Die Another Day

First Sentier Investors

Real Return Fund Neutral Asset Allocation Review

For institutional/adviser use only | December 2019

We have recently updated economic climate assumptions for individual countries and, in turn, amended the Neutral Asset Allocation (NAA) for the Colonial First State Multi-Asset Real Return Fund. It's a process that we complete twice a year. This note summarises the key drivers of investment markets over the most recent six-month period and, more importantly, outlines changes made to the NAA following the formal review process.

Our first NAA review for 2019 occurred in May, where we discussed the increase in uncertainty at the hand of global geopolitical tensions and concern due to rapidly deteriorating economic data including closely watched leading indicators. Six months on, it appears the key concerns around global macroeconomic and asset class performance have yet to fully materialise although lingering worries still remain as we look towards 2020 and beyond. Indeed, it appears we will 'die another day' with respect to this seemingly never-ending global expansion.

Below we explore the main areas of concern which – for the time being – have yet to see the most extreme risks come to fruition:

US-China trade war – gone but not forgotten

After more than 18 months of politically charged negotiations, the US-China trade war finally looks like it may be nearing the end – or at least the beginning of the end. A 'Phase One Trade Deal' is on the verge of implementation and markets are already behaving as if the entire issue has been resolved. While the global trade outlook appears to be moving in the right direction, the daily news flow indicates that this optimism can shift quickly. For example, in late November President Trump signed the Hong Kong Human Rights and Democracy Act into law, despite warnings from Beijing of 'consequences' for 'meddling' in China's affairs. This legislation endorsed by Trump will place sanctions on any Chinese officials found to have cracked down on Hong Kong protesters. Further, this will compel the State Department to certify on an annual basis that Hong Kong possesses enough autonomy to retain favourable trading terms with the US. If trade talks do stall we will have to stick out this dispute well into 2020, perhaps dragging out through the US Presidential election in November. Meanwhile, the United States' multi-front trade war continues to expand with the latest proposals including tariffs on French goods such as cheese and champagne while threatening aluminium and steel tariffs on Brazil and Argentina.

Brexit – kicking the can down the road... again

Since that fateful referendum took place in June 2016, the United Kingdom's withdrawal from the European Union, or Brexit, saga continues to run on borrowed time after receiving its third extension. With hopes of a resolution supposedly around the corner, the British pound has been remarkably resilient, finishing November at 1.30 vs the US dollar, which is a rise of 1.5% during 2019 so far. Since our last review, the FTSE All-Share Index has returned 5.4% between 31 May and 30 November 2019. However, if recent history is anything to go by, then this might not be the end of this complicated separation. Brexit continues to be a major risk for not just the UK but the rest of the world, particularly if a fragile Europe slips into recession as a result. Capital markets seem to now think that this Brexit problem will ultimately be 'figured out' but all that has really happened has been a delay (again) with a potential reckoning next year.

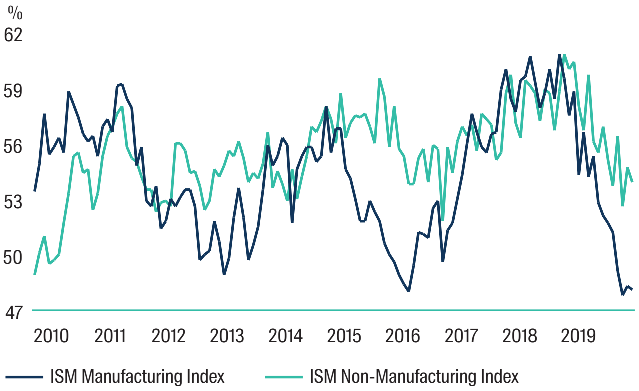
What exactly is the NAA review?

The first step in our investment process is to determine the economic outlook, both globally and for individual countries. Twice a year, we formally review existing assumptions and determine the likely long-term values for inflation, risk free rates, long-term bond yields, and earnings growth. Using current valuations as a starting point, these determinations enable us to calculate expected returns for various asset types globally. In turn, this helps inform the most appropriate mix of investments (NAA) that have the highest likelihood of achieving the Fund's long-term objectives.

