ALLIEDWEALTH

Implemented Portfolios

Monthly Economic & Investment Market Commentary

April 2021

This month the Asset Class Tipping Points tables get a promotion to the top of the commentary, so that we can discuss a couple of important changes that were agreed at our most recent Asset Allocation and Investment Committee. While the charts will be quite familiar to most readers, experience has shown that a deeper explanation can help with understanding the important elements of the tables and ultimately why specific countries, sectors and regions are held (or not) in your portfolio.

Asset Class Tipping Points - April 2021

Australian Equities

	All Ords	10 Year Forecast	Valuation	30-Apr
	10,300	1.3%	Overpriced	
	10,000	1.6%	Overpriced	
	9,700	2.0%	Fully Priced	
	9,400	2.4%	Fully Priced	
	9,100	2.8%	Fully Priced	
	8,800	3.3%	Fully Priced	
	8,500	3.7%	Fully Priced	
	8,200	4.2%	Fully Priced	
	7,900	4.7%	Fair Value	
	7,600	5.3%	Fair Value	
	7,300	5.8%	Fair Value	Aust 5.8%
	7,000	6.4%	Fair Value	Fin'l 6.6%
B	6,700	7.0%	Cheap	
	6,400	7.7%	Cheap	
	6,100	8.4%	Cheap	
	5,800	9.2%	Cheap	
	5,500	10.0%	Cheap	

Income	4.1%	p.a.
Earnings	3.1%	p.a.
Valuation	-1.4%	p.a.
Forecast	5.8%	p.a.

International Equities - Developed

World ExAust	10 Year Forecast	Valuation	30-Apr
3,600	1.4%	Overpriced	
3,500	1.7%	Overpriced	
3,400	2.0%	Fully Priced	
3,300	2.4%	Fully Priced	
3,200	2.7%	Fully Priced	
3,100	3.1%	Fully Priced	
3,000	3.4%	Fully Priced	Dev 3.4%
2,900	3.8%	Fully Priced	
2,800	4.2%	Fully Priced	
2,700	4.7%	Fair Value	
2,600	5.1%	Fair Value	
2,500	5.6%	Fair Value	
2,400	6.1%	Fair Value	
2,300	6.6%	Fair Value	
2,200	7.1%	Cheap	Euro 6.9% UK 7.0% Japan 7.3%
2,100	7.7%	Cheap	
2,000	8.3%	Cheap	

Income*	2.4%	p.a.
Earnings	3.1%	p.a.
Valuation	-2.2%	p.a.
Forecast	3.4%	p.a.

International Equities - Emerging

Emerging Markets	10 Year Forecast	Valuation	30-Apr
1,900	1.2%	Overpriced	
1,850	1.5%	Overpriced	
1,800	1.8%	Fully Priced	
1,750	2.1%	Fully Priced	
1,700	2.4%	Fully Priced	
1,650	2.7%	Fully Priced	
1,600	3.1%	Fully Priced	
1,550	3.4%	Fully Priced	
1,500	3.8%	Fully Priced	
1,450	4.2%	Fully Priced	
1,400	4.6%	Fair Value	
1,350	5.0%	Fair Value	EM 5.1%
1,300	5.5%	Fair Value	A-P 5.4%
1,250	6.0%	Fair Value	
1,200	6.5%	Fair Value	
1,150	7.0%	Cheap	
1,100	7.5%	Cheap	

Income*	-0.5%	p.a.
Earnings	6.4%	p.a.
Valuation	-0.9%	p.a.
Forecast	5.1%	p.a.

Listed Property

ASX200 Property	10 Year Forecast	Valuation	30-Apr
2,050	1.1%	Overpriced	
2,000	1.4%	Overpriced	A
1,950	1.8%	Fully Priced	
1,900	2.1%	Fully Priced	
1,850	2.4%	Fully Priced	
1,800	2.8%	Fully Priced	
1,750	3.2%	Fully Priced	
1,700	3.6%	Fully Priced	
1,650	4.0%	Fully Priced	
1,600	4.4%	Fair Value	
1,550	4.8%	Fair Value	
1,500	5.3%	Fair Value	
1,450	5.8%	Fair Value	A-REITs 5.6%
1,400	6.3%	Fair Value	
1,350	6.8%	Cheap	
1,300	7.4%	Cheap	
1,250	7.9%	Cheap	

Income	4.2%	p.a.
Dist Grwth	1.4%	p.a.
Valuation	0.0%	p.a.
Forecast	5.6%	p.a.

Risk-Free Rate [Ref: A]

As the name implies, this is simply the return that you can receive without taking any risk. It is an important number in its own right, but also serves as an essential reference point from which we can judge the expected returns of other assets, both defensive and risky. Traditionally, the most common input for risk-free returns is the interest rate paid on government bonds (known as their yield), and that is what we have decided to revert to using at our most recent meeting.

The reason we have not been using government bonds up to this point is that better returns were available from term deposits issued by our major banks, and for just about all investors these came with an effective government guarantee, as of course do government bonds. In the aftermath of the Global Financial Crisis, there were incentives in place for the banks to reduce the amount of funding they sourced from overseas wholesale markets, and for a time the term deposit rates offered to individual investors in Australia were actually quite generous. Up until quite recently, whilst that generosity steadily diminished, better rates were still readily available on term deposits than on government bonds.

When using term deposit rates as our risk-free reference the figure was 1.4%, which was based on the then current 5-year TD rate of about 0.8% averaged out with an expectation that the same investment would pay around 2% in 5 years' time. Then, in early November last year the announcement of how effective the newly developed vaccines were against Covid-19 was a significant catalyst in a number of areas. Obviously and most importantly this was from a health perspective, but it also led to big changes in expectations for the recovery in the global economy, for the outlook in financial markets and continuing conjecture about how central banks might adjust their monetary policy stance.

