First State Investments

Colonial First State Global Asset Management

Semi-Annual Review

Multi-Asset Solutions

Licence to lift

July 2017

Foreword from Kej Somaia

Our previous Neutral Asset Allocation (NAA) review took place in the immediate aftermath of the US Presidential election result. With so much coverage, the media and markets would be forgiven for experiencing election fatigue. However elections continued to be the major preoccupation in the first half of 2017, with the focus primarily on Europe. The victory in the Netherlands for centre-right Prime Minister Mark Rutte put a pause on the populist movement sweeping through 2016. Populism was ultimately stopped in its tracks by Macron's march to the French Presidency. Theresa May's attempt at increasing her Party's majority ahead of Brexit negotiations instead resulted in the Conservative Party forming an unlikely coalition with Northern Ireland's Democratic Unionist party to prop up her minority government. But wait, there's more. The coming months will see elections in Germany and possibly Italy, again. Outside of Europe, there is a leadership transition in China towards the end of the year.

On the economic front, as Trump moved from President-elect to POTUS in 2017, the prospect of massive fiscal stimulus (tax cuts and increased spending) and a move away from globalisation challenged the current low inflation, low interest rate equilibrium, giving the Fed a "Licence to lift".

In our most recent review, conducted in May 2017, we witnessed a continued, but more muted, reduction in overall risk from traditional assets, driven by lower expected returns. This review saw us marginally increase our optimism for the long term economic climate, with reflation being the main theme. This has been offset however, by the increase in valuations that we've seen in the months since President Trump's victory.

A key outtake of the latest NAA review was that unless we see an improvement in market fundamentals, we need to reduce risk assets and preserve capital to deliver on the portfolio's long term objectives. We discuss the implications of this in more detail later in this paper.

We also discuss the major themes which we believe will shape the future economic climate, including Trump's policy agenda and the continued rebalancing of the Chinese economy.

Following this, we provide detail on our latest review and how this impacts the asset allocation decisions in our objective-based portfolios.

I hope you find this note interesting and useful in understanding more about our objective-based strategies and our process. Of course I welcome your feedback and any questions you may have.

Regards,

Kej Somaia
Senior Portfolio Manager

Investment process

Within our investment process we have two building blocks. The first, which we call Neutral Asset Allocation (NAA), sets longer-term asset allocations. The second part, which we call Dynamic Asset Allocation (DAA), allows us to exploit short-term opportunities in markets.

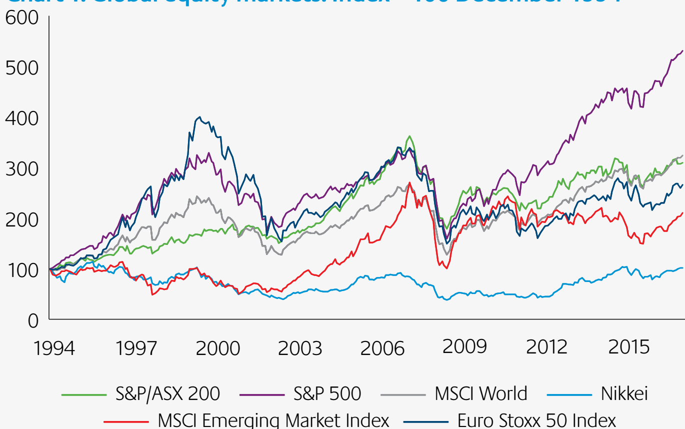
The first step of our NAA process is to set the economic climate for each country. We use the economic climate assumptions within our set of proprietary stochastic simulation models to determine forward looking risk premia and expected returns. The process of determining the NAA uses these expected returns for the building blocks of the portfolio allocations incorporating the return objectives, constraints, and investment horizon of the portfolio. The process of determining changes to the NAA is based on the economic climate, prevailing market conditions, valuations of financial assets, and political and market risks.

Our DAA process, on the other hand, takes into account the shorter-term market dynamics to deliver additional returns and abate portfolio risks, such as tail events. This part of our investment process, which includes our investment signals and qualitative overlay, is formally reviewed each week and looks at (among other things) markets and fundamental data to take advantage of possible dislocations.

