View from the OUTER

23 July 2020

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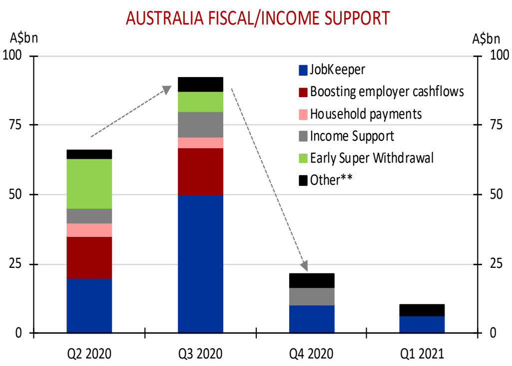
Close to peak recovery

Global equity markets remain challenging at present with valuations continuing to bounce around record highs.

A large part of the remarkable performance of equity markets in recent months has been *stimulus overkill*. However, the stimulus story is itself close to a peak and households will soon be in a position where their spending power will sequentially decline. Even with the extension in Jobkeeper and Jobseeker announced this week there will be an enormous difference between household finances in Q3 and Q4. A similar story is also playing out in the US.



Source: APRA, AU Treasury, ABA, Evans & Partners

***includes mortgage deferrals, other business support measures*

There are a number of risks that appear to be coalescing around the end of the year and could make this a challenging period for equity markets. These include:

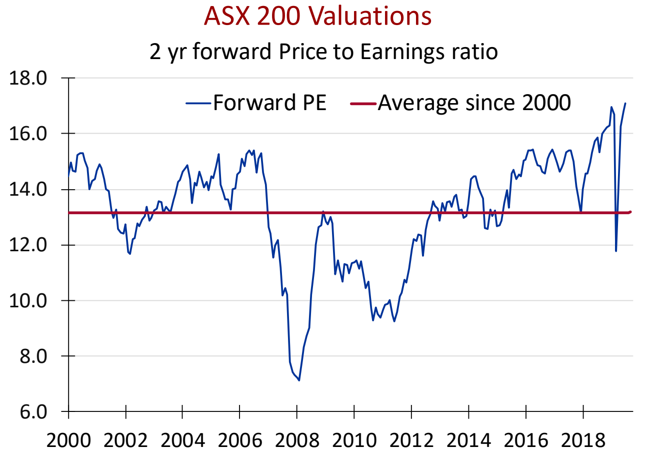
- A potential peak in the economic recovery. Equity markets are very sensitive to changes in economic momentum.
- Crunch time for a vaccine. Most are assuming that multiple vaccines will be approved by the end of this year and rolled out in the early months of 2021. Any slippage in that timetable could see an outsized market reaction.
- Political risks around the US election. Polls are clearly favouring a Biden win and Democratic clean sweep of the house. More importantly, there will be volatility in November regardless of the outcome. Substantial postal voting will mean that the result may not be known on the night, and there is a chance Trump will refuse to accept a vote that goes against him which could lead to chaos.

Recommendation

We remain underweight Australian and international equities and overweight cash and gold. We will hold these positions until markets have corrected or until risks and uncertainties have eased. Q4 this year is shaping as a critical period for this.

Close to peak recovery

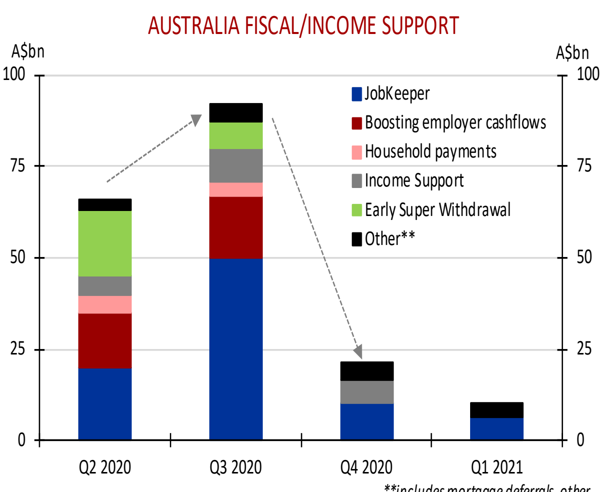
Global equity markets remain challenging at present with valuations continuing to bounce around record highs, particularly for Australia as shown in the chart below.



