Duncan MacKintosh, CFA

DIRECTOR & AUTHORISED REPRESENTATIVE (458414)
SENIOR INVESTMENT ADVISER

Quarterly Commentary

December 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

December 2020 Quarter

The December 2020 quarter was a particularly strong one for portfolios with impressive performances across all growth asset classes. Highlights included:

- A spectacular performance in risk assets in November following positive announcements from three of the COVID-19 vaccine candidates.
- US election: markets reacted positively to the prospect of a less erratic leadership approach under President Biden and an increase in fiscal stimulus while a lack of control in the Senate means the Democrats may have to moderate their plans for tax reform.
- Australian Equites were strong but a clear rotation between sectors was apparent with Banks, Energy, Tech and Materials outperforming while Healthcare, Utilities and Pharmaceuticals produced negative returns.
- International Equities saw similar returns in USD but a 7% rally in the AUD was a headwind for unhedged exposures.
- Within Alternatives, Equity Long Short and Market Neutral exposures performed well while gold was flat.
- Real Estate Investment Trusts (REITS) continued on their recovery path with another strong quarter.
- Fixed Income: rising bond yields in the longer end of the interest rate curve were a headwind for bond prices despite the US Federal Reserve (Fed) and the RBA both signalling short-term rates are likely to remain low for some time. Hybrid securities, mortgage backed securities and corporate credit outperformed.

Outlook

- **Improving growth outlook but questions remains around the vaccine rollout and inflation**
- **Where are we in the Investment Cycle?**
- **Implications for Portfolios**

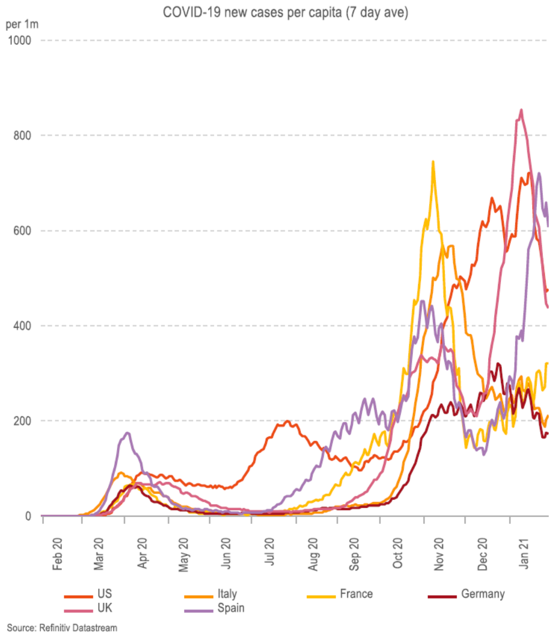
Since our last quarterly update, the global macroeconomic outlook has continued on an encouraging path. On the back of this, the International Monetary Fund (IMF) recently upgraded their economic forecasts for the global economy to +5.5% in 2021 and +4.2% in 2022. At the same time the IMF lifted their estimate of the 2020 contraction to -3.5% from -4.4% previously. In a nutshell, 2021 is seen as a year of economic repair aided by the vaccine rollouts together with ongoing monetary and fiscal support.

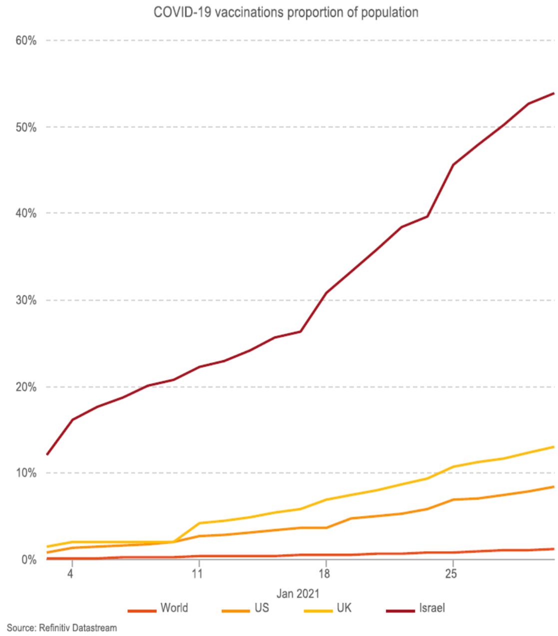
When looking back over the past 12 months it is interesting to revisit the comments we made in our December 2019 quarterly as the initial signs of COVID-19 were beginning to emerge. At that stage it was difficult to have a clear understanding of the likely impacts of the virus but we noted that the economic and market impacts of prior pandemics had tended to be large but short lived. If 2021 is in fact a year of economic repair the COVID-19 experience would seem to be in line with these historical examples albeit it is certainly an extreme example!