Macro themes

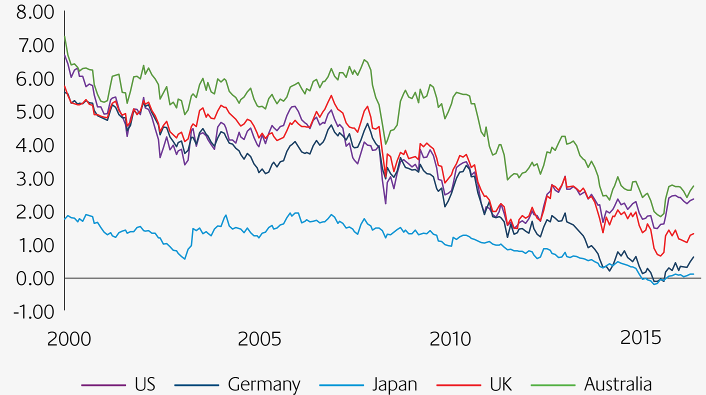
Equity markets are currently in their ninth year of a bull market and, despite the backdrop of political noise and uncertainty about policy development in the US, there is a level of calm reflected in implied volatility, which is hovering at all-time lows. Simultaneously, a thirty year bull-run in fixed income markets, extended by synchronised central banks easing in recent years, is leaving investors second guessing the sustainability of the low rate environment. It is not surprising then, that the valuations of both major asset classes look unattractive for astute long term investors looking to place all their faith in either asset class. We multi-asset managers can often sound like a broken record but, in this environment, it is very prudent to adopt a diversified and flexible approach to investing.

Chart 1: Global equity markets. Index = 100 December 1994



Source: Bloomberg. Data to 21 June 2017.

Chart 2: Global 10 Year Bond Yields



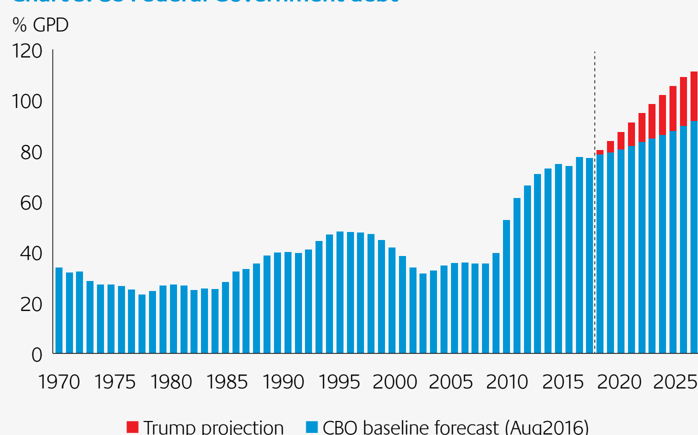
Source: Bloomberg. Data to 13 June 2017.

Before considering the markets and positioning in more detail, we will first summarise the current macro themes shaping the economic climate across the major regions.

US: The US Government has announced a list of objectives for tax reform. However, to date the details on how these changes would be funded and the timetable for legislation is limited, resulting in some skepticism of 'Trumponomics'. Trump's proposals have been estimated to increase US Government debt from 76% of GDP to 105% by 2026, compared to the current projections of 85%, which puts a lot of pressure on these policies to deliver higher GDP growth rates.

While the US unemployment rate continues to move lower, recent economic data out of US has been weaker, which is keeping a lid on underlying inflation, which printed at 1.4% in May. With the March and June rate hikes successfully flagged and implemented, we expect the Fed to continue its move towards policy normalisation, as the US economy moves closer to full capacity with higher inflation. That said, their focus in the coming quarter may shift to preparing markets for the commencement of normalising their $US4.5trn balance sheet. The motivation to do so may also be influenced by the fact that Fed Chair Yellen's term is expiring in February 2018. Yellen seems keen to get the balance sheet normalisation process well underway before she departs, rather than leaving this process to her successor – whoever that may be.

