



June 2020 Quarter Asset Allocation Report

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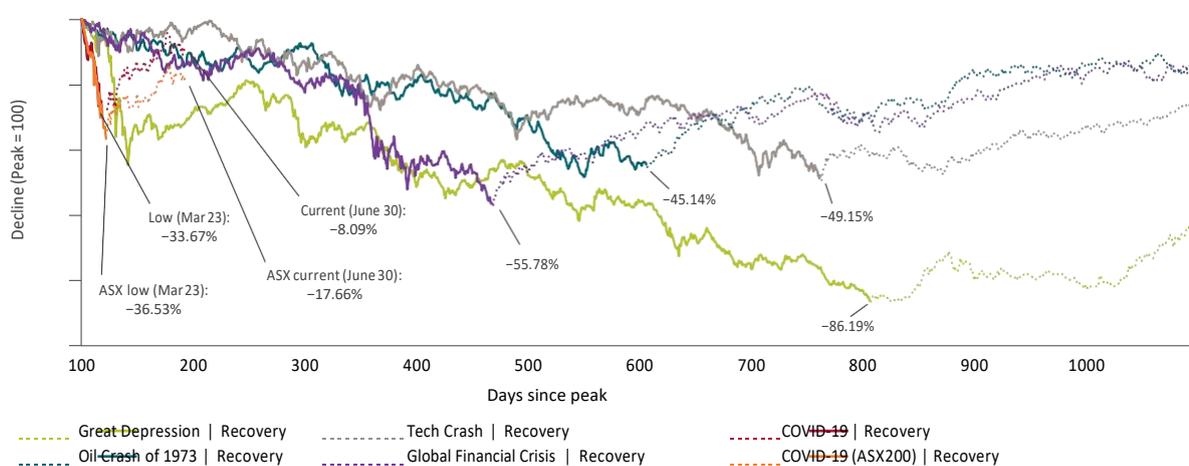
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Quarter in review

Following the sharp fall in markets at the start of the year, Q2 saw strong rallies across global equity markets as investors shed their bear skins for bull horns. Despite the continual spread of COVID-19 across the globe, the backdrop of ultra-loose policy and expectations that economic lockdowns could soon ease restored some positive sentiment in markets, fostering conditions for a “V-shaped” recovery in risk assets (Figure 1). However, there is validity in questioning the speed and magnitude of the rebound given much of the real economy is only slowly emerging from hibernation. Indeed, towards the latter part of Q2, markets started showing signs of “slight fatigue” after retracing much of their losses in April and May. We interpret this as a suggestion that investors have begun incorporating some caution into their outlooks, especially when assessing the loss of output, profits and employment that can be recouped in 2020.

Figure 1. From bear to bull: “Lightning speed” in markets

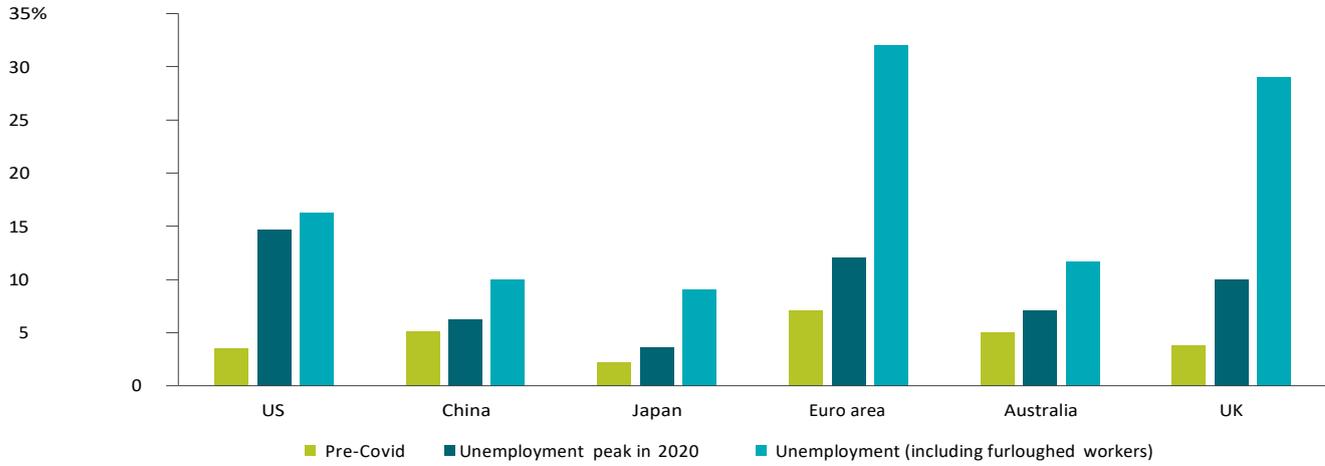
S&P 500 performance in five bad bear markets



