The Best Bond (in honour of the late Sean Connery)

First Sentier Investors

2020 has been a bumpy ride for many since the Covid-19 outbreak first took hold earlier in the year. Since our last Neutral Asset Allocation (NAA) review, there have been several developments however attention is still dominated by the ongoing pandemic. At least as we near the end of this turbulent year, there seems to finally be a light emerging at the other side of this seemingly never-ending tunnel.

The year of the Covid

Almost ten months later, lockdown measures have been on and off in several regions, with parts of the world facing another brutal wave even as of mid-December. The northern hemisphere has entered winter, accompanied by an increase in Covid-19 cases and associated hospitalisations in recent weeks. While the current restrictions in the UK and Europe were planned to ease by Christmas, talks of these continuing into the New Year remain a possibility. Similarly in the US, the battle continues with many States still facing an exceptionally high level of active cases. Things are however looking up as successful vaccine news has remarkably buoyed financial markets and general investor optimism. In the US and the UK, inoculation of the most vulnerable people has begun, with widespread distribution shortly on its way. With numerous successful vaccine candidates emerging, investors generally appear reassured that there will be a vaccine both available and widely distributed globally by early 2021.

Biden-Harris for the win!

The results are in and even despite subsequent recounts, President-elect Joe Biden and Vice-President-elect Kamala Harris remain triumphant. The composition of Congress however has not been completely decided, with two Senate seat runoffs in Georgia in January, likely pointing towards a split legislative branch with a Republican controlled Senate and Democrats retaining the House of Representatives. This will determine how successful Biden will be in enacting some of his initial plans as President, such as approving an enlarged fiscal spending plan to help the United States economy further rebound from the Covid-19 associated fallout.

Some of the key policies expected from Biden during his presidency, termed 'Bidenomics', are anticipated to most notably include improved Covid-19 testing; increased fiscal support for small businesses and families; adjustments to climate change and energy policies and to re-join the Paris Climate Accord; and eventually increased taxation among others. As it relates to the ongoing pandemic, continuing expansionary fiscal policy will provide a further boost to the US economic recovery, accompanied by the rollout of several Covid-19 vaccines in the very near future.

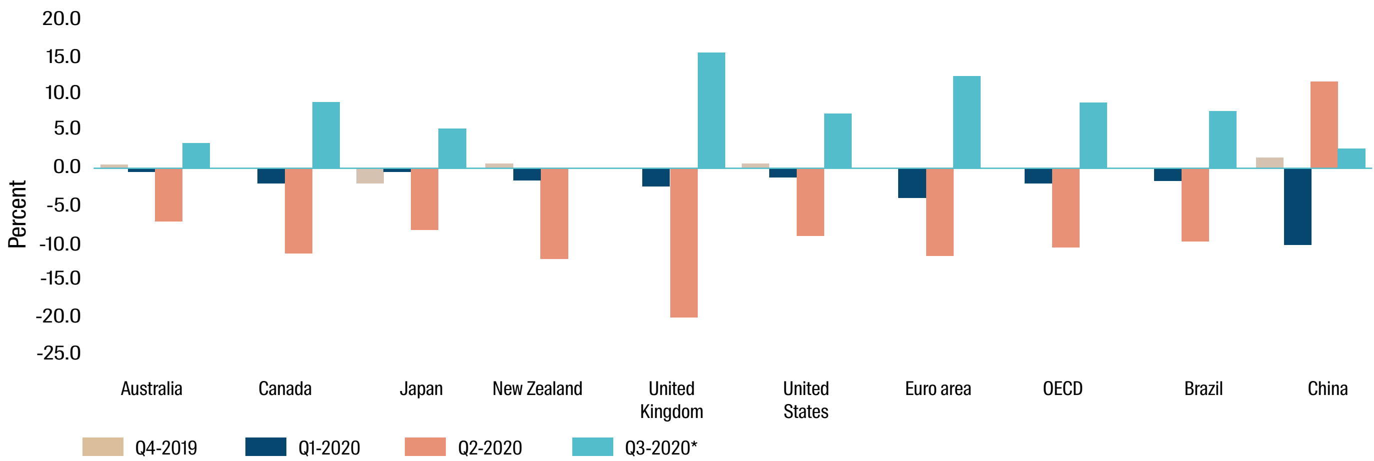
In terms of international relations, while President-elect Biden advised he has no plans to immediately remove tariffs from the China-US trade war, he does however plan to review the existing agreement and further work on a strategy with other allies in Asia and Europe. The plans for multilateralism in trade and in international diplomacy are likely to be good for global growth and potentially outperformance within regions such as Asia.

