iNDEPENDENT WEALTH Partners

Asset Allocation Report – March 2020

Quarter in review

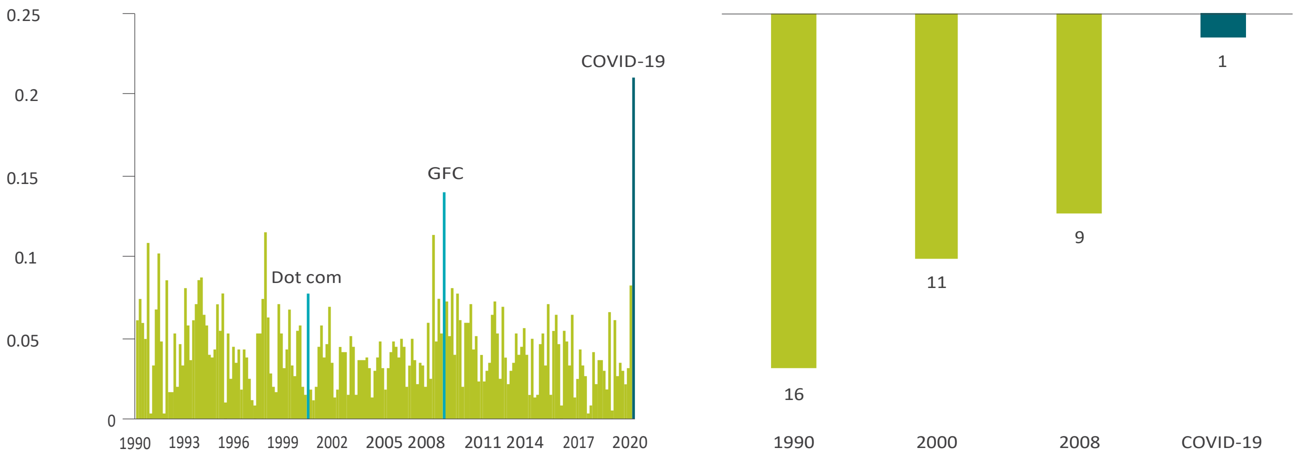
The beginning of 2020 has brought with it turbulent times as the accelerated spread of COVID-19 presents unprecedented challenges for the world's economies. The events of Q1 leave 2019's concerns regarding a possible US recession, trade wars and Brexit feeling inconsequential in comparison to the uncertainty and market carnage wrought by COVID-19.

While initially assumed to be an epidemic confined to China, the speed of spread outside of China soon ensured that the declaration of a global pandemic was all but inevitable. Reflecting this new reality, global equities have fallen sharply, with the ASX recording its worst sell-off in recent history (**Figure 2**). While bonds have not been immune to this selling pressure, extraordinary monetary accommodation from central banks have limited some of these effects, pushing bond yields to historical lows (**Figure 3**). As volatility continues to plague global markets in the coming months, investors should remain focused on long-term outcomes – most often realised by staying the course.

Figure 2. A very volatile month for Australian equities

All Ordinaries absolute percentage change by month

Time for markets to hit bear territory (months)



Source: Vanguard, based on data from FactSet.

Figure 3. Extraordinary monetary easing has seen bond yields reach historical lows

Source: Vanguard, based on data from FactSet.

Initial government responses were at best modest and had little effect in calming market fears of a GFC-like recession. It was only when unprecedented fiscal packages were announced by the world's governments did we gain some reprieve from the fall. Most encouraging has been the policy response from the likes of certain parts of Europe and Australia, where the respective governments have committed to pay a significant proportion of workers' wages during the lockdown to enable companies to keep their staff despite the dramatic hit to sales. This is exactly the type of policy needed to deal with this type of shock, to give those economies the best chance of rebounding sharply once the health situation is under control.

On the monetary front, we also saw some historic moves from global central banks, with the Fed announcing unlimited Quantitative Easing (QE), ECB and BOJ expanding their asset purchase programs, and the RBA locally also launching Yield Curve Control QE for the first time while cutting rates to the effective lower bound of 0.25%. These extraordinary policies should help to keep government borrowing costs low, despite the massive fiscal stimulus that is required to deal with the economic consequences of the virus.