Source: Vanguard, using data from Factset.

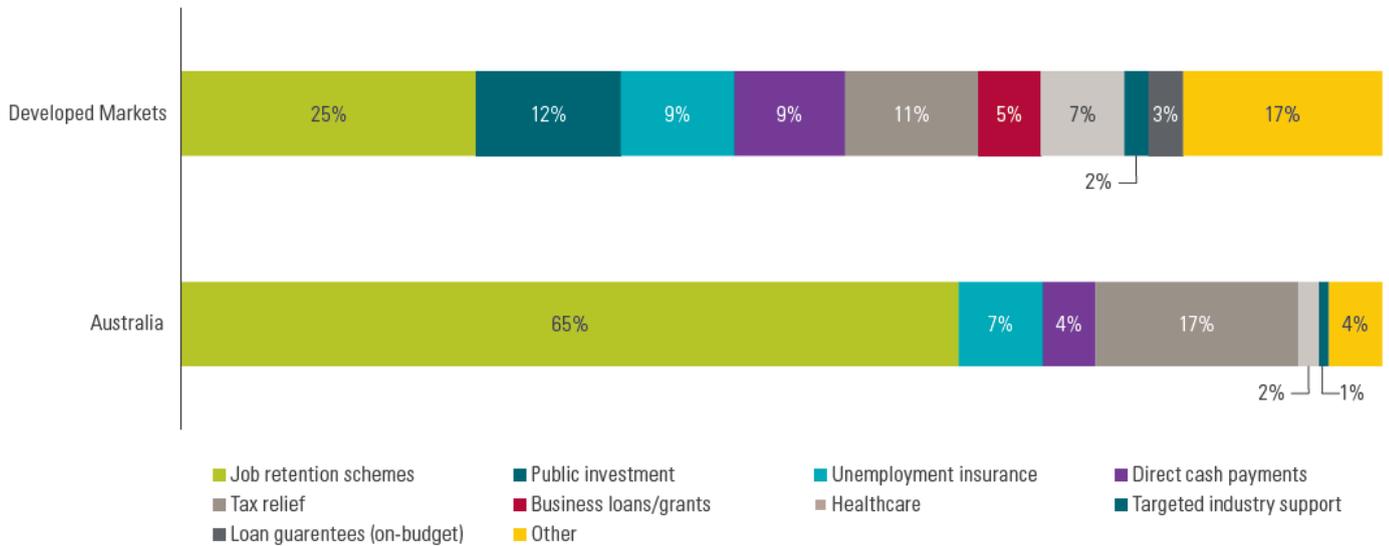
A closer look at Q2’s macro data highlights the uncertainty that lies ahead. In the labour market, for instance, the impact of the lockdowns on unemployment has remained substantial, even considering the huge fiscal interventions designed to mitigate the impact on the real economy. Vanguard estimates the global economy lost over 300 million full-time jobs in Q2 alone, with official measures of unemployment rates rising by historically unprecedented amounts in a short time. In fact, our calculations suggest that the ‘true’ unemployment picture is even worse once furloughed workers are taken into account, that is, people who have been given a temporary leave of absence from work (Figure 2). The ‘true’ levels of unemployment paint a much bleaker picture, with the US unemployment rate exceeding 15%, while a rate higher than 30% is observed in Europe. The employment situation is slightly more sanguine for Australia, owing to expansive fiscal programs dedicated to job retention schemes (Figure 3). With the consideration that these programs will eventually be wound down, compounded by the possibility of further localised restrictions, it remains to be seen whether job losses can be reversed since reinstating many jobs will be time-consuming and difficult as some businesses struggle to re-open. This will, in turn, have implications for the sustainability of the consumer recovery, which to date has been supported by federal income support.

