
Authorised to Provide Financial Services | AFSL 222152 | ABN 80 100 088 168

September 2020 Quarter

The September quarter was another positive one for portfolios with all asset classes adding to performance.

International Equites significantly outperformed Australian Equities. This outperformance is particularly impressive considering the headwind from a strong AUD over the period and continues to highlight the benefit of diversifying some equity exposure away from Australia.

Within alternative investments gold rallied although finished well off its intra-quarter high. Long/short equity managers in general also had an impressive quarter.

Real Estate Investment Trusts (REITs) continued the positive momentum we saw in the July 2020 quarter while both domestic and international fixed income performed well with credit exposures, including hybrid securities, outperforming.

Another contributing factor to performance over the quarter was a general reduction in discounts to net tangible assets (NTA) for listed investment companies (LICs).

Model Portfolio Movements

Within Australian Equities we added to our Telstra (TLS) holding on price weakness and reduced the position size of News Corp (NWS) as it approached our price target and ran into some technical resistance. We lifted our exposure to Adelaide Brighton (ABC) following a better than expected profit result and an improving outlook for construction materials. We also initiated a new position in IGO Limited (IGO) as price weakness, in our view, was at odds with a rally in the nickel price and the high levels of fee cash flow IGO is expected to generate this financial year.

The property portfolio received some attention as we looked to capitalise on the significant pull back in prices and our large underweight exposure to the sector. As part of this we added to Dexus (DXS) and GPT Group (GPT) as both provide exposure to high-quality commercial property portfolios at significant discounts to book value. We also initiated a new position in Cedar Woods Properties (CWP) given its leverage to WA residential property and our view of an improving outlook for the WA economy.

We took advantage of the rally in the gold price to trim our exposure to the Betashares Gold Bullion ETF (QAU) and initiated a new position in ActiveX Ardea Real Outcome Bond Fund (XARO) as part of international fixed income exposure.

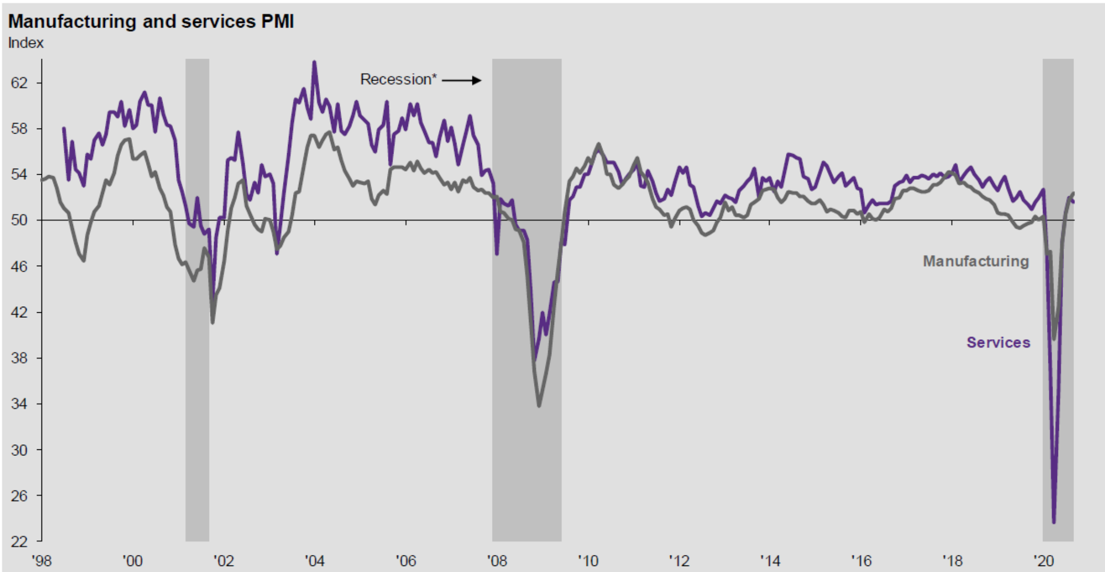
For more detail on changes to the model portfolios please refer to our monthly Portfolio Trade Updates.