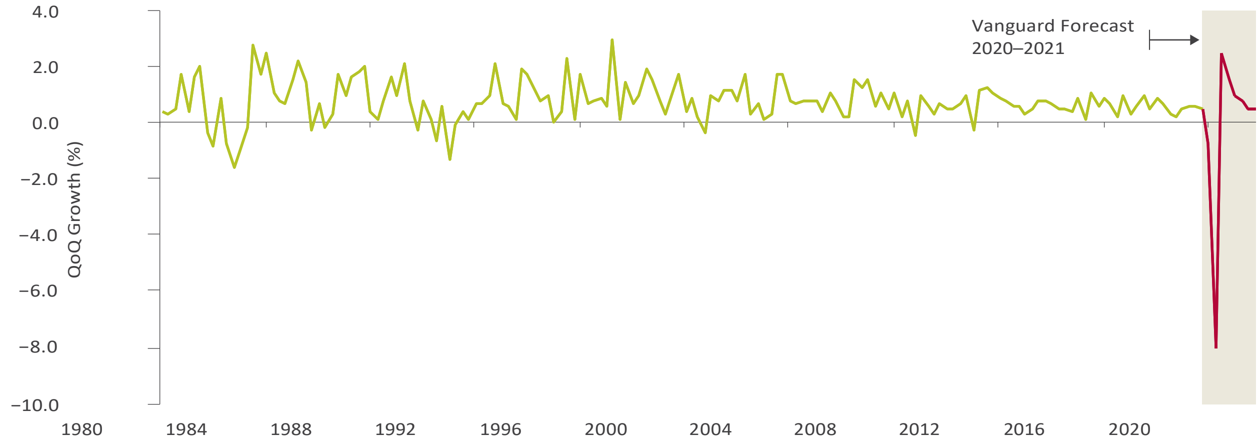
While we have had experience and prior exposure to economic downturns, the current situation presents a unique conundrum. Akin to a war-time recession, the fall in economic activity has been forced through both a demand and supply-side shock. This is a stark contrast to the events of the GFC, dot com bubble and 1987 crash downturns, which were mostly brought on through crashes in financial markets and imbalances in household and corporate balance sheets. A unique situation demands a unique outcome – which leads us to believe that investors should expect a deep recession offset by the potential for a swift recovery.

Economic outlook

The effects of the 'one, two punch' simultaneous supply and demand shock will be the main drivers behind the deep global recession investors will likely face. On the supply side, the temporary closure of many factories will see a sharp decline in the production of goods and services. This will be complemented by a decrease in global demand, as people are confined to their homes except for only the most essential of outings and purchases.

The combination of the above should lead investors to expect the unexpected and fuels our belief that the coming recession, while possibly being the deepest we have experienced in modern times, will be of relatively short duration. **Figure 4** shows the trough occurring in Q2 under our baseline scenario, where we see the exogenous shock running a relatively short duration as lockdown restrictions are lifted and business returns to normal conditions.

Figure 4. Sharp but short recession expected in Australia



Source: Vanguard.

Further out, the outlook for global growth is heavily dependent on the extent to which COVID-19's spread can be slowed or eradicated. Should the infection curve flatten and we observe a relaxing of social distancing measures by mid-2020, growth will likely rebound in the second half of the year. The strength of an eventual recovery and its presentation as a 'U' or a 'V' shape depends largely on the depth and breadth of unemployment and the extent to which consumers can overcome lingering fears of a COVID-19 resurgence and resume normal activities. In more negative scenarios, where strict isolation policies are prolonged for the remainder of the year, a recovery is much less likely to occur and a protracted recession should be expected.

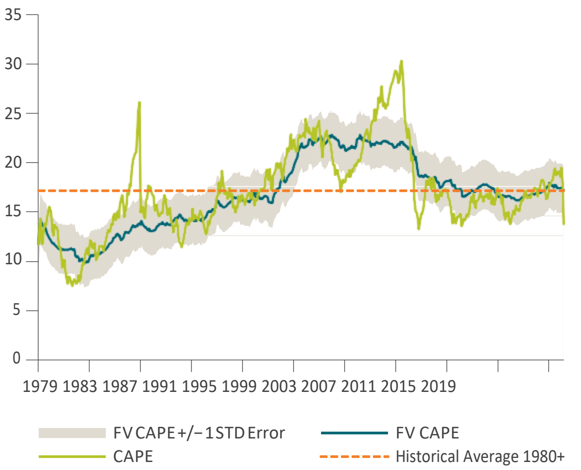
On a more specific scale, we expect the world's biggest economy, the US, to experience moderately negative growth. Similarly, Japan and Europe will experience contractions, though the depth of the contraction is contingent very much on the aggressiveness of containment policies in the coming weeks. Meanwhile China, who on face value has already experienced the peak of the crisis, is expected to show weakly positive growth.

