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Quarterly Commentary

March 2021

Entrust
WEALTH MANAGEMENT

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March 2021 Quarter

Despite a sluggish start, the March 2021 quarter saw another solid performance for portfolios with exposure to growth assets. Fixed income portfolios, however, faced some headwinds as longer dated bond yields lifted sharply.

Quarter highlights:

- At an index level, the rotation within **Australian Equities** continued with the Banking (+15.57%) and Telecom (+13.67%) sectors generating strong returns as did Hotels and Restaurants (+11.44%) on the expectation that an improving economic outlook will see a return to fortune for those sectors hit hardest by the Covid-19 lockdown. The Tech sector (-11.27%) was on the losing side of this rotation with the rise in yields a contributing factor to a negative quarter for gold equities (-14.50%).

- **International Equities** were also stronger with a falling AUD providing additional assistance to unhedged exposures. At the regional level Europe outperformed, a beneficiary of the rotation into value and cyclical sectors. The US S&P 500 also outperformed in anticipation and final approval of a $1.9 trillion fiscal stimulus package as well as the potential for a further $2 trillion infrastructure package to follow. Chinese equities underperformed on the back of concerns that the Government would start to take their foot off the stimulus pedal.

- Equity Long Short and Market Neutral strategies continued to perform well within the **Alternatives** portfolio while gold bullion had a weak quarter.

- As a sector, **Real Estate Investment Trusts (REITS**) were slightly negative overall but there was a wide divergence in performance within the sector so appropriate stock picking paid off.

- **Fixed Income:** As discussed above, a sharp lift in longer dated bond yields, particularly in the US (10-year yield increased 0.91% to 1.74%) and Australia (10-year yield increased 0.97% to 1.79%), proved to be a significant headwind for fixed income benchmarks. With shorter dated interest rates (up to three years) anchored by central banks, this resulted in a steepening in the yield curve (longer dated bond yields rising at a faster rate than shorter dated bond yields) highlighting increasing growth expectations. In such an environment corporate credit, floating rate and hybrid securities were able to easily outperform.

Outlook

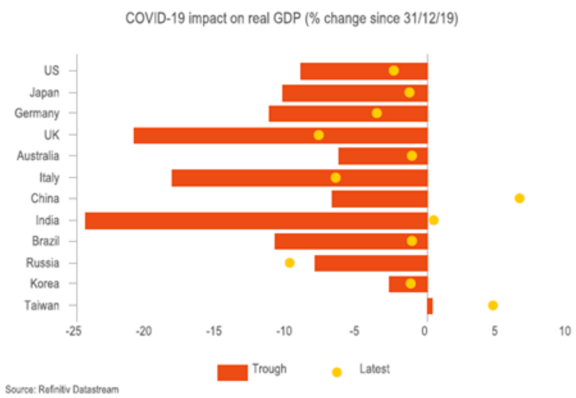
- **The positive outlook for growth continues**
- **Current asset valuations**
- **Appropriate inflation hedges**
- **Implications for portfolios**

The current outlook looks and feels very similar to what we were contemplating in our December 2020 quarterly with an improving economic outlook and accommodative monetary/fiscal policies providing a positive backdrop, however, challenges around asset valuations in the short term remain.

Positive Outlook for Growth Continues

The economic rebound can be seen clearly in the two charts below. The left chart shows the per centage change in GDP in various regions since 31 December 2019 (pre Covid-19), comparing current readings to the post Covid-19 troughs. Most regions are showing a significant improvement from their troughs with many back around their pre Covid-19 levels. China and Taiwan are the outliers with their economies well above pre Covid-19 levels.