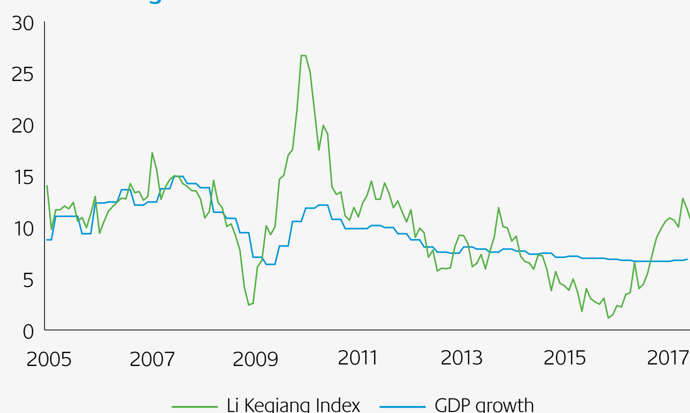
Chart 3: US Federal Government debt



Source: CBO as at August 2016. CRFB as at October 2016. CFSGAM.

China: We continue to see improvement in economic indicators and credit remains supportive. However, the Chinese regulators are moving to implement reforms to contain financial risks. In this policy shift, they should be careful not to cause a liquidity and credit crunch and a subsequent drastic slowdown. This would pose a global financial risk, given the sheer size of its economy and the interdependence of global economies. While we expect the political leadership to be looking for economic stability ahead of the five-yearly reshuffle of China's political leadership later this year, we will be monitoring the developments in its reform initiatives closely. The International Monetary Fund has cited China as a driver of global recovery this year, as we see fiscal stimulus at work. The worry is that the fiscal stimulus can only keep growth going for so long. The lack of structural reforms in China and other emerging countries has suppressed productivity growth. Debt to GDP has also been rising. While the loan-to-deposit ratio is high in China to avoid a financial crisis, given the size of its economy, any slowdown or deflation scare will pose financial risk globally. The official growth target for 2017 has been set at 6.5%, which is materially lower than the 6.9% delivered in Q1 2017, however the Li Keqiang Index is signaling more positive readings.

Chart 4: GDP growth versus the Premier Li Index



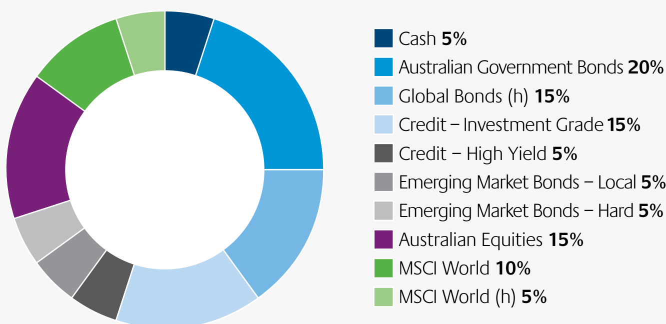
Source: Bloomberg. GDP data to 31 March 2017. Li Ke Qiang Index data to 30 April 2017. Investment data to 30 April 2017.

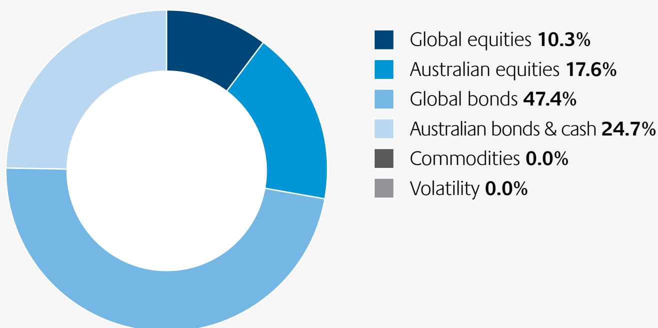
Europe: With the French elections behind us and the positive sentiment that has accompanied the result, we are also seeing positive momentum in Europe's earnings growth, making the region more attractive from a valuation perspective. The Eurozone economic recovery continues to broaden, and the rescue of two Italian banks means that financial risks that could hold back policy normalisation have diminished. The key event when looking forward is the German general election in September. However, between now and then, there will be heightened focus on the European Central Bank's (ECB) plans to start tapering their asset purchase program. This was raised in Draghi's Sintra speech, sparking a mini taper tantrum in developed market bonds. Across the Channel in the UK, economic growth has held up much better than expected post-Brexit vote, with Q1 GDP up 2.0%. However, investment is still expected to slow over the next few years as the Brexit negotiations evolve, particularly following the political gaffe that Theresa May's early election now appears to be, with the benefit of hindsight. This will likely see a deteriorating UK economy, seen in consumer spending, business investment, net trade and a weak position in regard to Brexit negotiations. This, in turn, increases the likelihood of prolonged uncertainty surrounding the economic outcomes, such as trade deals, economic infrastructure, and migration of jobs. Against this backdrop we expect the Bank of England to remain on hold for an extended period.