Outlook

Macroeconomic

From a macroeconomic perspective we are seeing some encouraging signs in the data but recent rises in the number COVID-19 cases along with the potential outcomes of a range of other events have increased the uncertainty around the near-term path to economic recovery.

An example of the improving data can be seen in the chart below. This shows that both the global manufacturing and services PMI are back above 50 indicating a pickup in economic activity as COVID-19 health restrictions are eased.



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

Ongoing policy support has been a key part of the economic recovery thus far after providing a much needed circuit breaker early on.

Demonstrating the evolving nature of this support, the US Federal Reserve (Fed) recently changed their inflation policy to an average target of 2 per cent over a cycle rather than its historical fixed target. With this change, the Fed is signaling that interest rates will remain low for an extended period as they are prepared to let inflation run a bit hotter than normal before feeling the need to raise rates. Their objective is to give business the confidence to invest and thus stimulate economic growth and employment.

At its Melbourne Cup day meeting, The Reserve Bank of Australia (RBA) also increased its support by dropping the cash rate and its 3-year bond target rate to 0.1 per cent. Significantly, the RBA also announced a quantitative easing (QE) program involving the purchase of $100 billion of 5 to 10 year government bonds over a six month period.

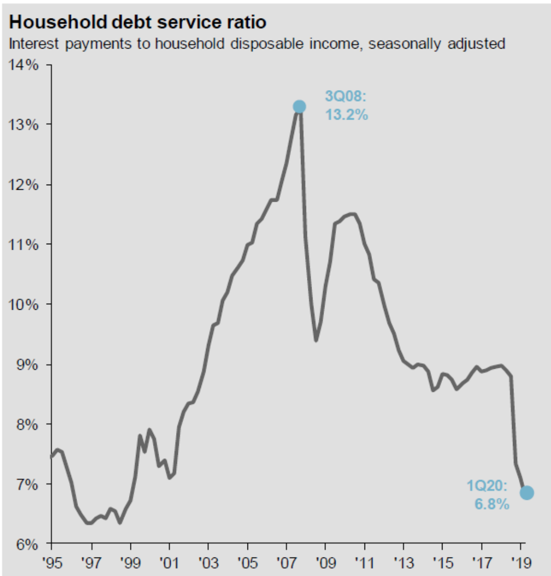
Outlook

The RBA also adjusted its inflation policy stating they will not raise the cash rate until actual inflation is sustainably in the 2 to 3 per cent range rather than basing their rate decisions on forecast levels of inflation. Once again, the message is that low rates are here for some time with the RBA not envisaging raising rates for at least three years.

At the macro level, Australia continues to look relatively well positioned. We have not escaped a recession but so far it has been less severe than in other parts of the world. In addition to monetary support, the lower government debt profile upon entering this period has allowed the Australian Government to assist via short-term income support and a longer-term infrastructure investment program.

Australia's economic links to a recovering China has also been an important factor. However, what appears to be a deteriorating political relationship with our number one export market is throwing up some not insignificant risks that need to be monitored.

High household debt levels in Australia is an area of vulnerability although at current interest rates and despite low wages growth, the serviceability of that debt is the best it has been since the late 1990s.



Source: Australian Bureau of Statistics, FactSet, Reserve Bank of Australia, J.P. Morgan Asset Management.
Guide to the Markets – Australia. Data as of 30 September 2020.

China has been the standout economy with its GDP broadly back to where it was before the COVID-19 break out. As well as strong fiscal and monetary support China's success perhaps also reflects its political ability to undertake strict lockdowns to combat COVID-19 with restrictions only lifted when the virus was largely under control. Other countries that may have emerged from their lockdowns prematurely are perhaps now paying the price with second and third waves.