US Economic Growth – despite old age, world's largest economy lives to fight another day

In the midst of a declining global trade outlook, resilience remains the salient trait for the world's largest economy as the US growth expansion has now entered its 11th year (and counting), making it officially the longest US expansion on record. Fickle trade negotiations have seen sentiment plunge amongst consumers and businesses alike. Along with impacting confidence, it appears that Trump's trade war was has started to flow through to the real economy, particularly hurting relevant manufacturing areas of the economy. The Institute for Supply Management ('ISM') said its manufacturing index sank to 48.1% in November from 48.3% the prior month (see Figure 1). This was the fourth straight sub-50 reading, indicating a contraction in manufacturing activity. Also, we don't need to guess as to the driver of this weakness – "Global trade remains the most significant cross-industry issue" as per the ISM. However, to-date we have not seen the manufacturing weakness spill over to the services sector. The ISM non-manufacturing sector grew for the 117th consecutive month, printing at 54.7% in October. Importantly, unemployment in the US has fallen to 3.6% - the lowest level since 1969 or over 50 years ago. Another sign of continued economic strength is a remarkably resilient corporate sector. As the earnings season finished for the quarter, almost 80% of companies beat last years' estimates - not overlooking that these had been revised lower during the year. Housing permits have reached their highest levels since 2007. This resilience may be attributed to the Federal Reserve (the 'Fed') easing, which had seen rates cut three times in 2019. Fed Chair Jerome Powell may have inferred that that monetary policy will stay where it is but markets anticipate one more cut early in the New Year. Whether or not this will continue only time can tell. With trade tensions unresolved and the 2020 US Presidential election approaching, political risks in 2020 have the potential to derail this seemingly never-ending expansion.

Figure 1: Institute for Supply Management Survey (above 50 is expanding, below 50 is contracting)



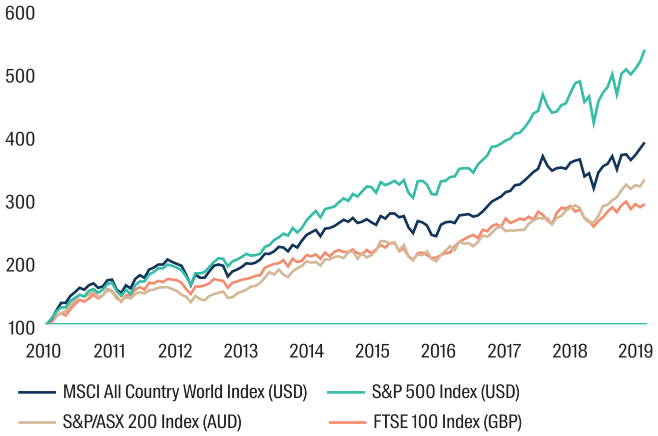
Source: Bloomberg as at 30 November 2019

Equity Bull Run – Bad news is good news

We are currently living though the longest US equity market bull market run[1] on record – now in its 130th month! It appeared that the party was coming to an end a year ago during December 2018 – where we saw a sharp correction of more than 10%. But it turned out to be just that: a correction. After the brief wipe-out, stock markets bounced back, and now we are likely going to see this bull market hit its 11th year. Other key equity markets have similarly performed well, albeit not quite to the same dizzying heights as the US (see Figure 2). Along with the ebbs and flows of trade war rhetoric, the key driver of equity market sentiment has been the activity of central banks around the world. We have been sitting in a sort of goldilocks zone (i.e. not too hot, not too cold) for most of the year, where deteriorating data has been consistently met by loose monetary policy. Bad news in this case means good news for equity investors given this playbook has been in place for the better part of the past 10 years. The US central bank has cut rates three times this year to a current range of 1.5% - 1.75% as growth has moderated while inflation has been well behaved, albeit uncomfortably low for some at the Fed. Outside the US, the European Central Bank ('ECB') has continued to cut rates into further negative territory with the latest move to -0.5% and the resumption of its bond purchase program (€20billion per month) in the pursuit of lifting inflation and avoiding a deflationary spiral. The Bank of England has kept its powder dry given the Brexit uncertainties but many other central banks around the world have shifted back to easing cycles: Australia, Canada, New Zealand, Hong Kong to name a few. Emerging markets are seeing even more extreme easing with too many to name here although the trend is clear – with the US dropping rates emerging market central banks are scrambling to match or exceed rate cuts in their countries to keep their currencies from appreciating too much and hurting exports.

[1] A bull market is defined as an equity market rise of 50% or more over a period which ends when equities fall 20% or more (i.e. bear market).