Australia: June saw Australia grab the record for the longest period of uninterrupted economic growth, (previously held by the Netherlands over 82 quarters, or 26 years). However, the most recent release showed the annual growth rate ease to 1.7% from 2.4% in Q4 2016. This is the lowest rate since the global financial crisis induced slowdown. On a more positive note, the trade balance continues to improve. Australia's key commodity prices have increased from the lows reached earlier this year, which contribute to growth in the years ahead. A lower current account deficit should also help Australia retain its AAA credit rating and, in turn, maintain demand for Australian Government bonds. There is some risk that the hawkish tone coming out of other major central banks may influence the RBA to move in sympathy. However, while markets may make their own assessment, we expect the official cash rate to remain steady for the remainder of 2017.

Real Return Fund Neutral Asset Allocations: The table below provides the neutral asset allocations as at November 2016 and May 2017, post their respective semi-annual reviews.

Asset class	Nov-16 NAA		May-17 NAA
Cash	5.0%	–	5.0%
Australian Government Bonds	15.0%	increase	20.0%
Global Bonds (hedged)	10.0%	increase	15.0%
Credit – Investment Grade	10.0%	increase	15.0%
Credit – High Yield	10.0%	decrease	5.0%
Emerging Market Bonds – Local	10.0%	decrease	5.0%
Emerging Market Bonds – Hard	0.0%	increase	5.0%
Australian Equities	21.5%	decrease	15.0%
World Equities	15.0%	–	15.0%
Emerging Markets Equities	0.0%	–	0.0%
Commodities	3.5%	decrease	0.0%
Total	**100.0%**		**100.0%**





Fund positioning

Bonds: Overall duration exposure is 4.0 years.

Currencies: 20.9% foreign exposure.

Equities: Prefer Australian over global equities.

Commodities: Zero allocation.

Cross Asset: underweight equities vs. the NAA.

Implications of the NAA review

Our proprietary Asset Return Model has indicated lower expected returns for equities and bonds, with slower growth and higher inflation predicted over the next five years. In the medium term, with stronger global economic data, credit impulse and fiscal efforts, we can expect the global economy to remain in decent shape. Further out, we are not seeing vast improvement in the productivity growth trend, which has been tepid globally. Global debt has been rising and structural reforms have been slow to implement, which can be a recipe for stagflation longer-term. This is not to say that the market will not sniff out what it perceives the future outlook will be and move ahead of it.

The implications for the NAA is that without an improvement in the fundamentals, we see a need to reduce risk assets and preserve capital to deliver on the portfolio's long term objectives:

Equities: Lower global equity return expectations are leading to an increased tilt to domestic equities, within the overall equities allocation. As an Australian dollar denominated Fund, the global equity exposure remains unhedged in terms of currency risk. There remains a zero weight allocation in the NAA to Emerging Market equities.

Bonds: A normalisation of interest rates is still factored in to expectations over the long term. However, the pace at which this occurs is expected to remain slow, and with a lower equilibrium rate than historical yields. Despite the trajectory for yields pointing higher, there is an increase in duration due to an increased allocation to global bonds for further diversification. An allocation to local currency emerging market debt has been retained. However this has been diversified to also include hard currency debt (hedged), as the Australian dollar continues to be resilient. Credit continues to play an increasing role in the portfolio due to the higher yields available, coupled with a lower risk profile than equities. However, given the recent gains experienced in High Yield over the last year, this allocation has been reduced and reallocated to Investment Grade credit.