Of course, if 2020 proves anything it's that expectations can be derailed by unforeseen events and despite the improving outlook there remain some areas of uncertainty that warrant some consideration. Below we discuss two of these.

Vaccine Roll Out

The most obvious risk for the recovery story is the effective rollout of COVID-19 vaccines. As the chart below shows we are still in the early stages of the rollout and we expect many challenges as we move forward including having adequate supplies, logistics, willingness to take the vaccine, its ongoing effectiveness, virus mutations and correct vaccine administration. Given the recent strength in markets, expectations are high, so as we progress through the rollout phase we would expect bouts of volatility as expectations face up against reality.





Despite this, we believe that on balance, there is a reasonable chance we have seen the worst of the COVID-19 related market weakness. The greatest risks to markets tends to come from the occurrence of low probability but high impact events. We would argue that the key reason for the large sell off in March 2020 was because modern day investors hadn't contemplated a world where the global economy could shut down. As a result, investors didn't know how to price for such an event and fear took over.

If we run into some stumbling blocks with the vaccine rollout it is reasonable to expect some negative market reactions. However, we believe investors will be less fearful the next time round. They know there are effective tools like lockdowns at dealing with infection rates, albeit with an economic cost. They know there are winners and losers out of such a scenario and they know that governments and central banks will be supportive.

We suspect this is the reason markets maintained their strength as we entered the new calendar year despite increasing infection rates in key regions such as the US, UK and parts of Europe.

Inflation Risks

The solution to one problem can often be the cause of another. One potential risk that has moved in and out of the focus of investors over recent years is inflation. Despite these fluctuating concerns realised inflation has maintained a stubbornly low profile. Given the quantum of the monetary and fiscal support in play it is understandable that this risk is again getting some airplay. In fact, higher inflation is one of the objectives of central banks.

So why then is rising inflation seen as a risk? In short, if inflation runs too hot central banks may be forced to aggressively raise interest rates. This is negative for equities and fixed interest bonds.

In our view, it is too early to be getting overly concerned about this. Central banks continue to communicate their expectation for rates to be low for an extended period of time and even if markets begin pricing in higher rates further out they are coming off such a low base there is a reasonable amount runway before they styme growth. In the meantime, low rates combined with improving growth expectations is a very positive environment for asset valuations.

Having said that, given the size of the stimulus and the mindset of central banks to allow inflation to run higher than normal when it does finally move back into their target range, there is a risk that once unleashed it may be hard to control. We therefore feel it is appropriate to have some assets in the portfolio that traditionally perform well in an inflationary environment, such as real assets, inflation linked bonds, energy and commodities.

Gold is arguably another inflation hedge but we are cognisant of the fact that it is 50 per cent above its 2018 lows with weakening momentum so for now we maintain a residual but not high conviction holding in portfolios.

Investment Cycle

The most important consideration for us at the moment is where we are in the investment cycle as this can have important implications for how portfolios should be tilted.

The table below outlines the five stages of a traditional cycle as defined by the CFA Institute.

