EL&C Baillieu
1889 ONWARD

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Investment Strategy

Asset allocation in a shock, after a major rally

A rapid correction on COVID-19 concerns has erased a large part of the global equity rally of the past year, despite the positives of easy monetary policy, the US-China trade deal, the resolution of Brexit and persistent low inflation. Bond yields have fallen sharply to new record lows, whilst industrial commodities and the Australian dollar have weakened. In this note, we provide our regular update of key investment themes, major asset class views and the implications for tactical-dynamic asset allocation.

International Equities: Valuation is back to neutral-to-very attractive levels. Global liquidity conditions are very positive. Beyond COVID-19 disruptions, policy stimulus and easing trade and political uncertainty should lift earnings growth. Investor sentiment is bearish. We add to our overweight in international equities, adding to the US and Emerging Markets.

Australian Equities: Absolute valuation is still above-average, whilst earnings indicators are soft. Liquidity conditions are supported by easy RBA policy. We remain underweight.

Fixed Income: Bonds are extremely expensive in absolute and relative terms. Flat yield curves and negative real rates discount a downturn and very low inflation. Whilst easy policy should keep bonds distorted, risk-reward in most scenarios appears unattractive. We remain underweight.

Property & Infrastructure: Valuations imply extremely low discount rates. Domestic demand is weak. We are underweight, preferring select global infrastructure.

Currency: The AUD faces challenges from record negative rate spreads, weak relative growth, Australia's high debt and soft commodity prices. We continue to recommend unhedged international exposures.

Investment implications: We remain comfortable with our overweight growth assets versus defensive assets. Looking beyond the COVID-19 correction, we would expect double-digit returns from growth assets and near zero-to-negative returns from defensive assets. As the current volatility eases, we will look for opportunities to increase our exposure to the US and Emerging Markets, trimming cash and bond exposures.

Fig.1: Tactical-Dynamic Asset Allocation Recommendations

Asset Class	Extreme Underweight	Underweight	Slight Underweight	Benchmark	Slight Overweight	Overweight	Extreme Overweight
Australian Equities							
Large Cap							
International Equities							
United States							
Europe							
Japan							
Emerging Markets							
Property & Infrastructure							
AUS & Global Property & Infrast.							
Fixed Income							
Australian & Global Fixed Income							
Australian & Global Credit & Hybrids							
Cash							
Cash							
Currency							
AUD							

Source: EL&C Baillieu. Notes: Black squares = current recommendation; Grey squares = last quarter's recommendation; Green squares = neutral

Tactical-Dynamic Asset Allocation: Detailed Recommendations

Fig.2: Tactical-Dynamic Asset Allocation Listed Recommendations by Investor Type

Asset Class	ASX/mFund Code	Conservative	Moderate	Balanced	Growth	High Growth
Australian Equities		**6.0%**	**11.0%**	**17.0%**	**20.4%**	**22.3%**
Australia Equities	A200/MVW	4.0%	7.0%	13.0%	15.4%	16.8%
Active Australia Equities	FIL08	2.0%	4.0%	4.0%	5.0%	5.5%
International Equities		**23.0%**	**29.0%**	**43.6%**	**60.1%**	**77.7%**
US Equities	VTS*	6.6%	9.1%	13.3%	19.1%	21.7%
European Equities	VEQ	3.5%	4.5%	6.9%	9.0%	11.6%
Japanese Equities	IJP	2.0%	2.3%	3.5%	4.5%	6.1%
Active Emerging Market Equities	FEMX	3.0%	3.1%	4.2%	6.1%	9.0%
Active Global Equities	MFF	2.7%	3.3%	5.2%	7.2%	9.7%
Active Global Equities	MPS04	2.7%	3.3%	5.2%	7.2%	9.7%
Active Global Equities	APL	2.7%	3.3%	5.2%	7.2%	9.7%
Property & Infrastructure		**0.0%**	**0.0%**	**4.0%**	**5.0%**	**0.0%**
Global Infrastructure	MICH	0%	0.0%	4.0%	5.0%	0%
Fixed Income		**24.0%**	**28.0%**	**21.9%**	**7.0%**	**0.0%**
Australian & Global Fixed Income	IAF	6.5%	8%	6.0%	2%	0%
Active AUS & Global Fixed Income	PMF04	6.5%	8%	6.0%	2%	0%
Australian & Global Credit & Hybrids	BAM05	6%	6%	5.0%	2%	0%
Australian & Global Credit & Hybrids	XKAP	6%	6%	5.0%	2%	0%
Cash		**47.0%**	**32.0%**	**13.5%**	**7.5%**	**0.0%**
Cash		47.0%	32.0%	13.5%	7.5%	0%

Source: EL&C Baillieu. Notes: Black squares = current recommendation; Grey squares = last quarter's recommendation; Green squares = neutral

Fig.3: EL&C Baillieu Multi-Asset Balanced and High Growth Portfolios

Asset Name	ASX/ mFund/ APIR Code	Balanced Portfolio Weights	High Growth Portfolio Weights
Australian Equities		**17.0%**	**22.3%**
VanEck Vectors Australian Equal Weight	MVW	9.0%	11.3%
Airlie Australian Share Fund	MGE9705AU	4.0%	5.5%
Greencape Broadcap Fund	HOW0034AU	4.0%	5.5%
International Equities		**43.6%**	**73.7%**
Vanguard US Total Market Shares	VTS	11.0%	19.5%
Vanguard FTSE Europe Shares	VEQ	6.5%	11.0%
BlackRock iShares MSCI Japan	IJP	3.75%	6.5%
Fidelity Global Emerging Markets	FEMX	4.75%	8.7%
Magellan High ConvictionFund (HCFB)	MGE9885AU	4.0%	7.0%
MFS Global Equity Trust	MIA0001AU	4.0%	7.0%
Antipodes Global Investment Company Ltd	APL	4.0%	7.0%
Alternatives			
Pinebridge Global Dynamic Asset Allocation Fund	PER0731AU	8.0%	10.0%
Property & Infrastructure		**4.0%**	**0.0%**
Magellan Infrastructure Fund (Currency Hedged) (Managed Fund)	MICH	4.0%	0.0%
Fixed Income		**21.9%**	**3.0%**
iShares Core Composite Bond	IAF	4.5%	0.0%
PIMCO Australian Bond Fund	ETL0015AU	6.0%	0.0%
Kapstream Absolute Return Income Fund	HOW0052AU	4.0%	0.0%
Bentham Global Income	CSA0038AU	5.0%	0.0%
Cash		**13.5%**	**1.0%**
BetaShares Australia High Interest Cash ETF	AAA	12.5%	0.0%
Platform Cash	N/A	1.0%	1.0%
		100.0%	**100.0%**

Source: EL&C Baillieu

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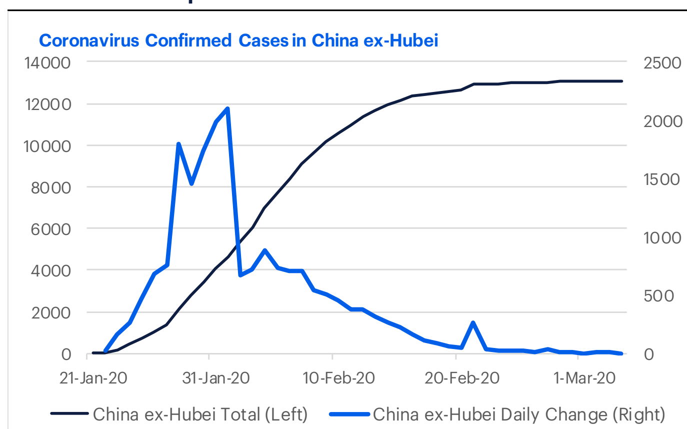
- A correction on COVID-19 concerns has erased a large part of the global equity rally of the past year, despite the positives of easy monetary policy, easing yield curve concerns, the US-China trade deal, the resolution of Brexit and persistent low inflation. Bond yields have fallen to new record lows and gold has rallied to unusually high levels. Most industrial commodities have weakened. In this note, we provide our regular update of our key investment themes, major asset class views and the implications for tactical-dynamic asset allocation.