As this chart shows, the yield on 10-year government bonds also adjusted quite quickly from the 0.75% in early November to more the 1.9% at the end of February, before settling back to the current 1.8%.

The red line is just the average of this yield over the last 20 days, and this figure of 1.75% is the actual input we will now use for the risk-free rate in the Asset Class Tipping Points.

The reason we have had such a focus on the outlook for inflation in recent commentaries is because a breakout there will likely mean that the lines in the chart above head higher again. Should that happen, and we expect that it will ahead of the next reading for Consumer Price Inflation to be published at the end of July, it will be critical to judge if it is only a temporary phenomenon as the CPI reflects last year's shut down and this year's re-opening, or if it represents the start of a more sustained increases in prices.

The consensus from the latest survey of economists is that we will see CPI spike to 3.2%, though this is likely to be revised upwards as we get closer to the data being published. However, importantly, that spike is then expected to recede to 2.3% and then back to 2.0% in the two subsequent quarterly updates. Over the next few months, it is going to be important that we don't over-react to a short-term anomaly in the inflation data, and also that we remain alert to the opportunities that this uncertainty might present.

Risk Premium [Ref: B]

For now, the change described above is quite subtle, but it has the potential to be a more important impact over the short to medium term. When higher returns are available on defensive investments, the expected returns from risky assets need to be commensurately higher to justify continuing to own them at the same proportion of your portfolio. Investors expect to receive higher returns over time for assuming the risk and volatility in asset classes like shares, and this Risk Premium is another important component in the Asset Class Tipping Points tables. The difference between when an asset class is considered to have initially become Overpriced compared to when it starts to become Cheap is 5%. So, quite simply that Cheap threshold has now increased from 6.4% to 6.75%, which is again quite a subtle change for now, but there is a reasonable chance this heads higher again in coming months.

This higher threshold to be considered Cheap also comes at a time when recent performance has actually been quite strong, especially considering the circumstances in which it was achieved. Many readers will have heard us say that higher prices today mean we should expect lower future returns, all else equal. Specifically, that translates to lower long-term forecasts now that much of the recovery has already arrived and as investor expectations start to consider the years ahead and the post-recovery normalised environment for dividends, earnings growth and where valuations might settle.

So, the current reality is that there is some pressure coming from both ends of the spectrum for the risky asset classes shown in the tipping points. It is important to note however that in both cases there is quite a positive reason for this pressure. Firstly, the recovery from the health crisis and the recession has been much quicker and stronger than anyone expected a year ago, principally because of the vaccine efficacy mentioned earlier but just as important is the truly unprecedented scale of the policy response from governments and central banks to support employment, business, and the economy more broadly.

Dynamic Asset Class Targets

To provide some historical perspective to this discussion we reference the Tipping Points tables from the end of 2018, when our long-term forecast for Australian Equities was 9.7%, and 12.7% p.a. for the Financials sector (as with all our forecast numbers, these are average annual expected returns over our 10-year forecast period).

At the time, both were comfortably into the Cheap valuation band which started at 8% (3% then Risk-Free + 5% Risk Premium), and as a result we maintained a significant Overweight to both Australian Equities, and within that to the Financials sector. In the nearly 2½ years since, the annualised performance has been 14.6% p.a. for Australian Equities and 11.2% for Financials. Other parts of the market were even stronger with annualised gains over the same period for the Resources sector of 20.1% and for MidCaps (medium-sized companies) of 18.1%.

Today, the combination of that quite robust recent performance and some adjustments made to the forecast inputs, sees the expected returns for Australian Equities at 5.8% p.a. and 6.6% p.a. for Financials. As you can see in the Asset Class Tipping Points above these figures now equate to respectively about the middle and close to the bottom of our Fair Value range. This is what informs our most recent decision to remove the long-held Overweight stance to Australian Equities. In simple terms, the Overweight was justified when the assessed valuation was Cheap, but now that they are back in the Fair Value range, we are gradually moving portfolios back to a Neutral stance.

We will finish with a couple of important points, the first of which is the word gradually in the last sentence. There are two parts to each decision that the Asset Allocation and Investment Committee makes; what is the target we are heading to, and how quickly do what we want to get there. The current view from the committee is that we will take about 6 months to gradually reduce the Overweight in Australian Equities, ideally selling into a rising market to capture further upside. In practical terms, for a No. 3 Investment Program this means an initial reduction from 28% exposure to 26%, and then about 1% per month to get back to the Neutral target of 20%.

Finally, it is important to acknowledge that the flexibility of the Individually Managed Account (IMA) structure means that we will have investors in the same program approaching a target from either side. This is a critical distinguishing feature of our portfolio management service, and we often talk about the importance of being able to treat new investors individually and differently from long-term investors. With Australian Equities at Fair Value, the portfolio management team will be buying for new portfolios to establish the neutral target exposures, in accordance with the guidance provided to us by your Adviser. In contrast, long-term portfolios who established their Overweight exposures years ago, will now gradually be selling to move to the lower Neutral. It is one of the most important ways in which we deliver on the individuality promised in the IMA structure.

We will keep you updated via the commentaries should there be any adjustments to the current plan for Australian Equities, or indeed other asset classes. It is possible that we will vary the current 6-month time frame outlined above, and we typically will expect to move a bit quicker if markets rise strongly from here.

We hope that the slightly different nature of this month's commentary helps you to better understand the decision making from the investment committee that determines the management of your portfolio. As always, we welcome any feedback you may have and would be happy to provide any further context or explanation on the issues discussed here, or more generally in your portfolio. Please direct any queries to your Adviser who can pass them on to us so that we can respond.

Kind regards,
Asset Allocation & Investment Committee

NOTE: *It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time, or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio, please contact your Adviser.*