Figure 2. Impact of the pandemic on unemployment



Source: Vanguard

Figure 3. Fiscal responses have varied throughout developed markets



Sources: Department of the Treasury (Australia), U.S. Department of the Treasury, Department of Finance Canada, European Commission, United Kingdom HM Treasury, Federal Department of Finance (Switzerland), Ministry of Finance (Czech Republic), Ministry of Economy, Trade and Industry and Ministry of Finance (Japan), Ministry of Economy and Finance (South Korea), The Treasury (New Zealand), Ministry of Finance (Singapore) and The Government of the HKSAR.

Economic outlook

As developed markets begin easing lockdown measures, many have begun focussing their attention on the shape of the recovery. Will the recovery be a more aggressive “V-shape”, as priced in by the equity markets, or will it be a more conservative “U-shape” as reflected in the bond market? Vanguard expects it will be a little of both. The sharp downturn experienced in a V-shaped recovery is so severe that it is unlikely to continue for extended periods of time. In technical terms, a recession is over once GDP rebounds from pandemic-induced lows and unemployment starts to decline, both of which we expect has already started to happen as reflected in our high frequency indicators (**Figure 4**).

Figure 4. High frequency indicators show a quick rebound from the trough, though certain face-to-face intensive sectors remain lacklustre



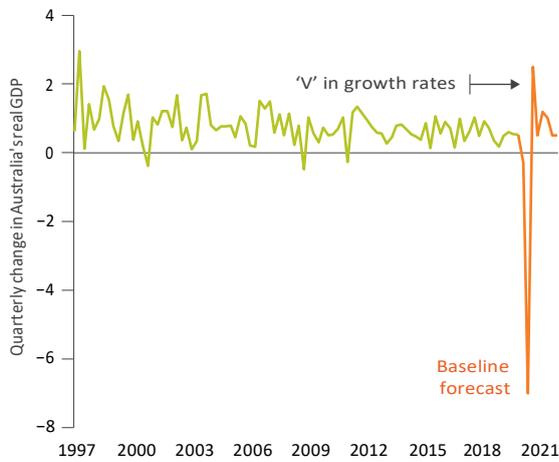
Source: Vanguard, based on data from OpenTable, CityMapper, Apple, Google, Box Office Mojo, OAG and Westpac.

But initial signs of positivity doesn’t mean the road to recovery will be easy going. Getting business activity back to pre-COVID levels could take more than a year in a scenario more closely resembling a U-shaped recovery (**Figure 5**). This outcome is built upon shocks to both supply (stemming from containment measures) and demand (stemming from consumers’ likely reluctance to resume face-to-face activities such as dining out, traveling, or attending large events). The confluence of these two shocks leads us to expect a “two-phased” path to recovery. Phase one would likely exhibit stronger growth rates as restrictions on the ability to transact and produce are eased, such as when factories can begin operations and restaurants can receive customers once again. However, the second phase will take a longer time to unfold, as growth bottlenecks shift from supply shocks to demand drags. Industries that have a higher direct exposure to consumer demand will likely be the most vulnerable in this stage, given their dependence on face-to-face activities (**Figure 6**). This lagging factor leads us to believe overall economic recovery will involve a slow, uneven return to normalisation, and that labour markets will unlikely be as tight as they had been in the next year or so.

With a large degree of uncertainty weighing on the outlook, the U.S. Federal Reserve and the Reserve Bank of Australia may choose to hold interest rates near 0% for the foreseeable future. On the fiscal front, while most unemployment benefits are slated to end by Q3, we expect governments around the world to recognise the fragility of the recovery and continue to provide targeted and tapered support, particularly to those industries less able to restart fully. Given the importance of policy support to the recovery, we expect this to be a key focus for investors over the coming months.