Global growth and equities are looking ahead to the good times

As we have seen over the past several months, global equity markets refuse to be discouraged and have been well and truly looking into the future at better times ahead. The election result also proved market-friendly with the MSCI ACWI continuing to trend upward since. Despite the constant barrage of 'equities reach all-time highs' headlines, it is important to note that it has not universally been 'good times' for equities this year. Further the divergence between the winners and losers – both at the sector and individual company level – has continued to widen.

As for global growth, the pessimism seen earlier in the year has waned, with most key regions seeing forecast revisions on the upside. In the International Monetary Fund's (IMF) October 2020 outlook, global growth for 2020 was projected at -4.4% which was an improvement from the -4.9% forecast made in June 2020. This was a result of an improvement in second quarter GDP, particularly in advanced economies, after restrictions in several regions were scaled back and economic indicators released during the third quarter showed improvements. The IMF also projects global growth over 2021 to reach 5.2%, which is lower than the June 2020 projection but reflects the possibility that in some regions, social distancing measures may need to continue for a bit longer until the health risks are further mitigated. Despite the expected recovery, this has been a brutal global recession by historical standards, which makes share market performance around the world even more remarkable.

GDP growth over the Covid-19 crisis



*Q3-2020 contains a consensus forecast: United Kingdom & United States
Source: OECD as at 15 December 2020

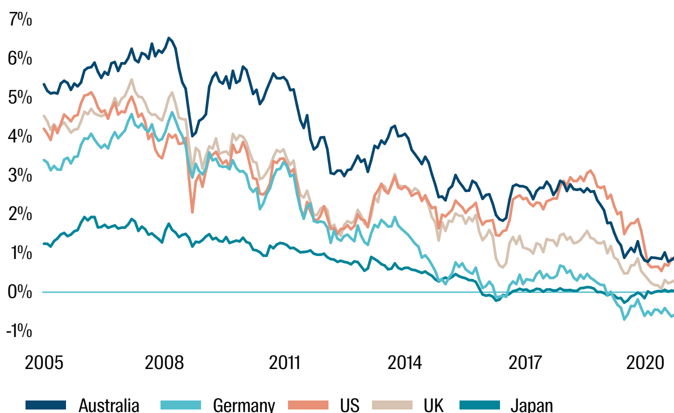
Bonds and the search for yield ...

While riskier assets like equities have enjoyed gains from the recent improvement in sentiment, fixed income assets – particularly higher quality securities – are under pressure as interest rates remain at record lows. This has begged the question of many investors: is there a point to owning bonds or cash anymore? Cash still remains king as it pertains to liquidity to fund transactions and to have available during more volatile times to deploy in riskier asset classes.

Despite the low yields, higher quality government bonds still play an important defensive and diversification role in a broader portfolio. The traditional negative correlation between equities and bonds continues to benefit in most risk-off scenarios, however over longer periods there have been several examples where the two asset classes have moved in concert with each other – most recently during the initial Covid-19 outbreak. This relationship must be closely watched, as a paradigm shift could prove disastrous for investors relying on the diversification benefits that have been enjoyed for several decades.

Even still, holding high quality government bonds should deliver some benefits during periods of extreme volatility. For example, even markets with negative yields (Germany, Switzerland, and Japan) have seen yields fall during the recent sharp equity sell-offs, propping up bond prices. In any case, this low yield environment is providing very limited income to compensate for the volatility. As such, we don't view there to be one 'best bond' but rather a diverse mix of fixed income instruments should continue to provide the benefits of diversification while still generate a positive return and contribute to a portfolio's overall objective.

Government bond yields: 2005 to present



Source: Bloomberg as at 30 November 2020

More monetary and fiscal firepower is (likely) on the way!

The continued, unprecedented central bank support has been a key factor in the economic recovery to date, despite the fact that the crisis is not yet over. Additionally, a staggering quantity of government fiscal support has also been a lifesaver this year, with the total global government spending as of 14 October 2020 sitting around USD $14 trillion and hopes of more to come.

In Europe, new restrictions have already started to stifle the region's recovery as the European Union (EU) battles negotiations in regards to both Brexit and its own budget. The EUR 750 billion pandemic recovery fund was announced as part of the EU's budget earlier in the year in response to Covid-19 however underwent months of debate, until the deadlock between EU leaders and Hungary and Poland was finally broken in December. On the monetary front, the European Central Bank (ECB) has kept rates low at -0.10%, and announced on 10 December 2020, the next round of stimulus to support the Eurozone recovery.