Outlook

COVID-19*

A recent lift in the number of COVID-19 cases globally is an obvious near-term risk as we start to see the reintroduction of restrictions in parts of Europe and the US. This raises the possibility of two speed economies in these regions where the service sectors face greater risks from any social distancing measures implemented.

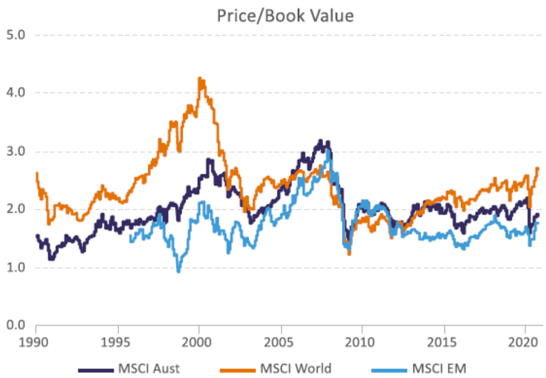
An effective COVID-19 vaccine remains the great hope with 11 currently in phase three trials. Experts and investment markets appear optimistic on this front; however, this comes with its own set of uncertainties such as how effective will a vaccine be, what is the likely time line for commercial production, will there be any side effects, will people take it and how long will its benefits last.

Asset Classes

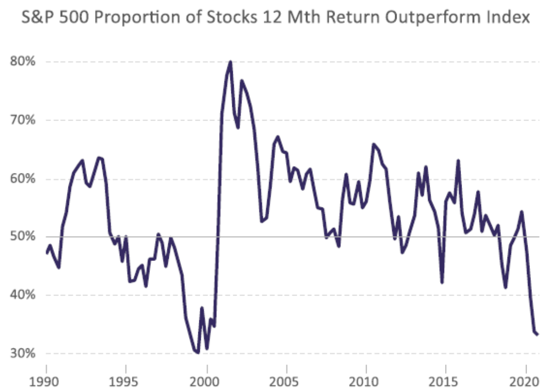
Given increasing valuations, potential constraints on economic growth from the reintroduction of COVID-19 restrictions and elevated event risk such as the US election, Brexit and vaccine trials, we continue to recommend a moderate underweight exposure to risk assets.

However, while economic activity is improving, monetary and fiscal policy remains supportive and cash rates close to zero, we do not recommend a large underweight position. We are also mindful that some of the events mentioned carry risk to the upside as well as downside. For example, the possibility of a large fiscal stimulus package post the US election or a positive outcome from the numerous vaccine trials.

For equity markets, the recent strength has pushed up valuation metrics, however, the breadth of the rally has been narrow with a concentration around technology, consumer discretionary and health care stocks. In the near term, this throws up the possibility of sideways moving markets at the headline level but with pockets of opportunity within that as confidence eventually returns to the sectors that have been left behind.



Source: Refinitiv Datastream



Source: Refinitiv Datastream

Outlook

Bond yields remain low but continue to offer a yield pick up above cash. With interest rates capped for the foreseeable future, bonds should also continue to provide some diversification benefits for portfolios in risk off periods. However, we are continuing to recommend an underweight exposure versus our longer-term target.

High quality credit and hybrid securities offer a relatively attractive yield pickup over government bonds. As cash rates converge to zero there is also room for credit spreads to contract further thus offering the potential for additional capital returns.

Credit defaults have begun to increase but remain below the levels seen in previous recessions. Recoveries from those that have defaulted are noticeably weaker though so we remain cautious on lower quality exposures such as High Yield corporate debt.

REITs have moved off their lows but remain well below their pre COVID-19 highs. When compared to their unlisted counterparts, REITs appear to be pricing in a lot more margin for error so we remain comfortable in selectively adding to the sector.