The NAA described above will remain the dominant driver of returns for the next six months. However, it is important to note that the actual portfolio will reflect both our NAA and Dynamic Asset Allocation (DAA) views. In the Real Return Fund, the NAA provides the fundamental framework off which we hang our DAA tilts, both at a cross-asset level, and also within each asset class. Furthermore, there is scope for us to add protection strategies, should we deem the overall risk setting of the portfolio too high for the returns available, or simply to protect the portfolio from specific event risk.

Table 1: Cross-asset tilts from DAA views as at June 2017

Asset class	Attractiveness
Bond	✓✓
FX	✓✓
Equities	✗✗
Commodities	✗✗

Fund positioning post the NAA review

Bonds: The Fund's duration has been increasing through much of 2017. Duration stands at more than three years at the time of writing, as we took advantage of the higher yields post the US elections and shifted to favour bonds over equities from a cross-asset perspective in April. The increased allocation to Investment Grade Credit also contributed to the higher duration.

Currencies: The Fund's long currency exposure is reflected by an allocation to the US dollar versus the Australian dollar, as we anticipate the interest rate differential between the two nations to narrow. Consistent with our view for slower growth in China and the indirect impact on Australia's commodity exports, a short Australian dollar exposure can provide a diversifier to lower domestic growth. Our investment signals have been largely neutral with respect to the Australian dollar and the currency has operated in a narrow range in 2017. However, we have taken advantage of shorter term opportunities to reduce our overall exposure to the US dollar during this period.

Equities: The underweight to equities is reflected via a reduced allocation to global equities (both developed and emerging markets), based on our investment signals. At the time of writing, the least favoured regions are Germany, Switzerland and Turkey. Australian equities are favoured from a valuation perspective, hence in June we implemented a moderate overweight to domestic equities.

Commodities: The underweight to this sector has been in place for all of 2017 and, on the back of our Investment Signals, we have moved to a zero weight in the portfolio (the minimum position in this Fund). The least favoured sub-sectors by our investment signals is Energy, followed by Agriculture.

Conclusion

While equities continue to be supported by low discount rates, price to earnings ratios are looking increasingly stretched. Unless we start to see higher corporate earnings, equities are unlikely to continue their strong performance. Interest rates play an important part supporting other areas of the market, as low discount rates make other asset classes look attractive. However, inflation and looser fiscal policy in the US, UK and, perhaps, Europe mean that continued double-digit percentage gains on government bond holdings are doubtful.

With inflation starting to take hold in developed economies, we would expect this nascent reflation of the global economy to continue and possibly become more pronounced in 2017. This is being supported by tighter labour conditions and some, albeit low, wage growth. Higher inflation will continue to place upward pressure on developed market sovereign bond yields.

Emerging market equities are at risk if the US starts to break away from trade deals, as emerging markets are highly dependent on an integrated world economy. From a valuation point of view, we prefer emerging market debt and global credit to equities and sovereign debt in developed markets going into the second half of 2017.

About us

The Multi-Asset Solutions team provides a range of services to institutional clients around the world in the fields of portfolio management, asset allocation, asset/liability management, portfolio construction and risk management. We advise on and design bespoke investment solutions and implement these solutions in the form of tailored risk managed multi-asset mandates and/or funds.

We are a team of nine, spread across Singapore, Sydney and London. Our experienced team members come from a variety of academic backgrounds, including mathematics, civil engineering and aerospace engineering. Each team member brings unique perspectives and collaborates across the organisation to provide solutions to our clients. Varied problems require diversity of thought and the courage to challenge conventional wisdom; traits we seek in our team members.

Our investment philosophy is based on the following beliefs:

- Fundamental valuations will ultimately assert themselves and be the most important driver of returns.
- Markets are not completely and globally efficient in the short-term due to investor behaviour. This provides opportunities to enhance and protect returns for our clients.
- Investment decisions should be made with respect to the portfolio's objectives.

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