Major investment themes

Gauging the impact of COVID-19 – likely a large, short-term hit

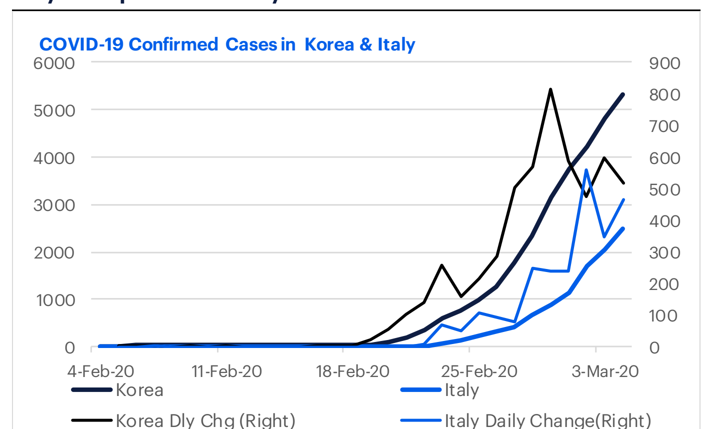
- The new coronavirus, COVID-19, emerged in Wuhan, Hubei province, central China in December 2019, and has spread globally. As of March 5th, the 95,333 global cases and 3,282 deaths have exceeded the SARS outbreak of 2002-03 by factors of 11.8x and 4.2x respectively.
- China has recorded 85% of global cases, Hubei 71%. At 16.3% of global GDP, China is ~4 times more important to the global economy as at SARS.
- After Hubei was quarantined on January 23rd, the number of daily new cases in the rest of China peaked nine days later at 2,101 and has since slowed to ~9 per day. Some key provinces have had no new cases for 14 days, enabling a phased return to work over the next few weeks. If China operated at ~50% of normal levels in February and ~90% in March, the immediate GDP hit would be ~5% of GDP; though catch-up, emergency financial support and some stimulus should substantially reduce the net impact over the year.
- The outbreaks in Italy (2.3% world GDP) and Korea (1.8%) are still in a high-growth phase following imposition of emergency procedures nine and 12 days ago respectively, but similar to China, daily new cases may have peaked (Figure 5). New pockets of cases are likely to disrupt activity elsewhere, limited by quarantining, seasonality – as the northern flu season ends in May – or development of a vaccine. Heightened alert, preventative measures and central bank and fiscal stimulus should further limit the economic impact.
- On these assumptions, most companies globally should be able to pay their dividend in 2020. After the correction, the world yield of 2.95% is a record 2.4% above the G7 bond yield, though the 2.25% gap versus 3-month rates is below the GFC record. With this valuation and policy support, we would expect the markets to rally as the global phase of COVID-19 peaks over the next 1-2 months.

Fig.4: COVID-19 new cases in China ex-Hubei peaked nine days after Hubei was quarantined



Source: Datastream, EL&C Baillieu

Fig.5: COVID-19 cases in Korea and Italy still rising rapidly – but may have peaked 7-9 days after lockdown

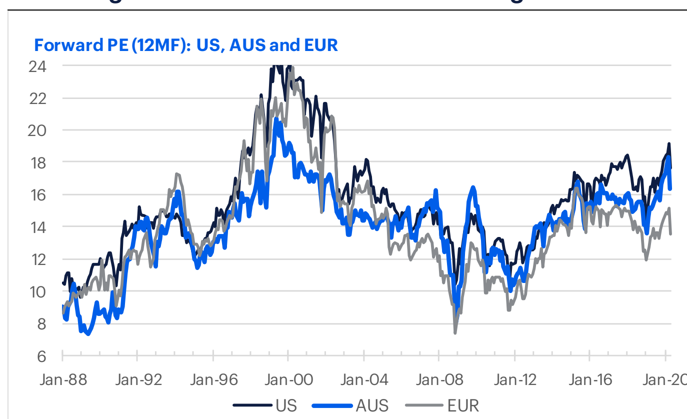


Source: Datastream, EL&C Baillieu

Valuation: can markets trade in new ranges?

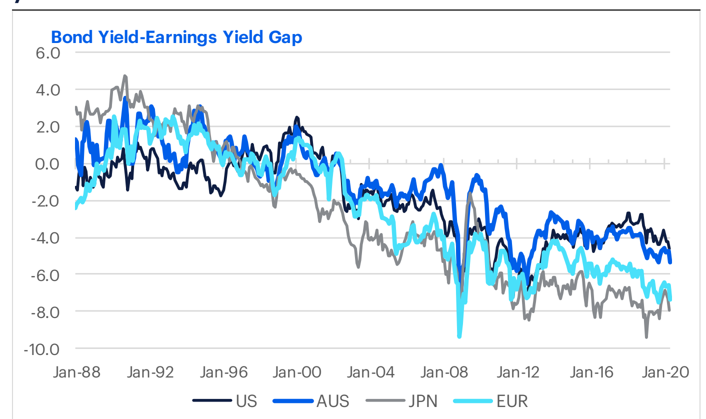
- In mid-February, equity markets in Australia and the US were trading at the highest forward PEs since the TMT-equity bubble of 1998-2002. Valuations were driven higher by the swing from tightening to easing by the US Federal Reserve and other central banks, an easing of inverted US yield curve concerns, the phase one US-China trade deal, Brexit, and lower oil prices. Indeed, the 2019 rally drove the forward PE for the US S&P 500 from ~14.5x to above 19x (now ~17.5x), the Australian ASX 200 from 13.7x to above 18x (now ~16.5x) and the MSCI World from 12.8x to ~17x (now ~15.5x) – see Figure 6.
- The correction has pulled valuations, ex-Australia, back to very reasonable levels. While Australia is still 1.0 standard deviation above average, the US is 0.5 standard deviation above average, while the World at -0.1, Europe at -0.1, Emerging Markets at -0.2 and Japan at -0.8 are now below average.
- We believe valuations should be above average given: i) central banks have set the bar high for any tightening – the liquidity boom can continue; ii) markets are extremely attractive against record low short- and long-term rates (Figure 7); iii) US investors remain cautious, so a swing to inflows could drive a market re-rating; and iv) US presidential re-election years have been positive for markets since 1948!
- Arguments against a valuation rebound include: i) COVID-19 proves to be a long-duration, deep shock; ii) debt-related risks – but China corporate debt, the US budget deficit and record Australian household debt are unlikely to matter at record low rates; and iii) political risks, such as a Sanders US presidency (though this risk appears to be receding), a UK-EU trade failure or renewed Hong Kong political protest at September Legislative Council elections. On balance, looking beyond short-term volatility we expect a return to above-average valuations.