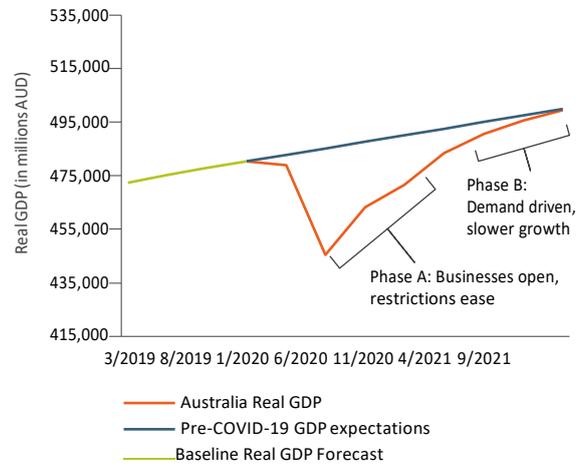
Figure 5. The recovery: Both a “V” and a “U”

Australian GDP levels



Source: Thomson Reuters Datastream and Vanguard forecasts

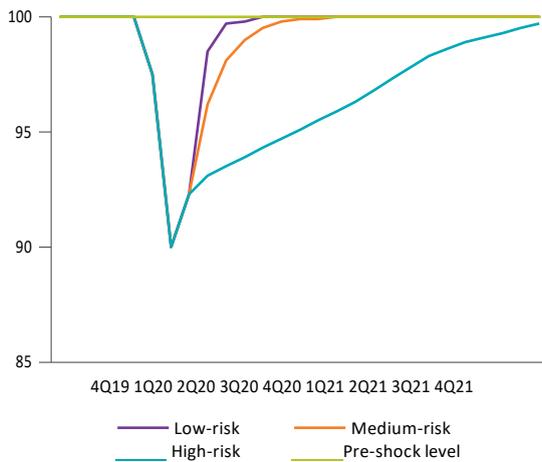
Quarterly Australian GDP growth rate



Source: Thomson Reuters Datastream and Vanguard forecasts

Figure 6. Certain industries could normalize at a slower pace than others

Example: Potential output shock persistence assuming 10% initial shock



Source: Vanguard

Methodology

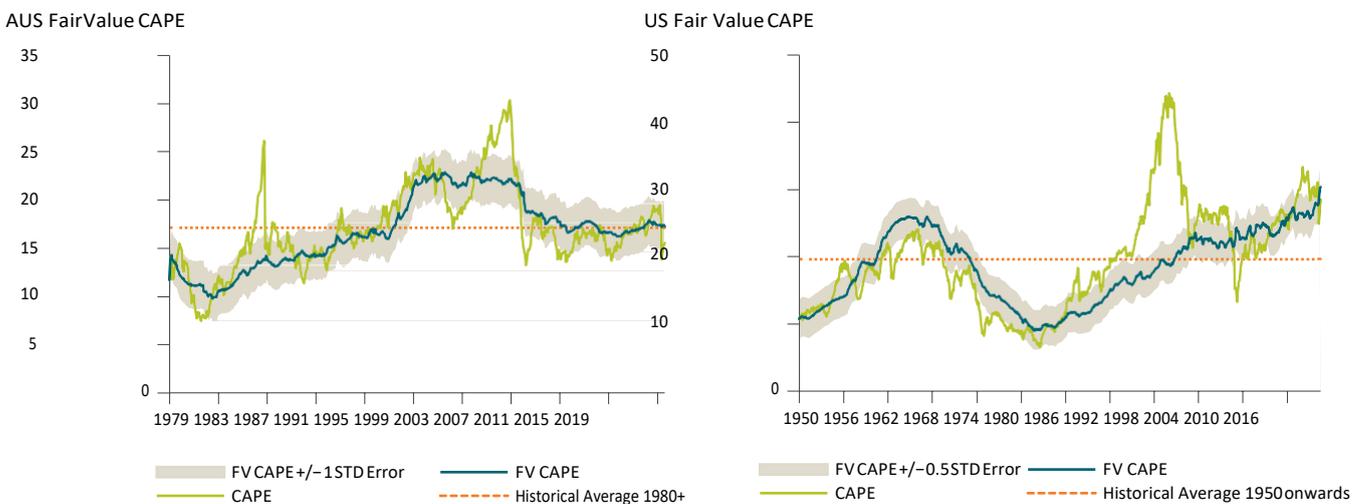
- Low risk – Construction, wholesale trade, IT, professional services, education, other services
 - » Lower supply shock persistence due to teleworking abilities and/or ability to produce while limiting virus spread at work through social distancing
- Medium risk – Manufacturing
 - » No teleworking ability and sometimes crowded working conditions but limited interaction with consumer
- High risk – Retail trade, transportation, real estate, healthcare, arts & entertainment
 - » No teleworking ability and supply of product necessitates face-to-face contact with consumers