The chart on the right compares the Purchasing Managers Index (PMI) for key regions over the past six months to the average reading of 2019. The improving trend of this indicator is also clear

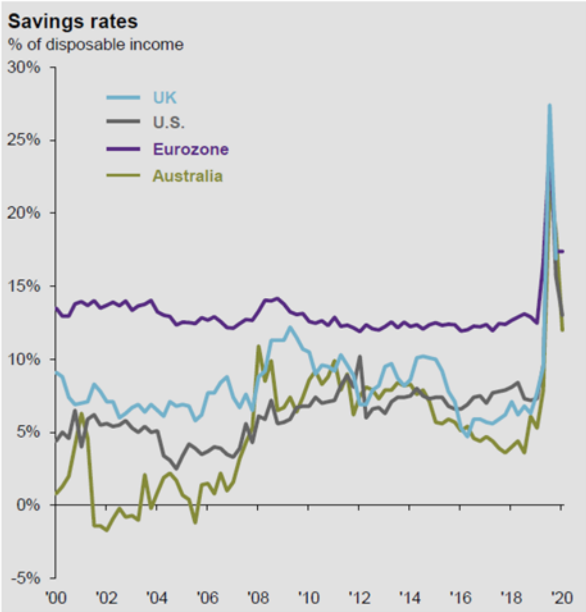


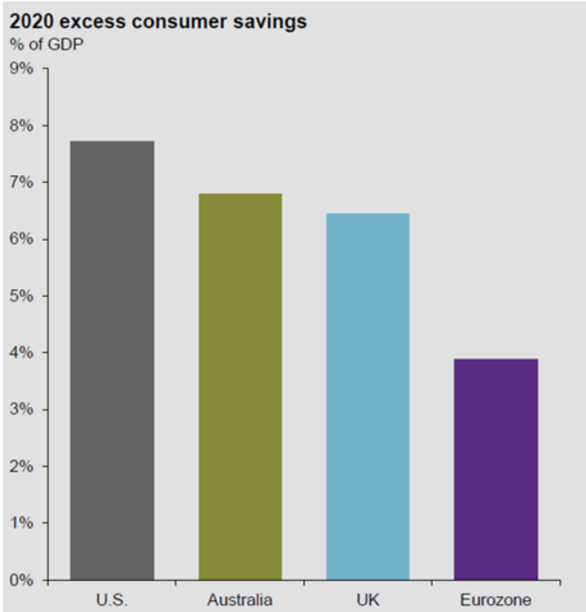
Global Manufacturing PMIs (Seasonally Adjusted)

Country	2019 (avg.)	-6M	-5M	-4M	-3M	-2M	-1M	Feb 21
Australia	51.2	53.6	55.4	54.2	55.8	55.7	57.2	56.9
Brazil	51.9	64.7	64.9	66.7	64.0	61.5	56.5	58.4
Euro	47.4	51.7	53.7	54.8	53.8	55.2	54.8	57.9
France	50.7	49.8	51.2	51.3	49.6	51.1	51.6	56.1
Germany	44.5	52.2	56.4	58.2	57.8	58.3	57.1	60.7
India	52.3	52.0	56.8	58.9	56.3	56.4	57.7	57.5
China	50.5	53.1	53.0	53.6	54.9	53.0	51.5	50.9
Italy	48.1	53.1	53.2	53.8	51.5	52.8	55.1	56.9
Japan	49.3	47.2	47.7	48.7	49.0	50.0	49.8	51.4
Russia	49.1	51.1	48.9	46.9	46.3	49.7	50.9	51.5
South Korea	48.6	48.5	49.8	51.2	52.9	52.9	53.2	55.3
Spain	49.1	49.9	50.8	52.5	49.8	51.0	49.3	52.9
Taiwan	48.4	52.2	55.2	55.1	56.9	59.4	60.2	60.4
UK	50.0	55.2	54.1	53.7	55.6	57.5	54.1	55.1
US	51.8	53.1	53.2	53.4	56.7	57.1	59.2	58.6

Source: Refinitiv Datastream

On the back of vaccination rollouts and the ending of lockdowns, this improving growth outlook is envisaged to continue through the second half of this year. As lockdowns ease, consumers will emerge with high levels of accumulated savings, a combination of stimulus payments and an inability to spend. It is estimated that in the major developed economies, excess household savings have reached almost $3 trillion. It is unclear how much of this pent-up will be realised in a post lockdown world but it is likely to be a strong driver of growth, particularly in the lagging services sectors. It is also likely that companies will need to increase investment to meet this demand.