Fig.6: Forward PE for AUS at 16.5x is stretched, while the US at 17.5x is high and other markets are below average



Source: Datastream, EL&C Baillieu

Fig.7: Equities are extremely attractive against record low bond yields



Source: Datastream, EL&C Baillieu

An advanced economy upside growth surprise

- Beyond COVID-19, a US GDP and earnings boom seems very possible (Figure 8), driven by: i) the Fed's large policy easing lifting housing activity; ii) the US-China trade deal lifting business investment and exports; iii) solid government spending in an election year; and iv) strong consumer fundamentals and confidence lifting consumption.
- Trade resolution and potential inventory cycles – industrial production growth is far behind real retail sales – should lift Europe and Japan. Emerging markets should benefit from a strong US, US-China trade resolution and the substantial global easing of monetary policy and likely fiscal stimulus.
- A rebound in global growth should drive a rebound in global earnings growth. MSCI World 12-month forward earnings are currently flat year-on-year (YoY), with the US +4.4% YoY, whilst other markets are down 4-6% YoY. We expect a double-digit rise in US earnings and an equally strong rebound in ex-US markets.

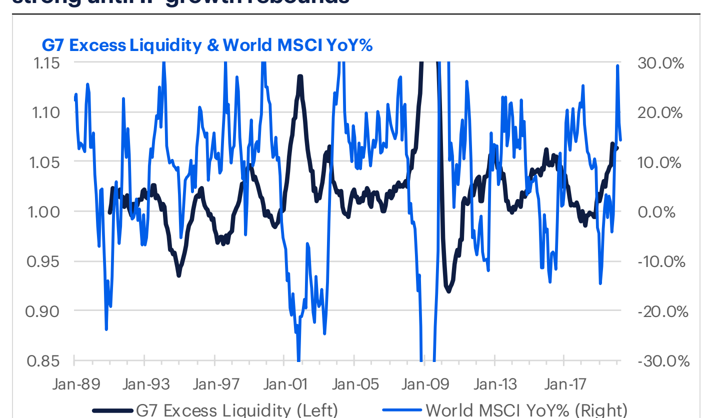
Extremely positive liquidity conditions – a high bar for any tightening

- After a very gradual tightening cycle over 2017-18, led by the US Fed, global monetary policy has eased significantly, led by the Fed, European Central Bank (ECB), Australia and the key emerging markets, including Brazil, Mexico, India, Korea, Indonesia, Thailand, Turkey and Russia. China has eased reserve requirements and rates.
- The Fed, Bank of Canada and Reserve Bank of Australia have already eased aggressively in response to COVID-19 fears, whilst the ECB and Bank of Japan have indicated a willingness to ease further if needed. Beyond COVID-19, the Fed and ECB have set a high bar for any policy tightening, requiring significantly higher and persistent inflation. In addition, both are reviewing their policy objectives. If they move to a price level objective – formally accepting above-target inflation for an extended period to compensate for the undershoot of recent years – this would further cement positive liquidity conditions.
- That said, the level of policy rates is already extreme, with the G7+ Australia ranging from -0.1% to just 1.25% (G7 average 0.7%) or, in real terms, ranging from -0.5% to -1.4% (G7 average -1.1%). Excess liquidity conditions have accelerated across the G7 but should peak as industrial production growth rebounds (Figure 9).

Fig.8: US ISM orders appear to have troughed, and should rise strongly post-COVID-19, a positive for earnings

Source: Datastream, EL&C Baillieu

Fig.9: G7 excess liquidity has accelerated, and should remain strong until IP growth rebounds



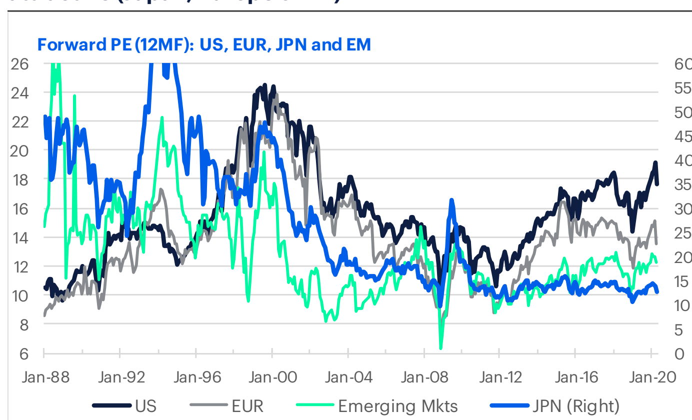
Source: Datastream, EL&C Baillieu

Major asset class views

Equities: Overweight International; underweight Domestic

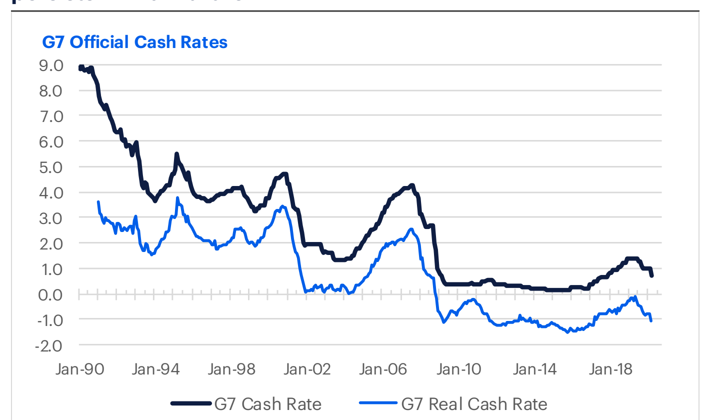
- **Valuation – neutral to attractive:** Australia at ~16.5x and the US at~17.5x are above their long-term averages of 14.6x and 16x respectively. MSCI World at ~15.5x is below average, as is Europe on 13.5x, emerging markets (EM) 12x and Japan ~13x (Figure 10). Versus bonds, equities are extremely attractive across all markets (Figure 7). Versus short rates, Australia, Japan and Europe stand out. Dividend yields are attractive in absolute terms, particularly in Japan and EM, and more so versus rates. Price-to-book value compared to the expected return on equity is expensive in Australia and the US. In relative terms, Australia is expensive versus the US, while in turn the US is expensive versus Europe, Japan and EM. Overall, composite valuation metrics range from about neutral in Australia and the US, to extremely attractive in Japan, and very attractive in Europe, EM and MSCI World.

Fig.10: Forward PE valuations range from stretched (AUS) to attractive (Japan, Europe & EM)



Source: Datastream, EL&C Baillieu

Fig.11. G7 real short rates are strongly negative and if COVID-19 persists will fall further



Source: Datastream, EL&C Baillieu

- **Liquidity conditions – ultra-easy policy versus flat yield curves:** Policy has eased across most major markets, led by the Fed (-125bps, ending quantitative tightening and adding a repurchase agreement program), ECB (-10bps and €20 billion per month asset purchases), RBA (-100bps) and major EM central banks (nine of the top 11 EMs have eased policy by 50-1325bps, while China has cut reserve requirements 100bps and eased rates 26-50bps). The G7 short-rate is now 0.7%, or -1.1% in real terms, down 100bps YoY (Figure 11). The recent rate cuts have helped flatten the yield curve to just -10bps.
- Looking ahead, the easing cycle could be extended in reaction to the COVID-19 shock. With the bar for tightening set high, rates should not rise for the foreseeable future. Post-COVID-19, an improving growth outlook should help bond yields rise, normalising yield curves; a positive for equities.
- **Earnings outlook – indicators troughing (easy policy and trade resolution to drive pick-up)**. By major market:
  - US: the ISM surveys appear to have soft-landed, with early signs of an upturn. The 4Q19 reporting season was a solid 5.0% better-than-expected, driving a 3.4% YoY earnings rise, despite headwinds from lower oil prices, slower global growth and the firm US dollar. 12-month forward (12MF) earnings expectations have picked up to 4.4% YoY, the best growth in nine months (Figure 12). Beyond COVID-19, we expect easy Fed policy, as well as

trade resolution and robust private sector fundamentals to drive strong earnings momentum.