Figure 2: Equity market performance (March 2009 – November 2019, rebased to 100)



	Total cumulative Return
S&P 500	+435%
MSCI All Country World	+288%
S&P / ASX 200	+229%
FTSE 100	+190%

Source: Bloomberg as at 30 November 2019. Based on cumulative performance of MSCI All Country World Index, S&P 500, S&P/ASX 200 and FTSE 100 indices

Bond bubble? – let (yields) slide

Are bond markets in a bubble? While we would not characterise current pricing as a 'bubble,' fixed income yields in many markets are certainly operating in uncharted territory. Monetary easing – both conventional and unconventional – is back in full effect by global central banks over the last six months. Both the US Fed and the RBA cutting rates three times in the second half of the year. In the last few months we have seen a price rally in the 10-year Treasury note which have pushed yields to new three-year lows. A similar story was seen amongst German bunds which is unsurprising with negative interest rates in the picture. In September bond markets were flashing alarm bells as the US yield curve inverted, with 10-year bond yields stooping below that of the two-year yields. This is of course contradictory to the concept that a longer-term bond should reward the holder with a higher return. While this has since corrected, inversion has typically been known as a recession indicator and has appeared before a majority of previous US recessions. The US yield curve has inverted before each of the last 7 recession, albeit with a lead time of between 11 and 23 months. There has also been one false signal in the 1990s around the time of the Long-Term Capital Management crisis, when the curve inverted however this did not precede a recession (not until inverting again prior to the early 2000s recession). Perhaps of a bigger worry is the $11.5 trillion USD or so of negative yielding debt which peaked at over $17 trillion earlier this year (see Figure 3). The prevalence of negatively yielding bonds does not indicate an imminent day of reckoning – that very well still may come. However, what we do know is that expected returns have fallen in line with yields and although any future normalisation of rates has been pushed well out into the future, any rise in yields from here will likely see negative returns on this supposedly 'defensive' asset class.

Figure 3: Government bond yields

	Official Interest Rate	Current Government Bond Yields								
		6mth	1yr	2yr	3yr	5yr	7yr	10yr	15yr	30yr
Switzerland	-0.75%	-0.66%	-0.88%	-0.82%	-0.82%	-0.77%	-0.73%	-0.64%	-0.45%	-0.28%
Denmark	-0.75%	-0.77%	-0.77%	-0.68%	-	-0.55%	-	-0.34%	-	-
Sweden	-0.25%	-0.42%	-	-0.31%	-	-0.29%	-	0.01%	0.16%	-
Japan	-0.10%	-0.21%	-0.17%	-0.18%	-0.18%	-0.18%	-0.20%	-0.08%	0.09%	0.41%
Germany	0.00%	-0.63%	-0.64%	-0.64%	-0.66%	-0.59%	-0.53%	-0.36%	-0.23%	0.14%
Netherlands	0.00%	-0.76%	-	-0.64%	-0.65%	-0.54%	-0.42%	-0.22%	-0.09%	0.16%
France	0.00%	-0.62%	-0.57%	-0.60%	-0.58%	-0.36%	-0.29%	-0.05%	0.20%	0.72%
Finland	0.00%	-	-0.62%	-0.63%	-0.60%	-0.50%	-0.34%	-0.12%	0.11%	0.36%
Austria	0.00%	-	-0.61%	-0.59%	-0.58%	-0.44%	-0.31%	-0.13%	0.12%	0.44%
Belgium	0.00%	-0.63%	-0.57%	-0.63%	-0.59%	-0.41%	-0.29%	-0.07%	0.20%	0.74%
Ireland	0.00%	-	-0.48%	-	-0.47%	-0.36%	-0.17%	0.04%	0.32%	0.84%
Spain	0.00%	-0.54%	-0.56%	-0.39%	-0.36%	-0.10%	0.14%	0.41%	0.81%	1.28%
Portugal	0.00%	-0.54%	-0.52%	-0.56%	-0.36%	-0.10%	0.16%	0.40%	0.78%	1.32%
Italy	0.00%	-0.22%	-0.17%	0.02%	0.24%	0.56%	0.91%	1.23%	1.80%	2.36%
UK	0.75%	0.74%	0.67%	0.54%	0.50%	0.51%	0.50%	0.70%	0.94%	1.21%
Australia	0.75%	-	0.76%	0.68%	0.65%	0.69%	0.84%	1.03%	1.27%	1.62%
New Zealand	1.00%	0.94%	0.94%	0.97%	-	1.10%	1.21%	1.30%	1.66%	-
Canada	1.75%	1.68%	1.69%	1.58%	1.56%	1.49%	1.48%	1.46%	-	1.55%
USA	1.55%	1.57%	1.59%	1.61%	1.61%	1.63%	1.73%	1.78%	-	2.21%
China	4.15%	2.52%	2.62%	-	2.82%	2.97%	3.15%	3.17%	-	3.78%