Source: Refinitiv, Evans & Partners

A large part of the remarkable performance of equity markets in recent months has been *stimulus overkill*. While the government was well intentioned there was always the risk that stimulus would end up being too large and hitting after the peak of the crisis. This is now playing out and equity investors have taken a lot of comfort from it and are willing to see through a range of lingering risks on the basis that stimulus can cure all ills.

However, the stimulus story is itself close to a peak and households will soon be in a position where their spending power will sequentially decline. In Australia's case the government is effectively delivering $200 billion in stimulus to cover an economic hit closer to $120 billion. Most of that is going to household incomes and the largest boost to incomes is occurring in the current quarter. This is shown in the chart below that looks at the amount of stimulus by quarter.



Source: APRA, AU Treasury, ABA, Evans & Partners

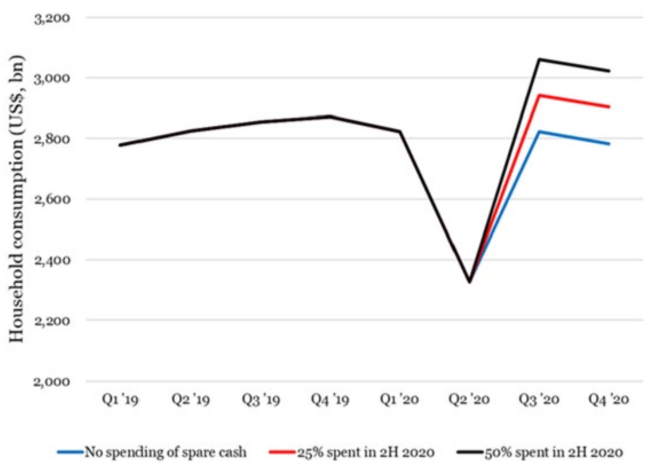
***includes mortgage deferrals, other business support measures*

Even with the extension in Jobkeeper and Jobseeker announced this week there will be an enormous difference between household finances in Q3 and Q4. In other words, there will still be a very large cliff.

This suggests potentially a very strong quarter for retail sales in Q3 but a significant change after that. Lockdowns might delay this spending to a degree, but it is looking very likely that there will be a significant shift in economic momentum at some point during Q4.

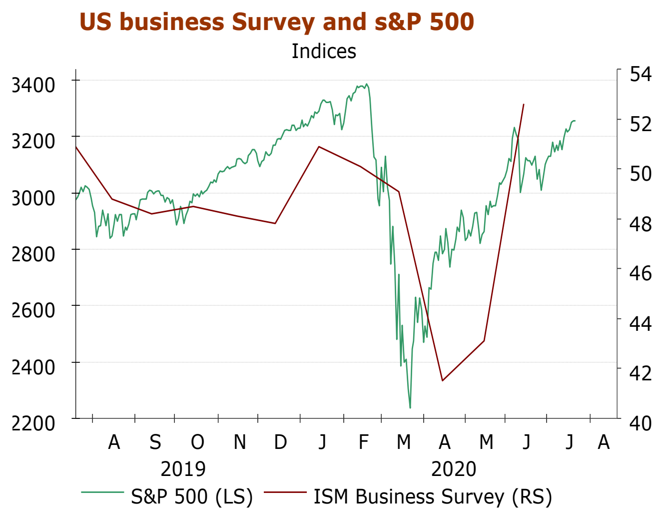
A similar story is playing out in the US. According to estimates by Longview Economics, household spending in the US will also peak in Q3. This assumes that the stimulus package currently before congress passes in the next few weeks.

Forecast US household spending by quarter



Source: Longview Economics

The Q3 peak in recovery could be very important for equity market performance. Equity markets are very sensitive to changes in economic momentum. So far this year the peaks and troughs in the equity market have corresponded to the peaks and troughs in economic momentum. The market trough at end March corresponded to the weakest point for economic momentum, as shown in the chart below.



Source: Refinitiv Datastream, Evans & Partners

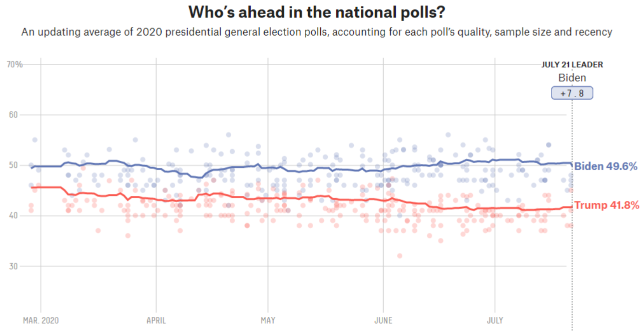
Risks combining in Q4

Importantly, this is not the only potential problem on the horizon. There are a number of other risks that appear to be coalescing around the end of the year which could make this a challenging period for equity markets. Given current valuations, equity markets will be highly sensitive to any surfacing of risks.

