A brief review of investment markets and broader factors affecting clients. **June 2020**

Macro-Economic and Asset Class

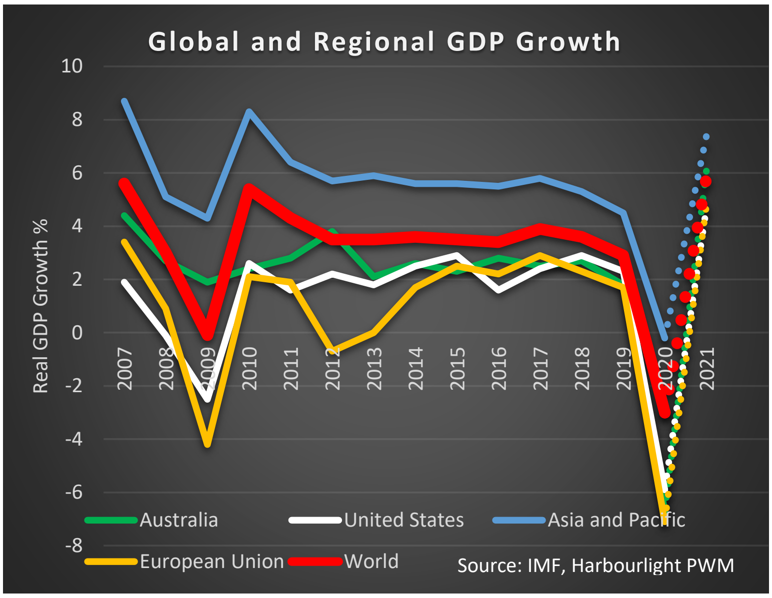
The first half of 2020 has been a testing time for investors globally. Australia has seen some of the worst fires on record, whilst globally, Covid-19 and divisive politics have created significant social tension. Since the end of February 2020 we have witnessed a very fast sell off in listed shares and property, followed by a meaningful recovery fueled by significant and much required government stimulus. Whilst this stimulus meant the low was not as deep as feared, property securities across the world lost nearly half their value, in stark contrast to direct property assets which held up well leaving meaningful valuation gaps in similar assets. Stock markets sold off sharply, though the fall in AUD provided shelter for unhedged international portfolios. Further falls in interest rates created difficulty for investors looking to assess relative valuations and those focussed on investment income.

We removed our defensive bias for portfolios through March embracing a more neutral to growth focussed stance for clients where suitable. Whilst a second selloff is possible post the recent rises in asset values, governments continue to support their economies and we believe falling earnings will recover by 2022. The 10 to 30 percent drop in asset values will likely increase asset class returns by 1% to 3% over the long term, further the current fragmentation across individual assets presents an opportunity.

Australian Shares - International Shares (local ccy) - International Shares (hedged AUD) - Australian Property Securities - International Property Securities (hedged AUD) - International Infrastructure (hedged AUD)

Economic Background and Developments

As economic data catches up with the events of the last 4 months we are better able to understand the economic implications of Covid-19 and its subsequent lockdowns. Amongst recent data we have seen UK GDP drop by 20% in April 2020 and US unemployment surge to near 15% (similar levels to World War II but below the 25% mark reached during the Great Depression). This has been followed by a series of slight improvements and revisions.



Annualised numbers present less alarming but still worrying forecasts. IMF data for example shows an expected reduction in global growth for 2020 of -3%. Some emerging markets including Asia appear to be fairing better, whilst many western nations are experiencing sharper contractions with the expectation of sharper recoveries in 2021 and 2022.

Asset class overview

Whilst we know some assets, not all, are much cheaper than they were before. Valuation in this environment becomes difficult. The concept of earnings yield and estimating long term returns for stocks becomes subject to earnings uncertainty and volatility. This makes assessing fair value through simple ratios such as price/earnings subject to greater error.

Difficulties aside, we can make some informed assumptions:

- We can assume with reasonable certainty that Covid-19 won't be a major issue forever. Thus making the assumption that in 2 years time, corporations globally should be able to restore their earnings to the levels of the beginning of 2020 is also fair.