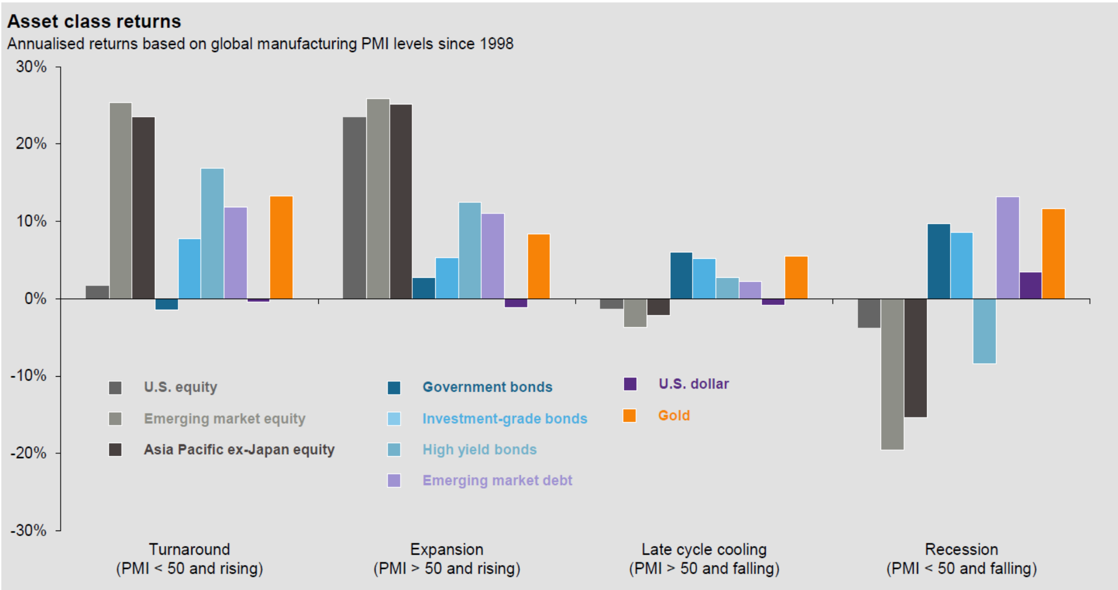
FIVE PHASES OF BUSINESS CYCLE

Phase	Inflation	Economic Policy	Markets
Initial Recovery	Initially declining inflation	Stimulative	- ST rates low or declining. - LT rates bottoming and bond prices peaking. - Stock prices increasing.
Early Upswing	Low inflation and good economic growth	Becoming less stimulative	- ST rates increasing. - LT rates bottoming or increasing with bond prices beginning to decline. - Stock prices increasing.
Late Upswing	Inflation rate increasing	Becoming restrictive	- ST and LT rates increasing with bond prices declining. - Stock prices peaking and volatile.
Slowdown	Inflation continues to accelerate	Becoming less restrictive	- ST and LT rates peaking and then declining with bond prices starting to increase. - Stock prices declining.
Recession	Real economic activity declining and inflation peaking	Easing	- ST and LT rates declining with bond prices increasing. - Stock prices begin to increase later in the recession.

Source: CFA Institute

These definitions suggest we are somewhere in the Recovery/Early Upswing phase given low inflation, improving economic growth, low short-term rates while long-term rates are increasing. The conclusion is an environment that is positive for equities.

To reinforce this view, the following research from JP Morgan Asset Management highlights the historical performance of various asset classes in different stages of the investment cycle as defined by movements in the Purchasing Managers Index (PMI).



Source: Bloomberg Finance L.P., FactSet, IHS Markit, J.P. Morgan Economic Research, MSCI, Standard & Poor's, J.P. Morgan Asset Management. U.S. equity; S&P 500; Emerging market equity; MSCI Emerging Markets Index; Asia Pacific ex-Japan equity: MSCI AC Asia Pacific ex-Japan Index; Government bonds: Bloomberg Barclays Global Treasury Index; Investment-grade bonds; Bloomberg Barclays U.S. Aggregate Credit – Corporate Investment Grade Index; High yield bonds: Bloomberg Barclays Global Corporate High Yield Index, Emerging market debt: J.P. Morgan EMBIG Index; U.S. dollar: Dollar Index; Gold: LBMA Gold price. All data represent total return in U.S. dollar terms. PMIs are relative to 50, which indicates deceleration (below 50) or acceleration (above 50) of the sector. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Australia. Data as of 31 December 2020.