Some of these risks that could be reaching a crescendo in Q4 are:

1. A potential peak in the economic recovery as discussed above.
2. Crunch time for the COVID vaccine. The working assumption for most investors and commentators is that multiple vaccines will be approved by the end of this year and rolled out in the early months of 2021. As we get close to these dates, news on the progress of the vaccine will become more important. Any slippage to this timetable or disappointment in the trials will see an outsized effect. Given where equity markets currently sit there will be more downside from disappointment than upside from positive news.
3. Political risks around the US election.

Polls are clearly favouring a Biden win and Democratic clean sweep of the house. More importantly, there will be volatility in November regardless of the outcome. Substantial postal voting will mean that the result may not be known on the night, and there is a chance Trump will refuse to accept a vote that goes against him which could lead to chaos.



Source: Nate Silver

A Biden win is likely to have some significant effects for US corporates that should see some market reaction. He is planning to raise the corporate tax rate from 21% to 28% and looks likely to specifically target a few major sectors such as banks (potential reregulation and changes to bankruptcy laws), healthcare (price caps on pharma companies) and possibly technology (privacy regulation and anti-trust measures). These will be offset by some positives from big infrastructure spending (the "Green New Deal" justified by modern monetary theory), increased immigration and a more constructive relationship with China.

Asset Allocation Recommendations

Asset Class	TAA Position	Brief View
Cash and TDs	+4%	Cash provides protection and positions investors to take advantage of any opportunities that arise from any future market falls.
Interest Rate Securities	neutral	• While we are neutral overall, we have different subsector views. We are underweight high yield credit and government bonds, and overweight investment grade credit including hybrids and opportunistic credit exposures. • The underweight in high yield market reflects concerns around defaults. Spreads have continued to fall despite growing evidence that there will be significant defaults in some key sectors. • Government bonds are vulnerable given the potential for an increase in yields as economies recover. Government bonds have not priced this to the same extent as equities. • We are overweight the domestic hybrid market but we note that margins have come in significantly. We are now watching the market closely and any further contraction in spreads could see us change our recommendation. • Within credit we have a preference for investment grade. The market has stabilised following Fed intervention and an improvement in underlying liquidity but spreads remain above pre-COVID levels at a time when other income options are limited. • We are overweight opportunistic credit exposures as conditions are conducive for skilled and experienced managers.
Australian Shares	-2%	• We have a moderate underweight position on Australian equities given extreme valuations at a market level. • We still have a preference for Australian over international equities as Australia is better positioned than most countries given the scale of its policy response, the position of government finances, the strength of its financial system and the relative effectiveness of the health response.
International Shares	-3%	• We have a moderate underweight in international equities reflecting high valuations after the big run in markets. There are also lingering macro and health risks in parts of Europe and Emerging markets. • We retain a preference for US equities over those in Europe and Emerging Markets. The US has had a more effective policy response and the other regions are more cyclical and more vulnerable to sovereign debt issues. • We remain concerned about emerging markets. Economic weakness will be more severe given worse health outcomes and the lesser scope for policy support and reliance on exports in some countries particularly Brazil and India. • China is better positioned than other emerging markets, however. Its domestic economy is benefitting from an easing in credit restrictions and Chinese tech companies are benefitting from an acceleration in behavioural change in favour of online spending and banking.
Real Assets	neutral	• Real assets have been particularly affected by the crisis due to their exposure to vulnerable sectors such as airports, toll roads and shopping centres. We remain neutral for now.
Alternatives	+1%	• Gold is now our preferred defensive asset and will be a beneficiary of any renewed market volatility. Over time extreme monetary policy measures will also benefit gold. We have moved to an overweight position and have been adding to this position as we cut our equity weights. • Hedge funds should benefit from increased volatility and market dislocation and we will look to add to selective exposures. • We remain supportive of private equity as the asset class has traditionally had shallower drawdowns and quicker recoveries in market sell-offs.

Source: E&P

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