Market outlook

In our Q1 report, we suggested that a silver lining came from equity valuations, which were at the lower range of our fair value estimate as a result of the sharp contraction experienced in March. **Figure 7** shows that while recent rallies within equity markets have pushed valuations upward, they still fall within fair value range, as the fair value range itself has been supported by historically low interest rates.

The recovery of equity markets gives rise to a prudent opportunity to praise the disciplined investor, who having held fast and rebalanced during the March downturn, has experienced much higher returns with the market rebound.

Figure 7. Despite a recent rally, equities remain in fair value range



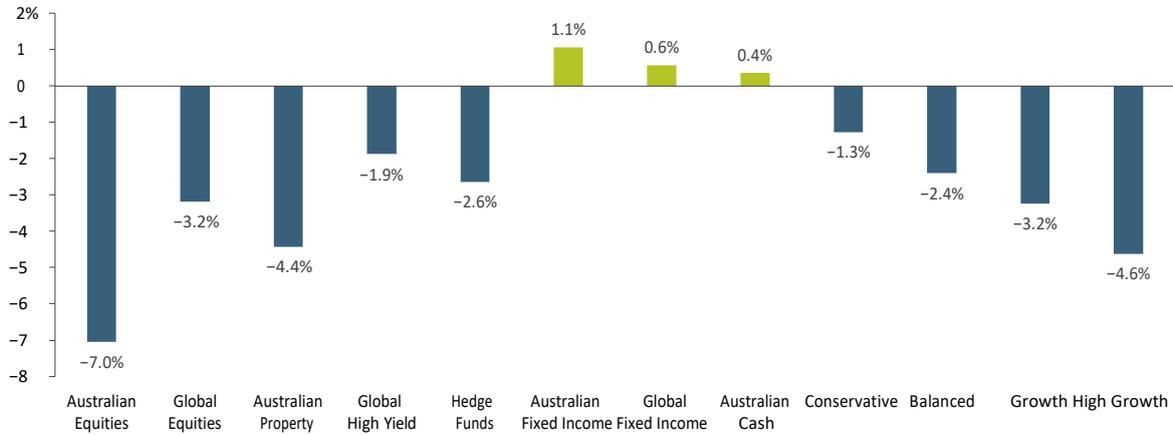
Notes: "Fair-value CAPE" is based on a statistical model that corrects CAPE measures for the level of inflation expectations and for lower interest rates. The statistical model specification is a vector error correction (VEC), including equity-earnings yields, ten-year trailing inflation, and ten-year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

On the fixed income front, while falling yields have led many investors to question the value of maintaining an allocation to bonds, **Figure 8** illustrates how the diversification properties of bonds are enduring regardless of the level of yields. Moving away from a broadly diversified, high-quality bond allocation to "reach for yield", whether in equities or particular segments of the fixed income market, will change the risk profile of an investment. For this reason, despite low yields, we encourage all investors to consider maintaining an allocation to a broadly diversified bond investment in their balanced portfolios.