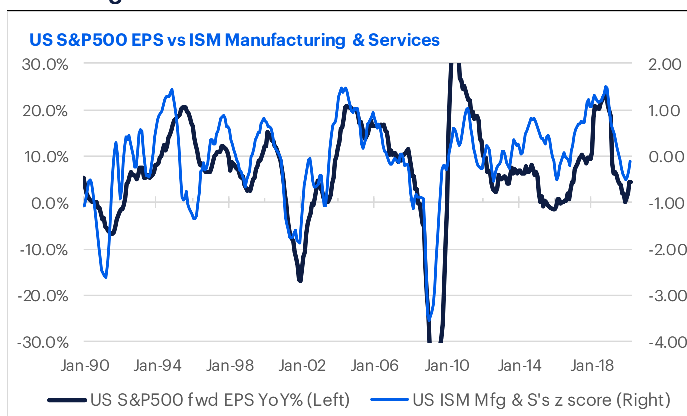
– Europe: business surveys appear to be soft-landing, with a gentle upturn to a six-month high. 12MF earnings also appear to have turned, though they remain down 2.5% YoY (Figure 13). Easing US-China trade tensions, declining European political uncertainty and a weaker Euro should all be positive for earnings.

– Japan: global uncertainty and a GST tax increase have moderated the Tankan survey and pushed 12MF earnings down 6% YoY (Figure 14). Trade resolution and improving corporate performance – buy-backs are up 48% YoY – should drive a rebound in earnings.

– Emerging markets: the trade war, global slowdown and crises in Turkey and Argentina pushed forward earnings down about 8% in 2019. 12MF earnings are still down 4% YoY (Figure 15). Looking forward, broad-based EM easing, the US-China trade deal and expected China stimulus should help drive a rebound from COVID-19, a positive for EM earnings.

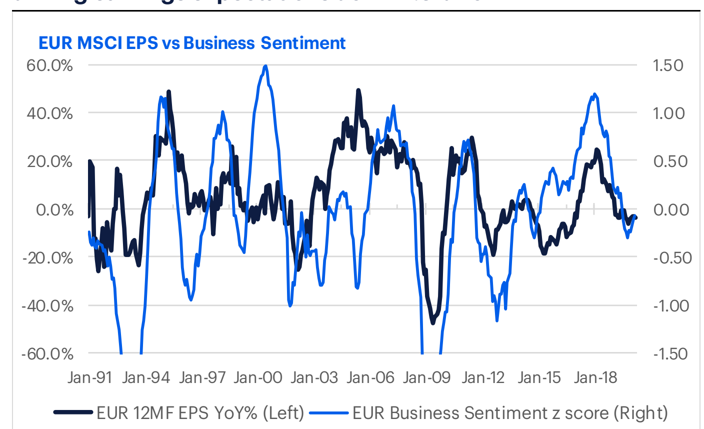
– Australia: a soft interim reporting season, despite strong iron ore prices, some global growers and a weaker AUD. 12MF earnings are down 2.1% YoY (Figure 17). Looking forward, COVID-19, soft housing construction, squeezed consumers, one-off headwinds and stall-speed risks should offset policy stimulus, meaning further soft business sentiment and earnings momentum.

Fig.12: US earnings momentum and the ISM surveys appear to have troughed



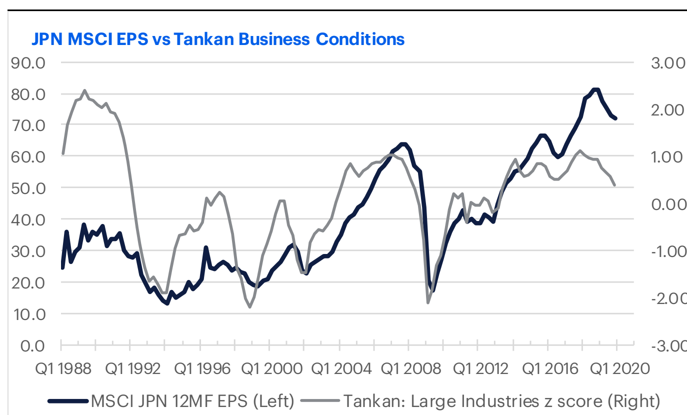
Source: Datastream, EL&C Baillieu

Fig.13: Europe business sentiment has stabilised at a soft level, driving earnings expectations down 2.5% YoY



Source: Datastream, EL&C Baillieu

Fig.14: Japan 12MF earnings are down 6% YoY as the Tankan has moderated



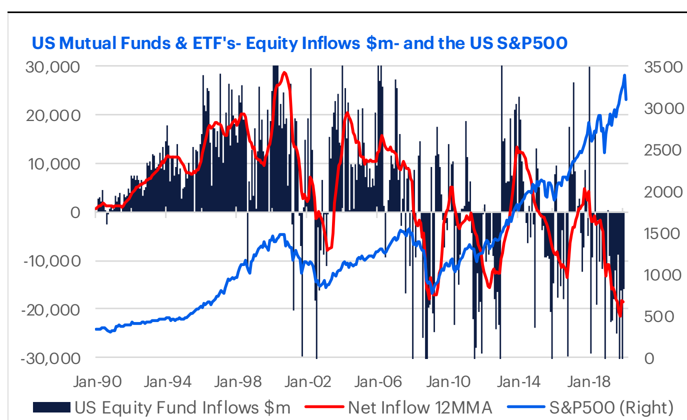
Source: Datastream, EL&C Baillieu

Fig.15: China's PMI, an important driver of EM earnings expectations, collapsed in Feb-20 on COVID-19