Despite having benefits of being a distant island, Australia will not be spared from a contraction either, with domestic lockdowns compounding the negative effects that were first felt from lower China demand. While many have pointed out that this will be Australia's first recession in close to 30 years, we would argue that according to other metrics pertaining to recession definitions, such as slowdowns in economic activity of over two standard deviations in size or per capita, Australia has actually had a number of recessions since the early 1990s and that moving away from a 'recession obsession' may help to reduce unnecessary panic.

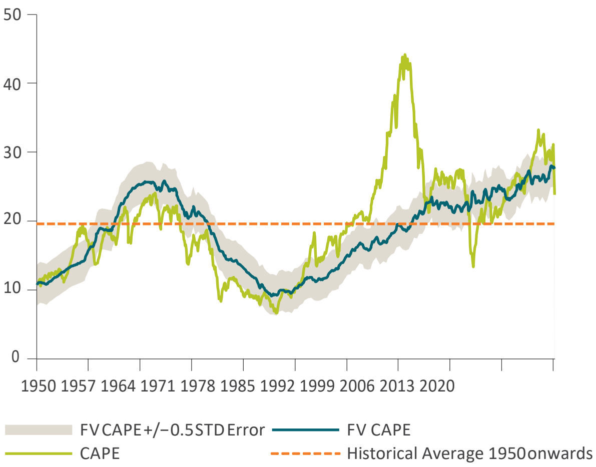
Overall, the global economic outlook may appear to be bleak at this stage, but we note the silver lining for financial markets is that valuations on many risk assets have become much more reasonable now, resulting in better long- term return outlooks. **Figure 5**, for instance, shows that Australian equity valuations are now not only fairly valued, but even somewhat undervalued given the sharp drawdowns in recent weeks. A similar statement can be said of many other equity markets across the world, including the US equity market, which for some time, was recognised as being in extended territory. Consequently, a sell-off of growth assets at this point would be mistimed and could give up potential large gains relative to a portfolio that stays the course.

Figure 5. Equities have now become undervalued

AUS Fair Value Cape



US Fair Value CAPE



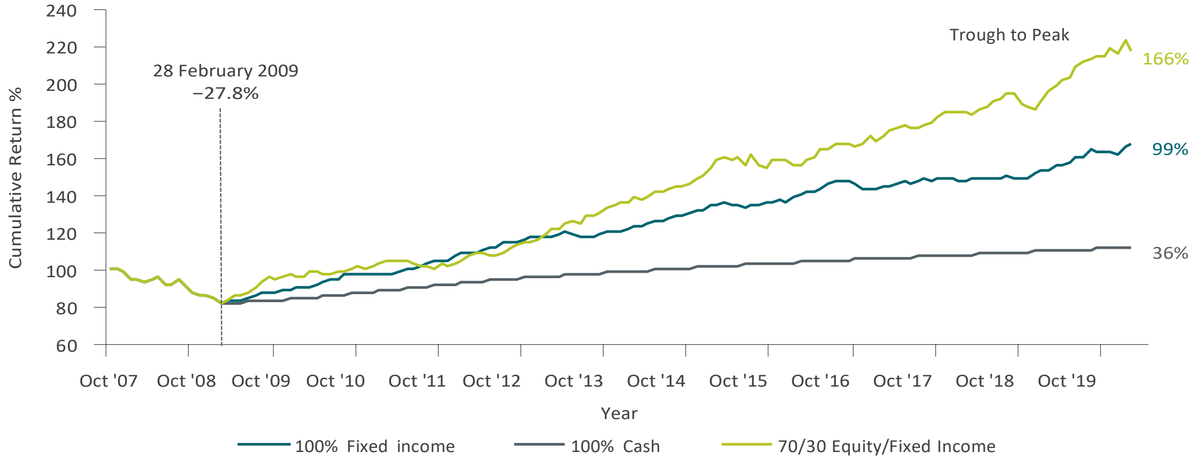
Notes: "Fair-value CAPE" is based on a statistical model that corrects CAPE measures for the level of inflation expectations and for lower interest rates. The statistical model specification is a vector error correction (VEC), including equity-earnings yields, ten-year trailing inflation, and ten-year Treasury yields. The U.S. FV CAPE uses ten-year U.S. Treasury yields and is estimated over the period January 1940 – March 2020. The Australian FV CAPE uses ten-year Govt. bond yields and also includes ten-year trailing equity and bond volatility, estimated over the period January 1970 – March 2020.