Source: Bloomberg as at 30 November 2019

Key points:

- The setting of the economic climate involves deciding on where we think the global economy is moving, and then for each country we determine the likely long-term values for inflation, risk free rates, long-term bond yields and earnings growth. By taking current valuations as a starting point, this allows us to determine expected returns for global assets from this point forward.
- Most recently, we have lowered our inflation assumptions across Europe and the majority of Emerging Market countries. As a result, we see lower risk free rates and bond yields across many markets.
- Portfolio positioning has focused on global equities, domestic bonds, and credit. We remain cautious on global government bonds, high yield, and commodities.
- Overall, changes to the neutral asset allocation have been relatively modest compared to 6 months ago.
- Just because the key risks impacting global economies and asset prices have not materialised in a dramatic fashion doesn't mean there were not risks over the past year. And we continue to believe these risks have the potential to play out more negatively in the period ahead. 2020 may be 'No Time to Die' either but we suspect at least some of these key risks will come to a more definitive resolution.
- While market conditions might appear risky and raise concern, this can also lead to opportunities. The risks the economic climate can present are always dealt with diligently and in line with the Fund's investment philosophy.
- The Fund continues to strive for consistent returns above inflation while minimising drawdowns and protecting investor capital.
- As a highly experienced team with over two decades' experience, the Multi-Asset Solutions team will continue to implement the Fund's established and methodical NAA investment process and then amend positioning through the Dynamic Asset Allocation (DAA) process as opportunities arise.

CFS Multi-Asset Real Return Fund: Neutral Asset Allocation as at November 2019

Based on our most recent semi-annual Neutral Asset Allocation (NAA) review completed in November 2019, our cross-asset views resulted in a decrease in our exposure to Australian government bonds, investment grade corporate credit, and emerging market equities. Global equities saw an increased allocation although the portfolio's overall equities NAA weight remains the same as 6 months ago. Emerging market debt (hard currency) and commodities both saw increases to their neutral allocation weight.

Equities

Overall, the portfolio's allocation to equities has remained consistent with that from our last review earlier in the year at 50% although with an increase in global equities at the expense of emerging markets. Emerging markets equities exposure was reduced to 0% from 8%. With a wave of anti-government demonstrations becoming commonplace across the emerging markets complex, we are increasingly cautious given the risk of increased political tensions and rapid capital outflows. An increase in unrest in certain countries could have a major impact on asset prices, especially equities. Although many emerging markets have benefited from an improving trade outlook and interest rate cuts, some economies such as Argentina, China and Venezuela are in the midst of local political disputes which makes the outlook appear increasingly cloudy.

Developed world equities have been on a steady upward trajectory through most of the year. Since our prior review at May month end, the MSCI World Index returned 13.3% through 30 November 2019. Risk assets have been positively responding to the perceived progress in geopolitical frictions in both the US, China and the UK. After the European Union allowed the UK another extension to negotiate Brexit plans, European equities rose during October with some indices reaching two-year highs. The Japan TOPIX was the strongest performer for the third quarter as well as October. The economic data releases from Japan indicate a growing disparity between a weakening manufacturing sector and a strengthening service sector. World equities however now account for a 30% allocation in the NAA while Australian equities has remained at 20%.

Government Bonds

While 2019 has seen a considerable repricing of bond markets around the world with yields plummeting, more recently there has been a pull-back due to improved economic data and encouraging political developments. Bond yields around the globe have been subject to monetary easing in many developed markets. While economic conditions remain subdued and inflation low, there appears limited scope for bond yields to rise significantly in key regions. This means that our expectations for returns in global government bond markets remain low and relatively unappealing – hence exposure remains at 0%. Instead, the Fund is focused on Emerging Market Debt (hard currency) where the neutral allocation has doubled from 5% to 10% in November. We continue to hold allocations to Australian government bonds although have reduced by 5% to 21% given the sharp fall in yields over the past six months. While cash rate cuts have paused for now and the rate at a historically low 0.75%, the prospect for future decreases remain data dependant and quantitative easing may be on the table once the rate reaches 0.25%. Given the relative weakness of the Australian economy and the prospect for further easing, Australian government bonds continues to serve as a strong diversifier in the portfolio going into 2020.