Source: Datastream, EL&C Baillieu

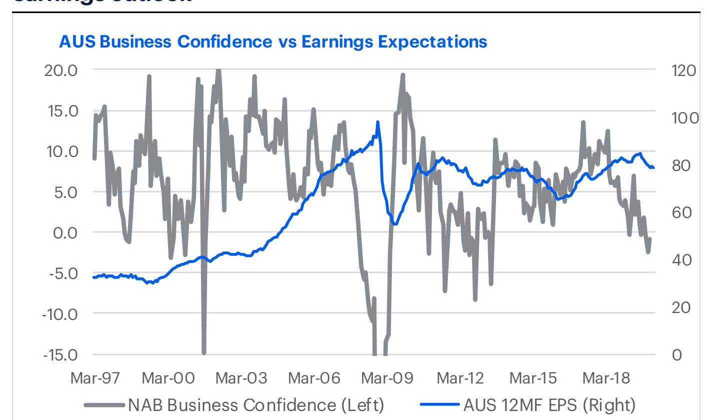
- **Supply-demand dynamics – record fund outflows, but strong buy-backs:** in the US, record outflows from mutual funds and ETFs have totalled a net US$69 billion and US$223 billion over the past three and 12 months respectively (Figure 16). This exceeds outflows seen around the Eurozone crisis or the GFC. Investor sentiment is back at bearish levels. Corporate share buy-backs have absorbed this selling, annualising at a US$731 billion rate over the first three quarter of 2019, albeit a moderation from 2018's record US$806 billion. Should individual investor selling pressure ease, this could drive a market re-rating.
- **Overall outlook – overweight International:** neutral-to-attractive valuation, ultra-strong liquidity support, catalysts to lift earnings momentum (particularly as COVID-19 eases) and bearish US investor sentiment should drive upside. We add to our overweight in international equities, expecting double-digit local currency total returns over the year ahead.
- Within international equities, we increase our exposure to the US market despite its premium valuation, seeing multiple drivers of a GDP growth boom and double-digit earnings growth, whilst the bar on Fed tightening is high. Europe, EM and Japan should benefit from a US boom, a strong US dollar, easing trade uncertainty and very attractive valuations.
- **Overall outlook – underweight Australia:** valuation in absolute terms and relative to the US (and other markets) is expensive. Earnings momentum is sluggish and highly dependent on asset inflation to lift growth (Figure 17). The Banks, a key market sector, are under earnings pressure from zero rates. The RBA has all but exhausted conventional policy tools. We are underweight Australian equities, expecting soft earnings and a partial PE retracement to lead the ASX 200 to underperform.

Fig.16: US equity fund outflows at a record pace



Source: Datastream, EL&C Baillieu

Fig.17: Soft AUS business confidence points to a soft AUS earnings outlook

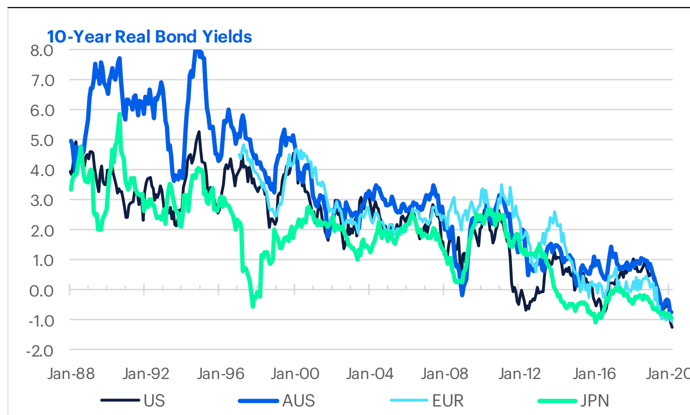


Source: Datastream, EL&C Baillieu

Fixed income: Underweight

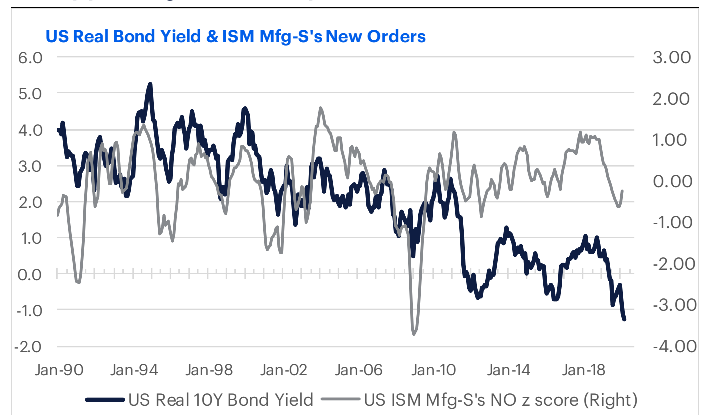
- Major bond markets have rallied again in early 2020, by 11-93bps to new record low yields on the back of COVID-19 fears. This follows yield declines in 2019 of 32-133bps in the G7 ex-Japan, driven by the turn in central bank policy direction to easing, softer global growth and persistent low inflation. Low bond yields have defied booming stock markets (partly retraced) and some easing of geopolitical tensions (US-China trade tensions and Brexit). Looking ahead, we see the risk-reward in bond markets skewed in favour of an underweight position given:
  - **Extreme absolute valuations:** nominal bond yields at record lows are 1.3 to 2.2 standard deviations below average! Real bond yields are at multi-decade lows, ranging from -0.5 to -1.7%; 1.4 to 2.2 standard deviations below average (Figure 18). The US real yield of -1.3% compares to the long-term average 2.0%; Europe -1.1% to the long-term average 2.1%; Japan -0.9% to the long-term average 1.4%; and Australia -0.8% to the long-term average 2.9%.
  - **Unattractive relative valuations:** bonds are at near-record valuations relative to equities, with the bond yield-earnings gap ranging from -4.7% to -8.0%, 1.0 to 1.7 standard deviations below average. European bonds are around the extreme relative valuations of the Eurozone debt crisis, Japan is at a near record spreads and Australia at a relative valuation only exceeded in the Eurozone crisis and GFC.
  - **Flattish yield curves:** yield curves are about flat, with short rates expected to remain at-or-below current low levels (G7: 0.7%) for an extended period (Figure 29). Bond markets seem to expect a sustained period of sluggish growth and low inflation.

Fig.18: Real bond yields in major bond markets are around record lows -0.5 to -1.7%



Source: Datastream, EL&C Baillieu

Fig.19: US real bond yield at multi-decade low, despite an ISM survey pointing toward an upturn



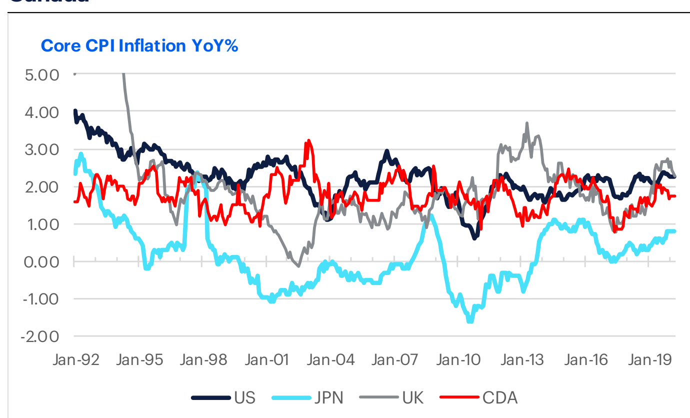
Source: Datastream, EL&C Baillieu

  - **Growth expectations beginning to turn higher:** PMIs appear to have soft-landed, with signs of an upturn led by the US (Figure 19). Policy easing, trade resolution, moderate commodity prices and counter-COVID-19 stimulus should lift growth expectations, a negative for bond yields.
  - **Inflation is not dead:** bond markets are discounting sustained weak growth and low inflation. But core CPI measures in the G7 are around-or-above long-term (post-1992) average levels in the US, Japan, UK and Canada (Figure 20). Labour markets in the major economies are the tightest in decades, driving gradually rising labour costs and inflation. In the US, 3.6% unemployment is around 50-year lows, supporting wages growth of ~3% YoY (Figure 21). In Japan, unemployment is at ~27-year low 2.4%, though wages growth is still around zero (Figure 22). In Europe, 7.4%

unemployment is within 0.1ppt of a 22-year low, supporting above-average wages growth of 2.6% YoY (Figure 23).