Source: Vanguard calculations, based on data from the Reserve Bank of Australia, Robert Shiller's website, at aida.wss.yale.edu/~shiller/data.htm., U.S. Bureau of Labor Statistics, the Federal Reserve Board and Thomson Reuters Datastream.

Impact of changing your strategy using history as a guide

Figure 6 shows the impact of fleeing an asset allocation during a bear market for equities. In this example, the investor moves out of equities on February 28, 2009, to avoid further losses. While the 100% cash portfolio experienced less volatility, the investor who chose to stay with the original asset allocation recovered most completely from the 2009 setback to earn a superior return.

Figure 6. The importance of maintaining discipline: Reacting to market volatility can jeopardize return



Notes: Fixed income represented by Bloomberg Barclays Global Aggregate Hedged in AUD. Cash represented by Bloomberg AusBond Bank Bill Index. 70/30 Growth strategy assumes 35% allocation to S&P/ASX 300 Accumulation Index, 35% allocation to MSCI World ex AU Accumulation Index and 30% allocation to fixed income.

Source: Vanguard calculations, using data from FactSet.

It's understandable that during the losses and uncertainties of a bear market in stocks, many investors will find it counterintuitive to rebalance by committing more capital to underperforming assets (such as stocks). But history shows that the worst market declines have led to some of the best opportunities for buying stocks. Investors who did not rebalance their portfolios by increasing their stock holdings at these difficult times not only may have missed out on subsequent equity returns but also may have hampered their progress toward long-term investment goals – the target for which their asset allocation was originally devised.

Because investing evokes emotion, even sophisticated investors should arm themselves with a long-term perspective and a disciplined approach. Abandoning a planned investment strategy can be costly, and research has shown that some of the most significant derailers are behavioural: the failure to rebalance, the allure of market-timing, and the temptation to chase performance.

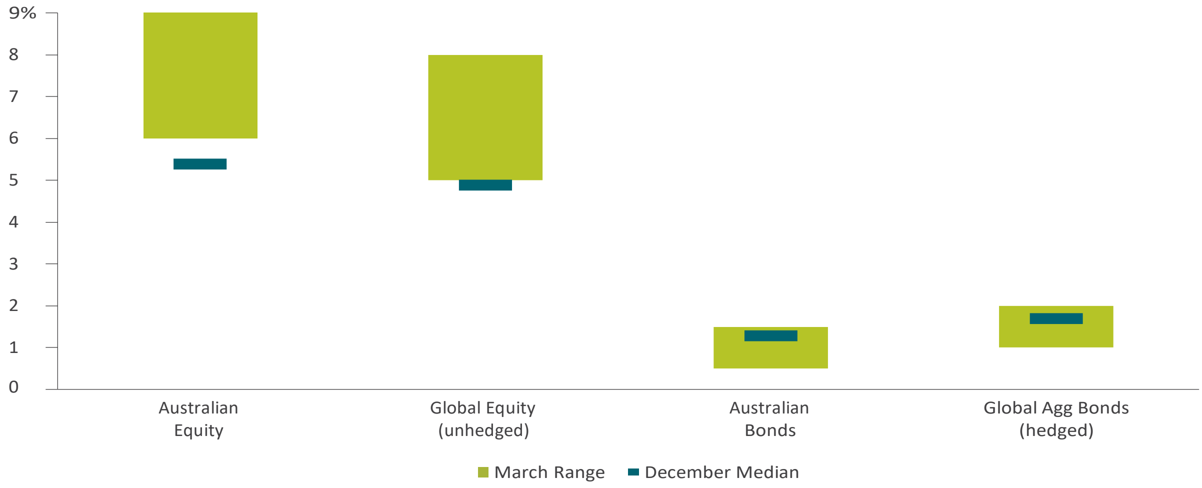
A note on recent market events and our forecast

The December forecasts (**Figure 7**) utilise data through 31 December 2019 – little over a quarter ago, yet a time that is feeling increasingly distant. As in our 2020 Economic and Market Outlook, return projections were subdued as both equity valuations remained elevated, and outlooks of restrained growth and inflation dampened fixed income.

However, a lot has unfolded since then – in order to frame these projections in the context of recent market events, we have contrasted our December forecast with an interim March outlook (**Figure 8**). This off-cycle update provides an indicator for the range of annualised returns we might expect, given market movements and volatility. The median 10-year annualised return for December is shown alongside a range of central expectations for March.