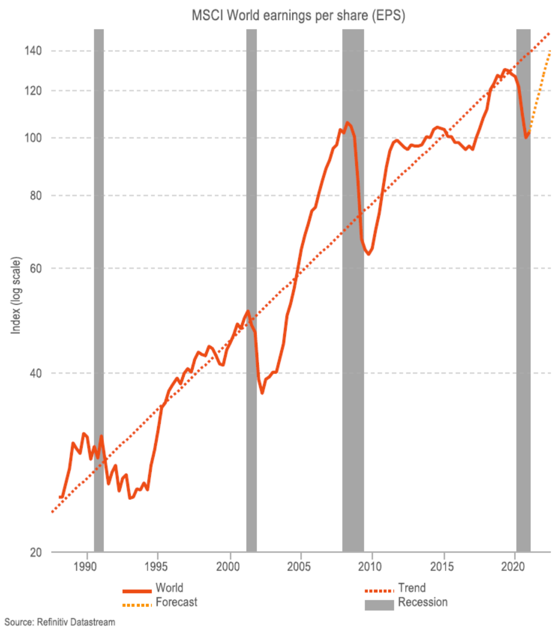
J.P.Morgan Asset Management

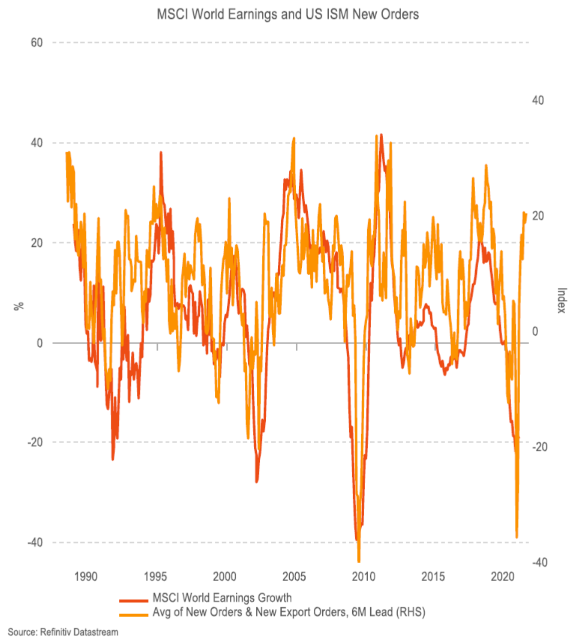
With global PMI's now largely back above 50 this suggests equities, high yield bonds and emerging market debt are the preferred asset classes at present.

As always with investing nothing is ever back and white, at least not in the short term. In applying the above analysis to the current environment there are some potentially complicating factors.

Firstly, given what looks to have been an unusually short recession, assisted in no small part by the unusually large fiscal and monetary support, it may be reasonable to assume that the progression through the next investment cycle may also be unusually swift. The upshot being that portfolios may need to be reasonably nimble in navigating through it.

Secondly, at a headline level, valuations for equities and credit look expensive for this part of the cycle. When compared to cash and high-quality bonds though, the return outlook is more palatable. It should also be noted that if a positive growth outlook becomes more apparent we would expect to see an ongoing increase in forward earnings expectations from equity analysts, which would improve the optics of current valuation multiples.





Implications for Portfolios

Given the improving economic outlook and our current assessment of where we are in the investment cycle we feel we are at a point where portfolios need to evolve somewhat from how they have been positioned recently. We summarise our views below:

Equities

- We are positive on equities for the medium term but given current valuations and uncertainties around the vaccine rollout we are cognisant of the potential for elevated levels of volatility over the journey;
- High quality growth and defensive equities remain attractive long-term but high valuations may prove a relative short-term headwind so position sizes may need to be reviewed;
- Value orientated sectors (low Price/Earnings) that have underperformed in recent years look well placed to start closing the gap;
- A rising yield curve is traditionally positive for financial stocks. This combined with a better than expected impairment outlook looks particularly interesting for banks. We have had a large underweight exposure to Australian banks in recent years but have been actively moving to neutralise that position;
- Dividend yields as a factor is likely to gain the attention of investors once again, which in itself could drive additional capital gains for these types of investments;
- Small cap equities traditionally outperform in such an environment particularly if access to cheap debt triggers a new M&A cycle;
- Cyclical exposures such as Materials, Commodities, Energy and residential property look attractive. These exposures tend to tick the “value” box while also providing a welcome inflation hedge.

Fixed Income

- Rising yields in longer dated bonds is a headwind for bond prices so we remain underweight interest rate risk overall. However, given the expectation that yields are capped to some degree we believe it is still important to maintain a core holding in high quality bonds. Over time higher yields will provide higher cash flows as well as room for additional portfolio protection during periods of equity market volatility;
- Given the improving outlook and yield pick-up that can be achieved, we feel it is time to start selectively adding some higher risk exposures such as corporate loans, high yield bonds and emerging market debt.
- Having exposure to inflation linked bonds as an additional inflation hedge also makes sense.
- Our preference for the last two points above is to gain exposure via high quality diversified fixed income funds with flexible mandates and are actively managed.

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

Entrust Wealth Management Pty Ltd ABN 80100 088 168 AFSL No. 22 2152 ("Entrust") provides no warranty of accuracy or reliability in relation to any information contained in this document and to the extent permitted by law, no responsibility for loss or damage whatsoever arising in any way for any representation, act or omission, whether express or implied (including responsibility to any person by reason of negligence) is accepted by Entrust or any officer, agent or employee of Entrust.

Entrust Wealth Management Pty Ltd, does not accept any liability for loss or damage suffered or incurred by any person however caused (including negligence), without limitation, the information contained within, any errors or omissions however caused or any person placing any reliance on this data, its accuracy, completeness or reliability. This information is of a general nature only and has been prepared without taking into account personal investment objectives, financial situations or particular needs.
Those acting upon information contained in this material without first consulting with professional advisers do so entirely at their own risk. The Directors and/or employees of Entrust Wealth Management Pty Ltd, holder of Australian Financial Services License 222152 (and its parent company or any subsidiaries) may receive financial benefits as a result of a transaction arising from any advice. This document is subject to copyright. No part of it should be reproduced without the consent of the copyright owner. The model portfolio is a theoretical internal model used by advisers as a reference point for their investment decisions.

Actions on your portfolio may be materially different from those undertaken on the model portfolio. Please speak with your adviser to confirm your current holdings and recent transactions.

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