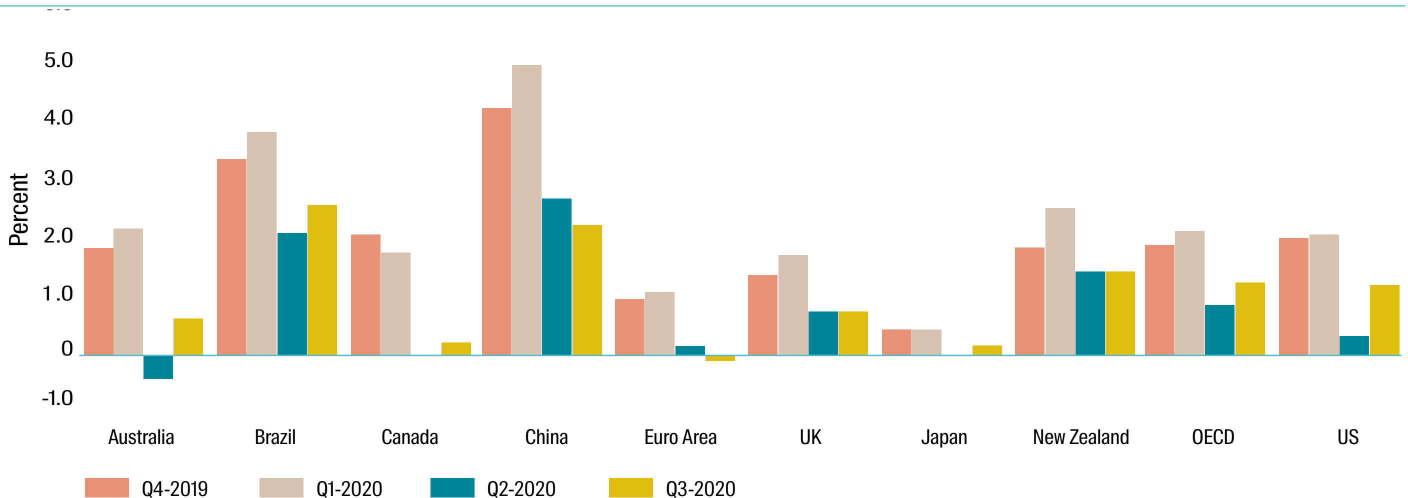
In the US, further fiscal support has faced debate within the bipartisan Senate for several months now. While the composition of the Senate is pending the result of the January Georgia run-off elections, on 1 December a smaller, USD $908 billion spending package was proposed after months of deadlock. While this is certainly short of the USD $2 trillion package passed by the Democrats, president-elect Joe Biden has urged for a bill to be passed before he takes office, and suggested that any package passed now will just be the start in any case. Over to the US Federal Reserve (the 'Fed'), Chairman Jay Powell continues to appeal for more fiscal support to be unveiled, while keeping monetary policy accommodative. While the target federal funds rate remains low, the Fed's emergency lending facilities still have excess capacity. While extra firepower would otherwise provide comfort, recent threats from the Treasury to shut some of these facilities down could lead to a reduction in monetary support.

Inflation

An extended period of low inflation is almost a near-unanimous view across investors. Despite the extraordinarily loose monetary policy over the past decade, developed markets have been unable to generate much inflation. Even in recent years, unemployment rates have fallen in the developed world, particularly in the US, while inflation has hardly budged. Further, the current global recession makes the prospect of inflation less likely than deflation at present. In any case, recent guidance from the world's central bankers has been that these record low interest rates are here to stay, with the US Federal Reserve advising they do not plan to respond to inflation for some time once it hits their 2 per cent target. This rather material shift in approach suggests central banks are likely to let economies run a bit hot before tightening policy through either traditional or unconventional means.

In Australia, the RBA advised in their November statement on monetary policy that underlying inflationary pressures are likely to remain subdued – both domestically and globally – as considerable spare capacity lingers. In the near term, headline inflation has been revised down further as government subsidies have been extended. Further out, a gradual increase to 1.5 per cent is expected by the end of 2022, which is still below the 2-3 per cent target.

Quarterly inflation



Source: OECD as at 15 December 2020

Brexit: deal or no deal

Negotiations for a trade deal between the UK and the EU are continuing in a somewhat theatrical manner, with the deadline creeping ever closer. Despite the ongoing stalemate, hopes of some sort of deal at the eleventh hour are still alive. Both Prime Minister Boris Johnson and European Commission President Ursula von der Leyen are committed to working on negotiations. With the 31 December 2020 deadline literally around the corner - upon which the UK stops abiding by EU trading rules - the two parties need to iron out the remaining sticking points on the most contentious issues like fishing rights. Whether a deal occurs or not, changes will still take place. Without a deal, border checks and taxes will be implemented for goods travelling between the regions, as per World Trade Organisation rules.