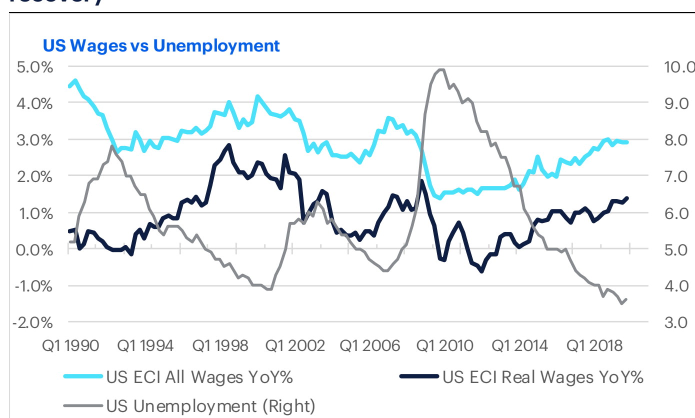
- Even with the US Federal budget deficit exceeding US$1.0 trillion, net **bond supply is down significantly** given the Fed's repurchase agreement QE program, the ECB's €20 billion per month QE and ongoing BoJ QQE.
- In our view, the risk-reward for bonds is very unattractive. The Australian Composite Bond Index is yielding ~0.7% with of duration of 5.5. Even in the event of a recession – not our base case scenario – it is unclear how much lower bond yields would go; particularly should the yield curve normalise. But even a decline to near-zero would yield limited upside, though offer some protection against an equity sell-off. By contrast, a very extended period of low growth and inflation will yield a nominal return of ~1% (a negative real yield), whilst anything better than that – even just approaching a return to normal – will yield substantial negative returns.
- Within fixed income we prefer lower duration, to protect against upside in yields, and credit securities that offer significant yield enhancement for the added risk.

Fig.20: Core CPI is at-or-above average in the US, Japan, UK and Canada



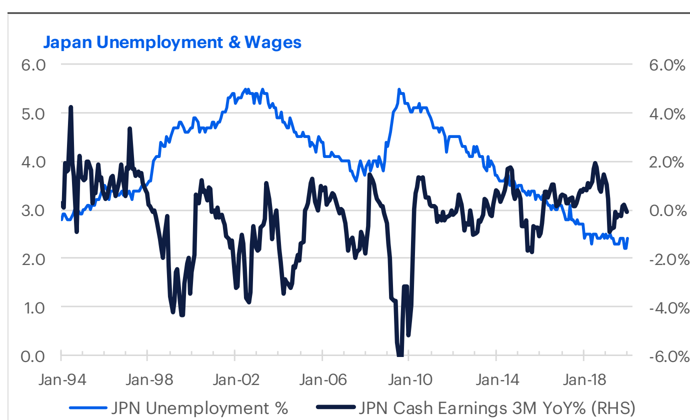
Source: Datastream, EL&C Baillieu

Fig.21: US: 50-year low unemployment driving a gradual wages recovery



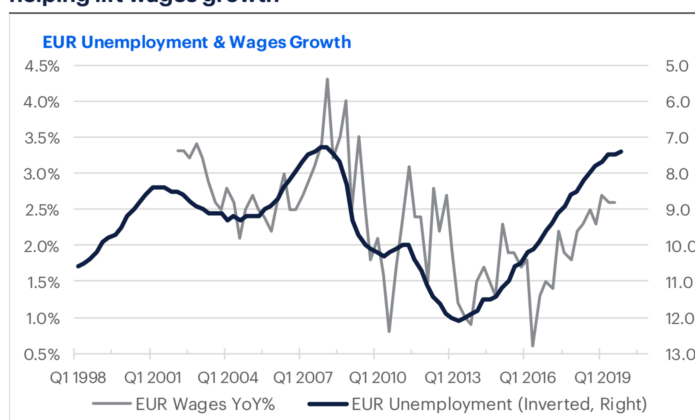
Source: Datastream, EL&C Baillieu

Fig.22: Japan ~27-year low unemployment yet flat wages



Source: Datastream, EL&C Baillieu

Fig.23: Europe unemployment within 0.1ppt of a 22-year low, helping lift wages growth

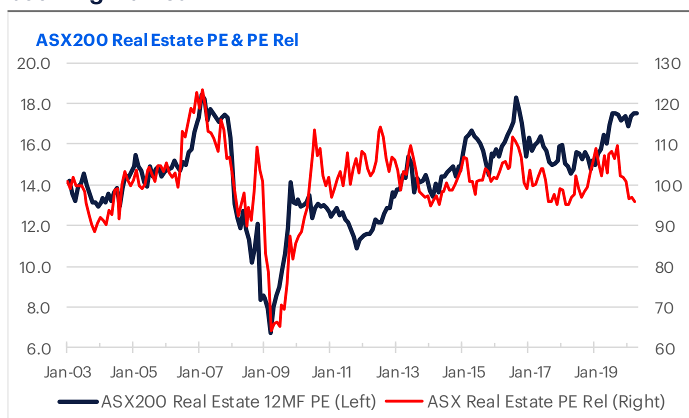


Source: Datastream, EL&C Baillieu

Property & Infrastructure: Underweight

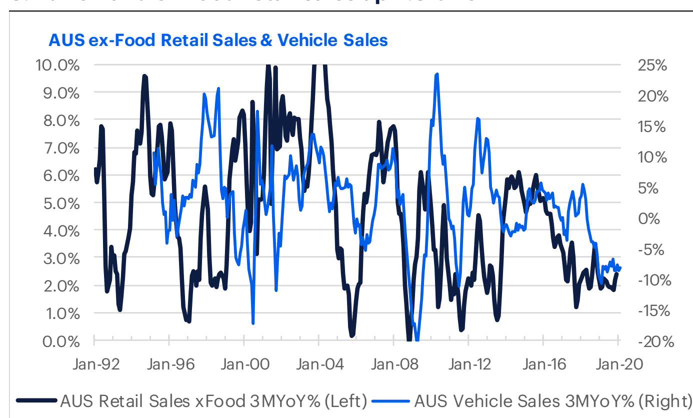
- Bond-sensitive equity securities have performed well, driven by record low Australian bond yields. The A-REIT sector has also benefited from strong fundamentals in office and industrial sub-sectors, though retail has been sluggish. Sector valuation at well above-average levels (Figure 22) trading at a 45% premium to NTA, which incorporates an average cap rate of 5.3%.
- The telecoms sector has benefited from lower bond yields and declining competitive intensity, with the TPG-Vodafone merger approved in court. The utilities have underperformed over the past year, facing an increasingly challenging regulatory environment.
- A key sub-group within the A-REIT universe is retail. We remain concerned about this sub-sector for two key reasons:
  - **The household sector squeeze**: household spending has been pressured by low wages growth, the switch to P&I mortgages, tax bracket creep and a low saving rate. Vehicle sales are down 8.1% YoY and retail sales ex-food are a sluggish 2.3% YoY (Figure 25). Looking ahead, slower jobs growth, the mid-year cycling of rate cuts and the tax rebate should limit any rebound in spending.
  - **Intensifying online competition:** online retail sales are strongly outpacing store sales. Retailers such as Harris Scarfe, JeansWest, EB Games, Bardot and Curious Planet have all recently entered administration. Others continue to shrink their store count and space. A high volume of malls are for sale.
- Infrastructure assets have some exposure to the domestic slowdown and energy policy risks. Sydney Airport has seen soft traffic growth, with the year to January traffic down 0.1% YoY (domestic -0.5% YoY and international +0.5% YoY). Transurban saw adjusted traffic volume growth of 1.4% YoY in 2H19.
- Utilities are vulnerable to a more hostile regulatory regime, cutting permitted rates of return and tightening the treatment of capex.
- We see better opportunities in global infrastructure and continue to prefer the Magellan Infrastructure Fund (ASX: MICH). Valuations are reasonable and this fund protects investors from competitive, commodity and sovereign risks, all of which can undermine infrastructure returns.