The Fund maintains a strategic allocation to cash, which can be deployed when attractive investment opportunities present themselves.

Credit

The investment grade corporate credit allocation has been marginally reduced to 12% while high yield exposure remains at 0%. While credit markets continue to perform well and our exposure is highly diversified across region, industry, and issuer, valuations are increasingly looking expensive as investors globally continue to rotate into higher yielding securities. The recent quarterly corporate earnings reporting season has come to an end with more than three quarters of firms announcing positive earnings surprises despite less impressive top line revenue growth. These solid fundamentals combined with low interest rates should help maintain already low default rates while continuing to boost investor sentiment. At the same time in Europe, credit markets were supported by the recommencement of the European Central Bank's asset purchase program. So far around a quarter of the ECB's asset purchases have been in corporate bonds, equating to an additional €5 billion per month of demand for European credit. Corporates took advantage of firm demand and favourable market conditions by increasing issuance. The pace of new supply has increased through the year, reaching nearly US$100 billion per month in the investment grade sector although some proceeds are funding mergers and acquisition activity which tends to be unfriendly to bond holders. However, all of this new supply was absorbed with few signs of market stress, underlining the appeal of corporate bonds among income-hungry investors.

Finally, the NAA currently has added an allocation to a broad basket of commodities from the previous zero weight.

Figure 4: CFS Multi-Asset Real Return Fund – Neutral Asset Allocation

Asset Class	May-19		Nov-19	Change
Cash	5.0%	–	5.0%	0.0%
Australian Government Bonds	26.0%	↓	21.0%	-5.0%
Global Bonds (hedged)	0.0%	–	0.0%	0.0%
Credit - Investment Grade	14.0%	↓	12.0%	-2.0%
Credit – High Yield	0.0%	–	0.0%	0.0%
Emerging Market Bonds - Local	0.0%	–	0.0%	0.0%
Emerging Market Bonds - Hard	5.0%	↑	10.0%	5.0%
Australian Equities	20.0%	–	20.0%	0.0%
World Equities	22.0%	↑	30.0%	8.0%
Emerging Markets Equities	8.0%	↓	0.0%	-8.0%
Commodities	0.0%	↑	2.0%	2.0%
Total	100.0%		100.0%	

Source: First Sentier Investors as at 30 November 2019.

How do we determine the right mix of NAA (beta) and DAA (alpha)?

Based on our assumptions for the economic climate, and our expected returns, we can determine the likelihood of meeting the portfolio's investment objective over the investment horizon. It is becoming increasingly likely that relying solely on the NAA in a constrained long only, unlevered environment will not be sufficient to meet the return objectives. This is where we use our DAA process to take into account shorter-term market dynamics which aims to deliver additional returns and abate portfolio risks, such as tail events. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting the investment objective.

The combination of NAA and DAA requires the consideration of the current allocations; as the extent to which active management may be used is managed through the portfolio's risk budget to avoid unwanted additional risks. We consider both the tracking error (as well as other risk metrics) and the expected return, in assessing the portfolio's ability to meet its investment objective. The ability to add scalable alpha to portfolios provides flexibility to deliver on the investment objective; even in a lower return environment.

In this lower return environment, by allowing the blending of alpha and beta strategies to be more dynamic within the framework described above, we still have the potential to deliver on our client's investment objectives.

In the current low return environment it is critical to have the flexibility to blend beta and alpha to deliver a real return of 4.5% pa above inflation over rolling five year periods before fees and taxes. We believe our investment process and philosophy provides our clients the highest possibility of obtaining a real return, with the current outlook making our DAA paramount.

Why First Sentier Investors?

Our investment strategy blends the qualitative views and experience of the team with the discipline and rigour of quantitative analysis resulting in a flexible approach to design and implementation of investment portfolios.

Investment decisions are taken with respect to the overall portfolio objective, unconstrained by conventional benchmarks or fixed asset allocation. Our flexibility to blend alpha and beta strategies is a key differentiator and essential to deliver on the investment objective over time.

Risk management is integral to our investment process. We continually seek to balance the trade-off between upside potential (meeting our investment objectives) and downside risk (capital loss), which we believe can generate consistent results.