First Sentier Multi-Asset Real Return Fund: Neutral Asset Allocation as at December 2020:

Real Return FUnd	Jul-20		Dec-20	Change
Cash	2.0%	↑	5.0%	3.0%
Australian Government Bonds	32.5%	↓	12.0%	-20.5%
Global Bonds (Hedged)	16.5%	↑	33.0%	16.5%
Credit - Investment Grade	11.0%	↓	0.0%	-11.0%
Credit - High Yield	5.0%	↔	5.0%	0.0%
Emerging Market Bonds	0.0%	↔	0.0%	0.0%
Australian Equities	13.0%	↑	18.0%	5.0%
World Equities	20.0%	↑	27.0%	7.0%
Emerging Market Equities	0.0%	↔	0.0%	0.0%
Commodities	0.0%	↔	0.0%	0.0%
Total	100.0%		100.0%	

Source: First Sentier Investors as at 14 December 2020.

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.

- Overall, substantial changes to the neutral asset allocation have been made as our economic climate assumptions evolve in response to the ongoing Covid-19 crisis
- We believe that although financial markets have stabilised in several markets, there is still much risk present and so caution is still required
- We have maintained our inflation assumptions low across all markets, along with lower cash rates and long-term yields to reflect the significant action taken by central banks. These emergency settings are expected to remain in place for most regions until a meaningful recovery is made.
- While earnings growth took a tumble over 2020, a pick up to more normalised earnings is likely to return in 2021 after the Covid-19 vaccine begins distribution and lockdown measures eventually subside.
- Portfolio positioning has focused on the balance between equities and bonds. As we have increased our equity allocation, we have also diversified our fixed income allocation further, reducing some of our domestic bond exposure and increasing that of global bonds. Our neutral position to investment grade credit has been removed while maintaining the small allocation to high yield credit.
- We remain cautious on commodities and the Fund currently has no allocation to this asset class.
- 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 and process.
- The Fund continues to strive for consistent returns above inflation while aiming to minimise drawdowns and preserve 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 Neutral Asset Allocation (NAA) investment process and then amend positioning through the Dynamic Asset Allocation (DAA) process as opportunities arise.

Equities

The portfolio's neutral allocation to equities has increased meaningfully by 7% and 5% for global and Australian equities respectively since our review in August 2020. While we still remain cautious as the ongoing Covid-19 crisis continues, equity markets have shown resilience amidst the volatility, with the several vaccine options providing a light at the end of the tunnel. As many countries are still experiencing lockdowns and social distancing measures, several of the hardest hit sectors may take a while longer to rebound however the central bank and fiscal support continues to provide a cushion. Since 30 August 2020 – our last review - the S&P/ASX 100 Accumulation Index rose by 11.57% (YTD 0.47%), while the MSCI World Index rose by 8.12% (YTD 12.56%), both in local currency. Despite this rebound, it is important to remember both indices experienced sharp falls in February, with the recovery uneven and US technology companies leading the charge. European bourses still remain in negative territory, with the UK being the biggest underperformer. So while there is room for opportunities in equities, a cautious stance must still remain.

Bonds and cash

Central bank officials have maintained that accommodative policy settings are here to stay (at least in the medium term), which have pushed Australian government bond yields to record lows. While exposure to defensive assets such as Australian government bonds and cash can be beneficial during times of uncertainty, as conditions continue to improve we expect a search for yield resume in earnest. As a result, we have reduced the overall allocation to fixed income, lowering the exposure to Australian Government bonds and moving part of this to increase that of global bonds. While the overall exposure to bonds has decreased, we have moved to a longer tenor so overall duration has increased, helping to provide a larger cushion within the portfolio. On the cash front, we have marginally increased this allocation by 3% as we believe cash is still king for liquidity purposes.

Credit – Investment Grade

We have further decreased our allocation to investment grade credit, following the reduction made during the most recent NAA review in August 2020, by 11% to 0%. Fixed income expected returns have fallen across the board and while some pockets of corporate credit remain attractive, implied returns overall have fallen considerably given both considerably tighter credit spreads and very low all-in yields. While support from central banks is likely to persist, the return outlook has diminished for this asset class, and it is hard to justify a significant position to be held in the portfolio at the moment. Although liquidity risk seen earlier in the year has stabilised thanks to ongoing central bank intervention, until lockdown measures are eased by the rollout of the vaccine, the likelihood of solvency risk coming to fruition in the period ahead makes credit less desirable compared to other asset classes.

As our risk and return expectations for these asset classes continue to evolve, we remain cautious in our NAA and will rely on our Dynamic Asset Allocation (DAA) signals to exploit shorter-term opportunities. While the increase in equities can be viewed as adding risk into the portfolio, the much larger reduction in exposure to investment grade credit works to offset this.

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 Fund'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.

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