Figure 8. In a sell off, few assets diversify as effectively as bonds

Median asset returns during the worst Australian equity months



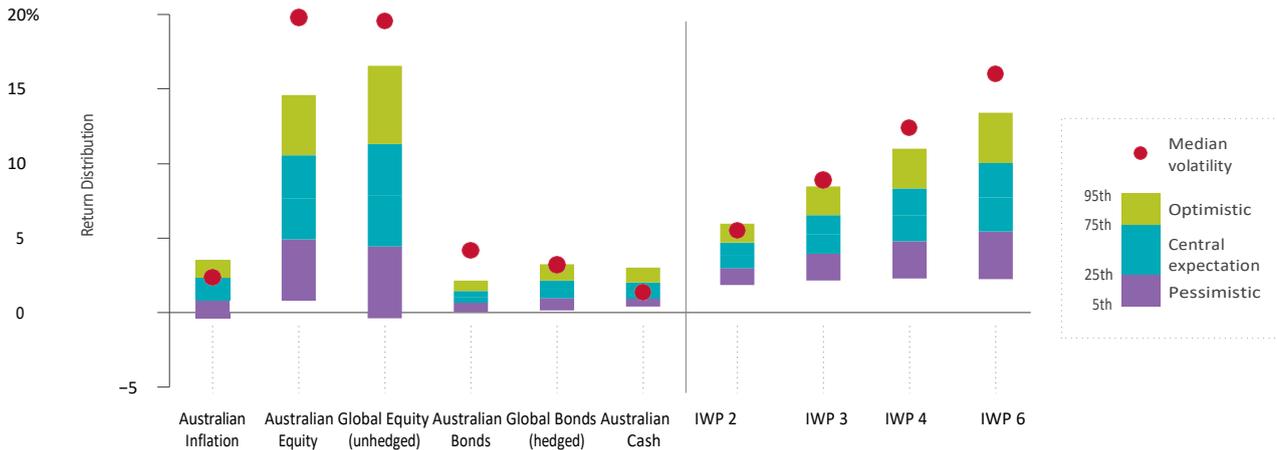
Notes: Median asset returns during the worst decile of Australian equity monthly returns for the period January 2007 – June 2020. Australian equities – S&P/ASX300 Accumulation Index, Global Equities – MSCI World ex Australia Index, Australian Property – S&P/ASX 300 A-REIT Index, Global High Yield Debt – Bloomberg Barclays USD Hedged, Hedge Funds – HFRI Fund weighted Index, Australian Fixed Income – Bloomberg Ausbond Composite Index, Global Fixed Income – Bloomberg Barclays Global Aggregate Index Hedged (AUD), Australian Cash – Bloomberg Ausbond Bank Bill Index.

Source: Vanguard calculations, using data from Factset.

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 the IWP lifestyle portfolios

Figure 9. Projected 10-year nominal return outlook



Source: Vanguard, 31 March 2020 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 10. Probability of achieving realreturn target

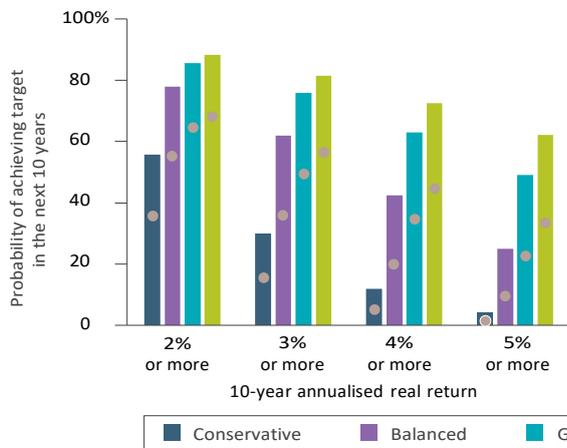
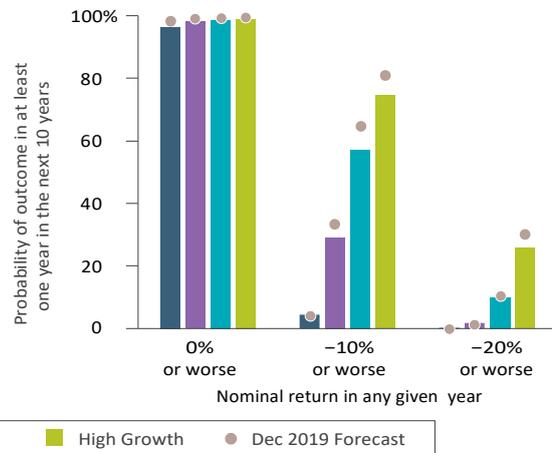


Figure 11. Downside risks



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 modelled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, 31 March 2020 and 31 December 2019 VCMM Simulations.

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.