Western Australia In Focus

One theme we believe is starting to emerge is the potential for the Western Australian economy to outperform. At this point our thesis is based partly on anecdotal evidence and partly on improving data but in essence we feel there are enough ducks beginning to line up to make this an opportunity worth positioning for. Below is a summary of some of our key thoughts and observations:

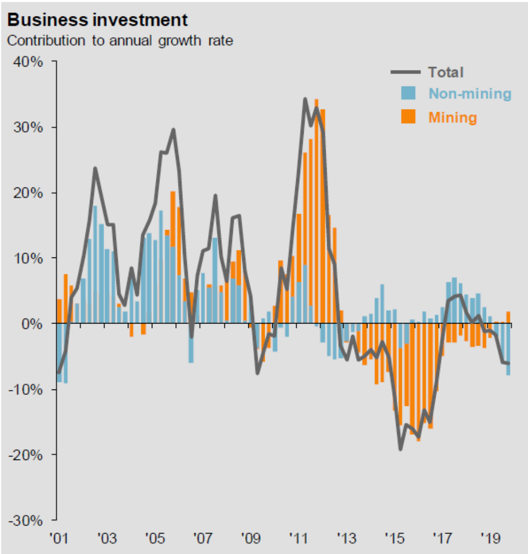
- Lifestyle re-evaluations - We are seeing increasing evidence that COVID-19 is leading to a general re-evaluation of lifestyle choices with many questioning the attractiveness of living in higher density cities.

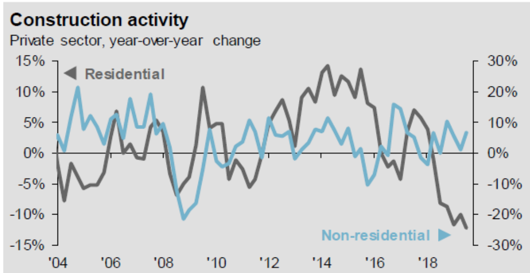
- WA's COVID-19 experience – There is no doubt that WA has been particularly fortunate with its COVID-19 journey. The lower density of living has perhaps had a role to play in this as well as the states' relative isolation. This makes WA an attractive lifestyle destination.

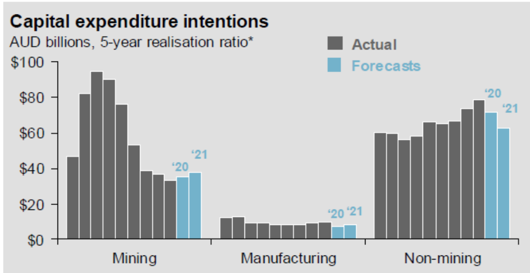
- Increased work flexibility – Out of necessity COVID-19 has shown that remote working is feasible and for many reduces the need to live and work in the same location.

- Increasing mining investment – Mining companies are once again beginning to invest as commodities are positively leveraged to any cyclical pickup. Exposure to an improving Chinese economy is part of this and WA is clearly well placed to benefit. Mining Companies are also publicly stating a preference for their workers to be based in WA.