Source: ABS, BEA. Eurostat, ONS, J.P. Morgan Asset Management
Guide to the Markets – Australia. Data as of 31 March 2021.

The vaccine rollout and move towards herd immunity remains a clear risk to the outlook. Israel is leading the charge with over 60% of its population having received at least one vaccine dose. The UK and US are also making solid progress with BCA Research estimating that both will have vaccinated enough of their population to reach herd immunity by mid to late 2021. In regions such as Europe however, the pace of rollout has been impacted for various reasons including supply issues, regulatory approvals and safety concerns.

Fiscal stimulus continues to underwrite growth. In its March 2021 Economic Outlook, the OECD suggested the fiscal stimulus in the US, together increasing vaccination, could boost US GDP by over three percentage points this year with important spill over effects for other regions.

Central banks continue to take a cautious stance as they look for evidence of a more even and sustainable recovery meaning short term interest rates remain anchored at very low levels. This is likely to be the case until there has been further improvement in employment conditions and inflation. Below is the Federal Reserve's current checklist for raising cash rates.

A Checklist For Liftoff

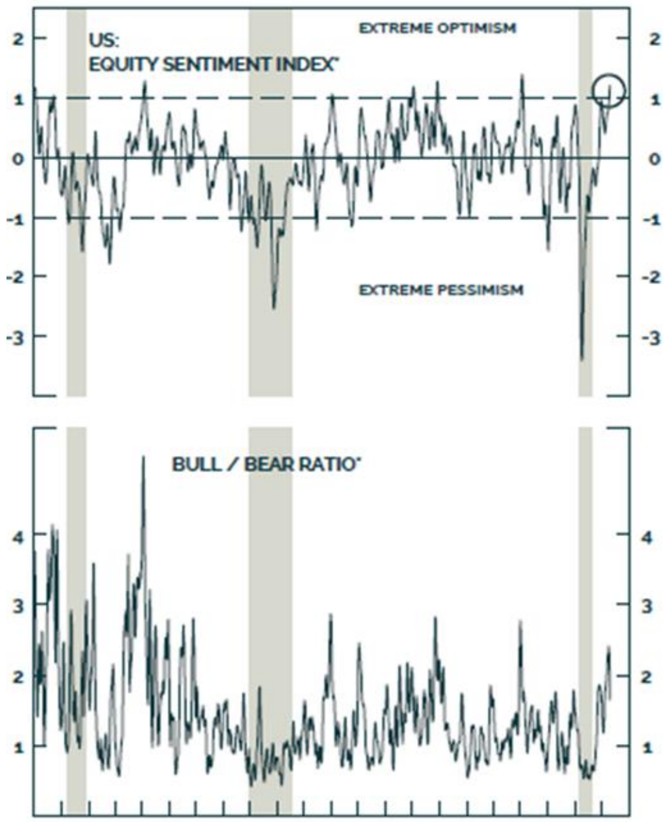
- 12-month PCE inflation must be 2% or higher ☐
- Labor market conditions must have reached levels consistent with the Fed's assessment of maximum employment ☐
- PCE inflation must be on track to moderately exceed 2% for some time ☐

Source: BCA Research

Current Asset Valuations

The combination of low interest rates and strong economic growth creates a very positive environment for risk assets. This has clearly been reflected in investment markets over recent months and on an absolute basis, valuations across most asset classes look full.

For equities, the rally has been driven not only by an improvement in the earnings outlook but an expansion in Price to Earnings (PE) multiples highlighting the positive expectations that are built into market prices at present. Indicators of investor sentiment are also at historical highs, which can be a sign that near-term upside is potentially limited.