As previously mentioned, more attractive valuations have buoyed our long-term equity return, placing December's medians at the bottom end of our revised range as stocks are afforded more room to grow. Meanwhile fixed income returns have been further pressured by historically low yields, shifting our expectation for the asset class downwards.

Figure 7. Interim projected 10-year nominal return outlook

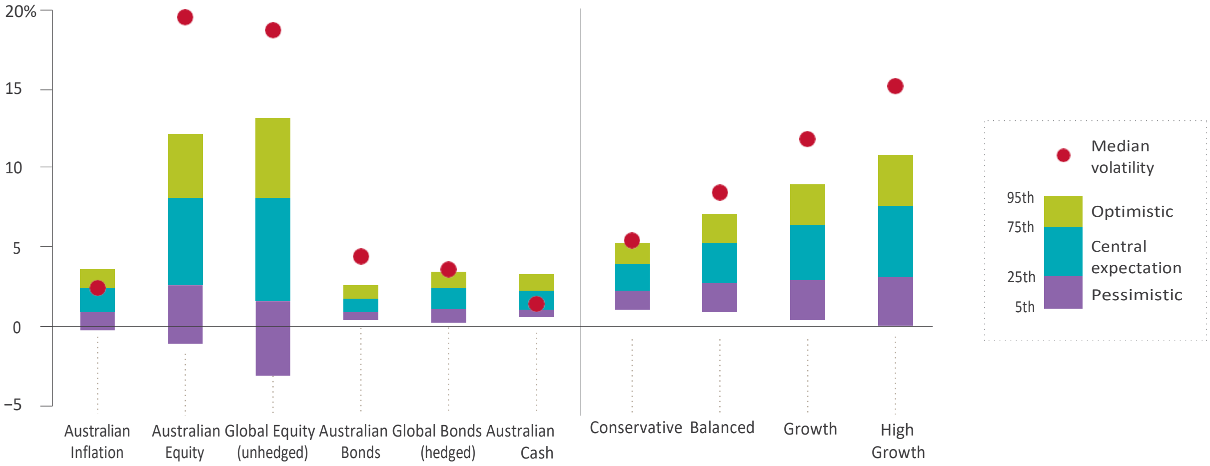


Source: Vanguard, 31 December 2020 and Interim March 2020 VCMM simulations.

Long-term market outlook

The chart below shows the Vanguard Capital Markets Model (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds.

Figure 8. Projected 10-year nominal return outlook



Source: Vanguard. 31 December 2019 VCMM Simulation.

It shows two concepts: the range of annualised 10 year nominal returns and the median volatility experienced.

The bars show the range of return outcomes over a 10 year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The red circles show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10-year period. The chart shows that equities are expected to produce a higher return over a 10-year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

The next two charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way.

Figure 9. Probability of achieving real return target

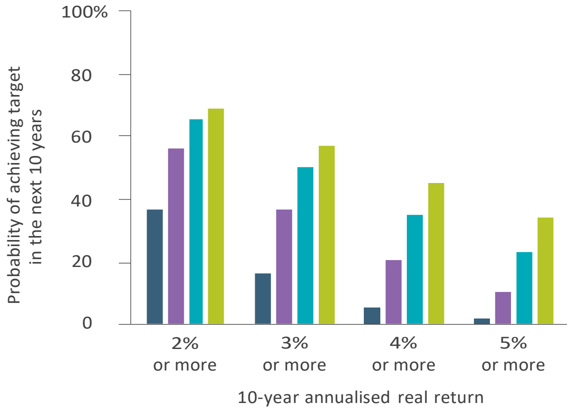
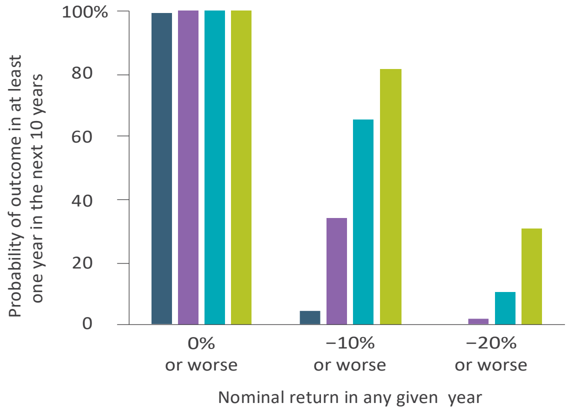


Figure 10. Downside risks



Conservative Balanced Growth High Growth

Note: The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, December 2019 VCMM Simulation

Taking more risk means that an investor increases the probability that they will achieve their target over 10 years.

Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.