Outlook

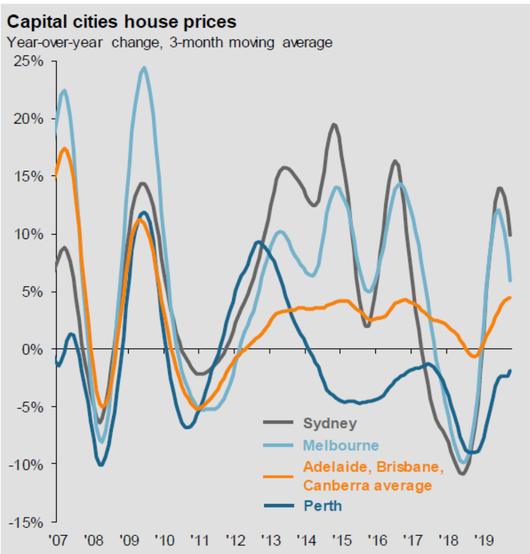


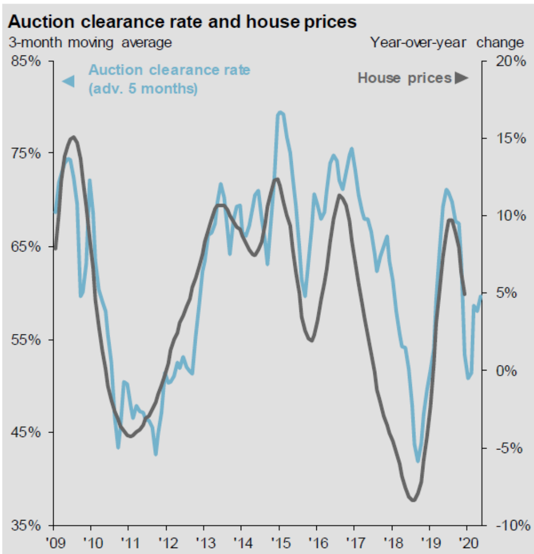




- Turning property market – After an extended period of negative price growth, WA property prices finally look to have troughed.

- Federal and State incentives – A contributing factor to the recent price strength in the property market is a combination of Federal and State incentives that have paved the way for a sharp increase in the pipeline of construction activity. Undoubtably there is an element of demand pull forward within this but when a long-term trend is broken often momentum kicks in, which sees the change in trend continue for longer than expected.





- Perth's rental vacancy rate has dropped below 1%, which over time may help to incentivise investors back to the property market.

Outlook

Potential beneficiaries to the above scenario include:

- Resource companies (e.g. BHP, RIO, IGO)
- Construction materials companies (e.g. Adelaide Brighton, Boral)
- Residential real estate developers (e.g. Cedar Woods)
- Mining services companies

Of course, this is not a riskless opportunity so we are mindful of the following:

- The potential for another COVID-19 wave in WA as borders open up.
- Continued deterioration of Australia's relationship with China that sees China impose further restrictions on imports from Australia with iron ore a particular vulnerability.
- An increase in COVID-19 infections in China which leads to another slowdown and less demand for our commodities.

In Summary

The economic data suggests there has been some repair to the damage caused by COVID-19, however, rising infection rates and risks around other events give us reason to remain somewhat cautious. That combined with higher valuations in aggregate mean we are recommending a moderately underweight exposure to risk assets but given low cash rates, large fiscal and monetary support and potential upside risk factors we do not believe a large underweight position is warranted.

Among the uncertainty we are continuing to identify new areas of opportunity and will look to allocate available cash as they are presented.

**COVID-19 Vaccine Update*

On the 9th November and post the writing of this quarterly, drug companies Pfizer and BioNtech announced their vaccine candidate was more than 90 per cent effective in preventing COVID-19 in people not previously infected with the virus.

The preliminary results from the companies phase 3 clinical trial, which has more than 43,000 enrolled participants, reported 94 confirmed COVID-19 infections. The trial will continue until 164 positive infections are confirmed at which point the study will end and the results fully analysed.

Although still preliminarily, it would appear that 90% "effective" is a particularly solid result and whilst logistics around managing the delivery (must held at 70 degrees below zero) brings challenges it is a great sign and raises hopes for results of other vaccines.

Global markets rallied hard on the news and it was a catalyst for a rotation from tech and 'growth' to 'value', property, travel sectors and infrastructure. This highlights one of the potential upside risks we noted above and justifies taking only a moderate underweight exposure to risk assets. We continue to maintain this view.

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Entrust
WEALTH MANAGEMENT

Level 18, Alluvion
58 Mounts Bay Road
Perth 6000
Western Australia

PO Box Z5034
St Georges Terrace
Perth 6831
Western Australia

T: +61 8 9476 3900
F: +61 8 9321 6333
info@entrustwealth.com.au

Entrust Wealth Management Pty Ltd
ABN 80 100 088 168
Authorised to provide financial services AFSL 222152
Part of the EUROZ group

entrustwealth.com.au