Fig.24: A-REIT sector re-rated to ~17.5x, but de-rated against a booming market



Source: Datastream, EL&C Baillieu

Fig.25: AUS consumer indicators are soft: vehicle sales down 8.1% YoY and ex-food retail sales up 2.3% YoY

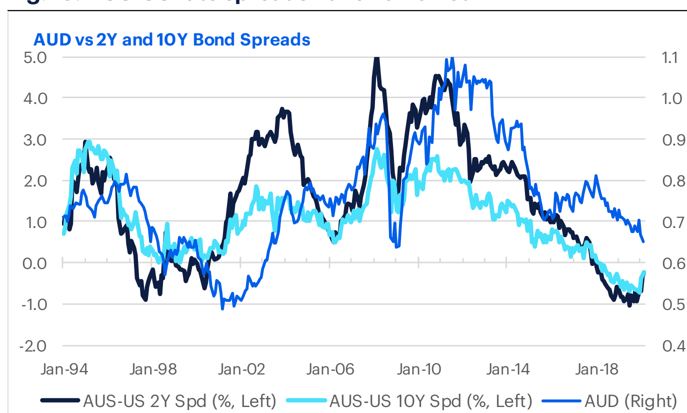


Source: Datastream, EL&C Baillieu

Currency: Underweight AUD

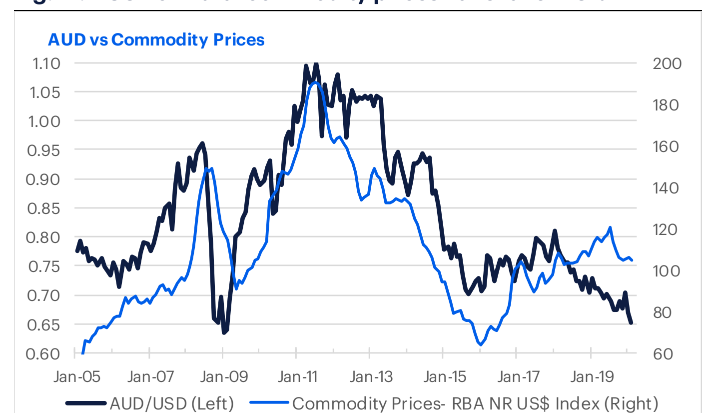
- The AUD is down 6.2% YoY against the US dollar (using a four-week moving average) and down ~14% versus its recent peak year average of US76.7 cents in 2017. We see a further 5-10% downside for the AUD in the year ahead (we have already seen a ~6% decline year-to-date) given:
  - **US dollar strength**: US growth and rate spreads compared to other economies should widen in a presidential election year boom. This should support renewed USD strength.
  - **Record negative rate spreads**: the Australia-US cash spread has narrowed to -63bps but should again widen in favour of the US as COVID-19 passes. The 2-year and 10-year spreads at about -25ps have narrowed on aggressive Fed easing, but should widen again by 50-100bps post-COVID-19 (Figure 26).
  - **Deteriorating relative growth and economic fundamentals**: Australian real GDP growth at 2.2% YoY is around the US at 2.3% YoY, but this masks the gap between private domestic demand growth of 0.1% YoY and 2.1% YoY respectively. On our outlook the gap should widen even further. Australia faces challenges from the housing investment downturn, squeezed households, emerging growth headwinds, near-term shocks, a lack of pro-market reforms and poor productivity performance.
  - **Structurally lower rates than the US**: Reflecting Australia's unsustainable household debt ratio of 189%, versus 97% in the US, it will be challenging for neutral interest rates in Australia to exceed US levels of ~2.5-3.0%.
  - **Australia's high net foreign debt level at 59% of GDP**. Although the current account is in surplus for the first time in 44 years, net foreign debt remains a high 57.5% of GDP. With Australian rates at a negative spread to the US, debt refinancing at current AUD levels, which are not far from long-term TWI average levels (ex-the resources boom), may prove challenging.
  - **China growth moderation**: Australia's non-rural commodity price index has fallen ~13% from its mid-19 cycle peak but remains around its China boom average (Figure 27). China's growth, already at a 3-decade low, faces the COVID-19 near-term shock and the medium-term challenges of negative demographics, high debt levels, advanced urbanisation, overinvestment and trade and social unrest pressures. It has strong external balances and significant policy capacity, though tax cuts and targeted credit for the private sector did not arrest its secular slowdown in 2019.
- We expect the AUD to fall 5-10% to the low-60s over the next year, driven by record low rates, sluggish growth and softer commodity prices. AUD upside probably requires US dollar weakness, aggressive Australian fiscal stimulus, bulk-intensive China stimulus and a powerful housing upturn.