Source: BCA Research/American Association of Individual Investors

For fixed income assets, low yields and an improving outlook has resulted in a reduction in the margins on offer over government bonds, so again it is hard to find absolute value here.

On a relative basis though, when compared to the yield on cash and high-quality bonds, equities and credit assets continue to offer a superior return profile for the medium term at least.

Appropriate Inflation Hedges

In our December 2020 quarterly, we discussed some risks around inflation but felt it was too early to be getting overly concerned about this. We are starting to see some short-term spikes in inflation, a combination of base effects (comparing current levels to last year's large drop in inflation) and an increase in demand when supply chains are yet to fully recover. Central banks continue to view these spikes as transitory so we are watching these releases with great interest.

From an economic perspective, mild levels of inflation is a good thing, which is why central banks are targeting higher levels than we have experienced in recent years. The key risk for markets should they be successful, is the ability of central banks to contain it within an acceptable range. To mitigate this risk, it makes sense to include assets within portfolios that are in line with our current economic outlook but also provide useful inflation hedges. That raises the question as to what are the best assets to own for this?

Our Global Asset Allocation consultant BCA Research released a research report in May 2019 discussing their analysis of periods of rising inflation since the 1970's. The conclusion was that the best assets to hold during inflationary periods varies depending on the level of inflation experienced.

When inflation is less than 3% the research suggests that equities are the preferred exposure as monetary policy tends to remain accommodative and cost pressures for companies are able to be passed on.

As inflation moves above 3% central banks become more restrictive as they attempt to slow down growth. This is a negative environment for equities but better for commodities and inflation protected bonds (TIPS).

If central banks are unable to curb rising inflation expectations and we move into a period of very high inflation (+4.9%), defensive equities such as Health Care and Utilities or gold become the preferred exposures.

These outcomes are summarised in the table below:

Winners During Different Inflationary Regimes

PERIODS OF RISING INFLATION				
QUARTILE	1	2	3	4
NAME	LOW INFLATION	MILD INFLATION	HIGH INFLATION	VERY HIGH INFLATION
THRESHOLD	LESS THAN 2.3%	BETWEEN 2.3% AND 3.3%	BETWEEN 3.3% AND 4.9%	MORE THAN 4.9%
ASSET LEVEL HEDGE	EQUITIES	EQUITIES	COMMODITIES / U.S. TIPS	COMMODITIES / U.S. TIPS
EQUITY SECTOR HEDGE	INFORMATION TECHNOLOGY	ENERGY	ENERGY / MATERIALS	DEFENSIVE SECTORS
COMMODITY HEDGE	ENERGY	ENERGY	INDUSTRIAL METALS	GOLD

Source: BCA Research

In line with this research and given our current economic and inflationary outlook we think to equites in general remain appropriate with energy and commodity exposures offering an attractive inflation hedge should we need it.

Implications for Portfolios

Equities

- Equities are attractive overall but current valuations may limit the near-term upside.
- There is an increased probability of market sell-offs on any disappointments vs the expectations currently being factored into market pricing. Barring any truly significant and unforeseen risks we expect these sell-offs to be cushioned by the high levels of cash sitting on the sidelines earning negative real returns.
- Overall, we will look to be a buyer on the dips but with the prospect of range trading markets we are actively looking to manage position sizes by trimming into gains and rotating that capital into better value opportunities as they are presented.
- Sector positioning remains important. Our current preferences include financials, energy and commodities as well as high quality growth stocks at reasonable valuations.
- As near-term upside for markets may be challenging, attractive and sustainable dividend yield is likely to be a factor that attracts investor interest and may in itself be a catalyst for capital gains for those companies that offer it.

Fixed Income

- We believe long-term bond yields are likely capped near term but there is a possibility of an overshoot to the upside so we remain underweight interest rate risk. However, we are actively considering opportunities to take advantage of the higher yields on offer to add to high quality bonds at the margin.
- Given the improving economic outlook we have begun lifting our exposure to more diversified credit opportunities including corporate loans.

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