Fig.26: AUS-US rate spreads have narrowed



Source: Datastream, EL&C Baillieu

Fig.27: AUS non-rural commodity prices have fallen 13%

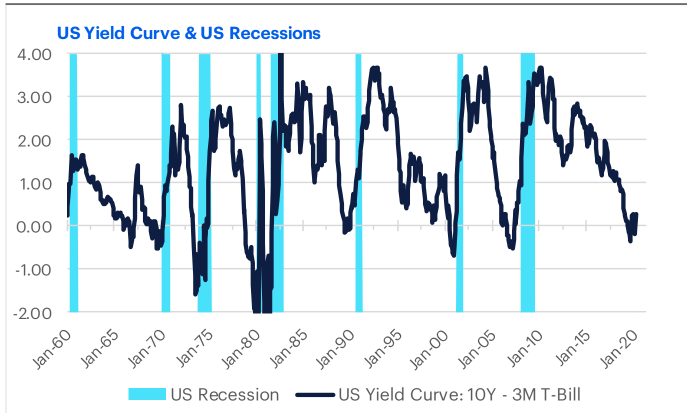


Source: Datastream, EL&C Baillieu

Tactical Asset Allocation signals

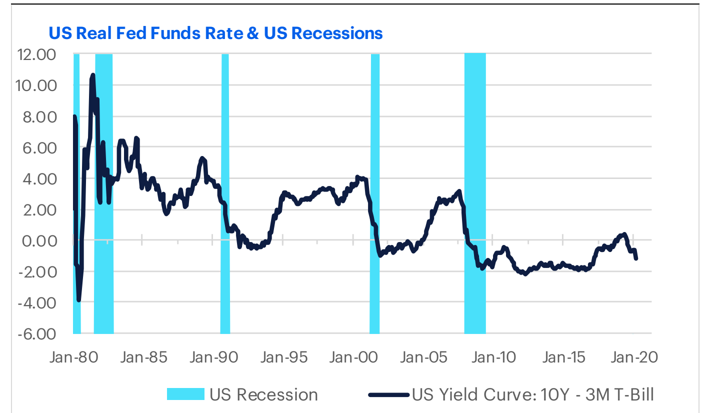
- We regularly track eight key Tactical Asset Allocation signals. Updating the signals:
  - **#1: Relative valuation – equities very attractive versus both bonds and cash (Figure 7)**: the bond-earnings yield gap is at levels not seen outside the GFC and Eurozone crisis in the US, Australia and EM, whilst Europe and Japan are just above record lows.
  - **#2: Absolute valuation – bonds very expensive (Figure 16); equities neutral-to-attractive (Figure 6 and 10):** bonds suffer from record low nominal and multi-decade low real yields. Australian equities are stretched, while the US' are high and Europe, EM and Japan are at-or-below average valuations.
  - **#3: US yield curve – less negative for equities:** the US yield curve has again flattened on the back of Fed policy easing (Figure 28), with more easing expected.
  - **#4: Liquidity conditions – equity positive:** rate cuts, negative real rates and strong money supply growth are equity positive (Figure 9). Europe, Japan, UK and Australia remain ultra-accommodative, China has resumed easing and the Fed is again extremely accommodative (Figure 29).
  - **#5: Credit spreads – credit negative; equity positive:** spreads narrowed to around pre-GFC average levels before the COVID-19 shock, consistent with low perceived risk (Figure 30).
  - **#6: Business activity expectations – mixed**: all surveys softened in 2019. Only Japan's Tankan remains above average (Figure 31). The US appears to have troughed, whilst Europe seems to be stabilising (Figures 12 and 13). Australia is around cycle-low levels (Figure 17).
  - **#7: Consumer expectations – US positive, AUS negative:** US confidence has rebounded to ~20-year highs (Figure 32). Europe has slipped but remains above-average. Australia has weakened despite RBA rate cuts.
  - **#8: Unexpected inflation – bond negative:** US implied inflation is at 1.4%, well below the current core CPI of 2.3% YoY (Figure 33). We see above-average inflationary pressures in the US, given 50-year low unemployment and a strong post-COVID-19 growth outlook.
- **Conclusions:** The TAA indicators are generally positive for equities, aside from the US yield curve and below-average business sentiment, though we expect sentiment to recover, led by the US. The bond market indicators are generally negative.

Fig.28: US yield curve has returned to flat, a less negative signal for growth and equities



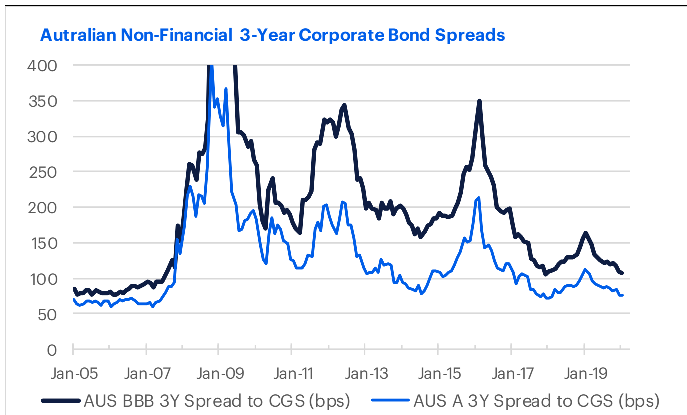
Source: Datastream, EL&C Baillieu

Fig.29: Liquidity conditions: US real Fed funds rate -1.1% vs pre-GFC average 1.6%



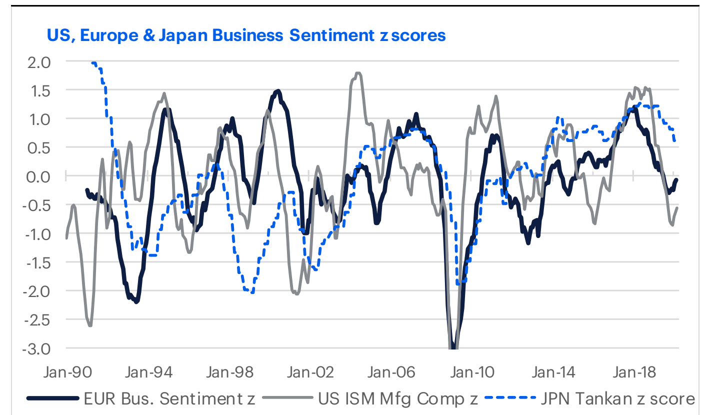
Source: Datastream, EL&C Baillieu

Fig.30: Credit spreads: AUS spreads narrowed to pre-GFC average levels



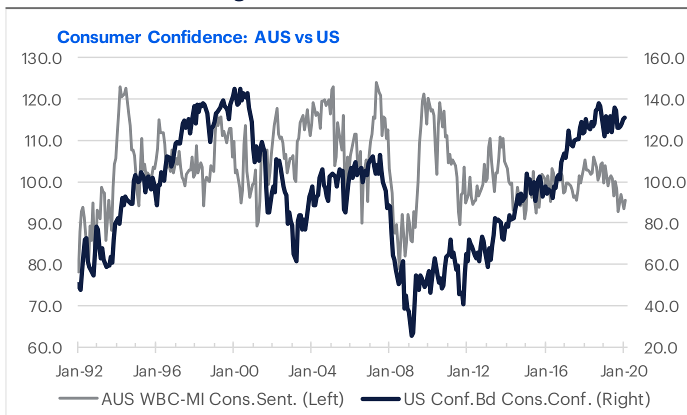
Source: Datastream, EL&C Baillieu

Fig.31: Business expectations have softened globally; but signs of a trough in the US & stabilisation in Europe



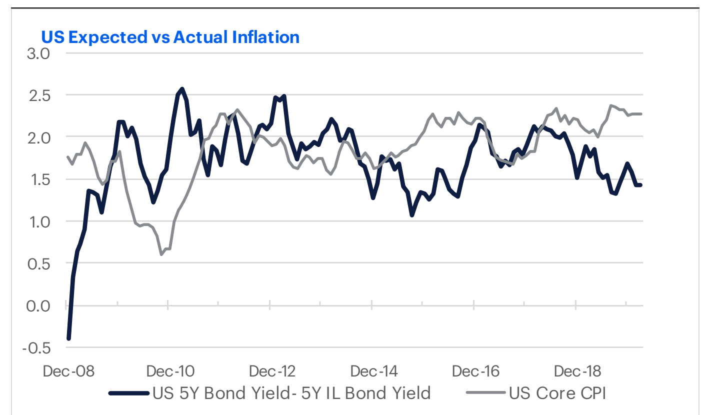
Source: Datastream, EL&C Baillieu

Fig.32: Consumer confidence: US is around 20-year highs; AUS is soft at below-average levels



Source: Datastream, EL&C Baillieu

Fig.33: US expected inflation at 1.4% is well below the current core CPI of 2.3% YoY



Source: Datastream, EL&C Baillieu

Asset Allocation implications

- At a high level, we remain comfortable being overweight growth assets versus defensive assets, seeing far better risk-adjusted prospective returns. Over the next year, growth assets, particularly following the COVID-19 correction, should deliver double-digit returns versus near-zero-to-negative returns in defensive assets.
- At the major asset class level, we remain overweight international equities and underweight Australian equities, property and infrastructure, fixed income and cash.
- Within our international equities overweight, once the period of maximum market volatility appears to have passed, we will increase our exposure to the US and emerging markets. The key indicator should be the new COVID-19 case pattern in the US and Western Europe. We continue to like Europe and Japan. International equity valuations are neutral to extremely attractive. Liquidity conditions are super-accommodative. Counter-COVID-19 stimulus, on top of earlier stimulus and easing trade and political uncertainty, should drive strong growth and earnings momentum.
- On scenarios other than a global recession, fixed income returns will be anaemic or worse and cash returns barely above zero. Investors should be mindful of the opportunity cost of holding cash – in terms of income, let alone capital gain. Property and infrastructure are trading at elevated valuations, with better opportunities available in international markets.

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