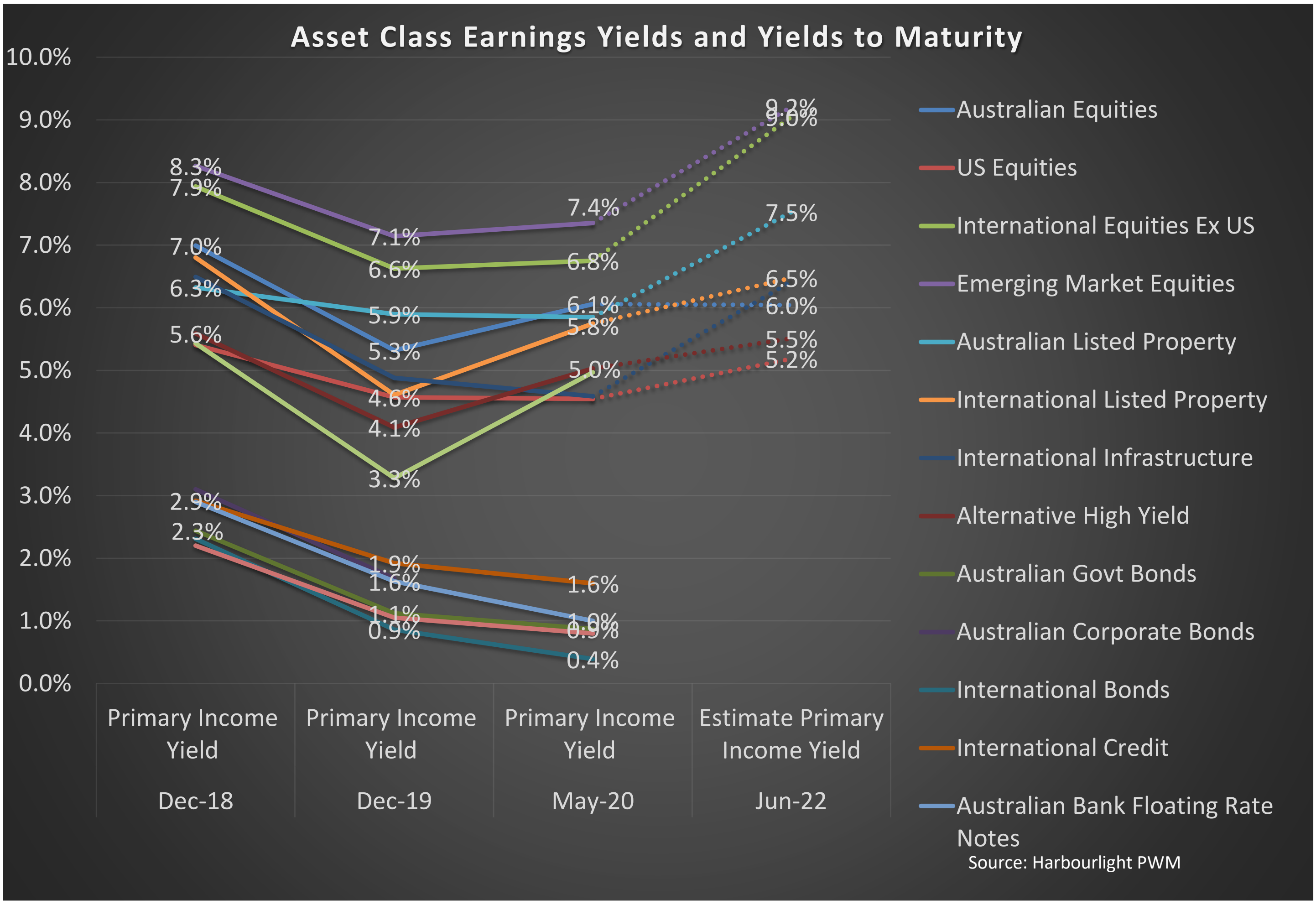
- We can assume in the meantime we will continue to see companies raise capital, allowing investors the chance to participate in some (not all) capital raisings.

- We can assume the use of real estate will be altered for the medium-term future. Social distancing will likely mean more people work from home and assets used for retail will receive less traffic in the backdrop of online sales. It's clear to see the companies that lost the least value (if not increased in value) were linked to healthcare and technology. The effects of this growing online spending are likely to have ongoing effects on retail real estate.

- Interest rates will need to remain low to shelter borrowers and stimulate growth, making it harder for conservative investment portfolio returns, thus increasing the appeal of growth assets with expected long term returns of between 5% and 9%.

Using these assumptions we can try to construct expected returns (forward earnings yields) for various asset classes.

The below chart shows the change in expected earnings yields since December 2018 and forecasts expected earnings yields for June 2022.



Whilst we might still have volatility to come, most asset classes are showing a significant improvement in their long term returns presuming earnings do normalise.

International equities in emerging and developed markets are looking more attractive with forecast earnings yields of 9% as is higher grade credit and listed property trusts which look meaningfully cheaper than direct property.

Our views for the next 12 months.

We expect the next 12 months to be volatile as the unknown nature of impacts of Covid-19 present themselves. The recent stimulus oriented recovery in growth assets factors in a quick return to normality that is yet to be confirmed. That said for investors with long term investment horizons who are willing to tolerate financial market and media noise, we believe slowly purchasing discounted assets will be rewarding.

With interest rates so low, there is a natural build-up of cash from investors looking for homes in quality assets. We believe this will play a strong force in supporting long term asset prices.

From a portfolio construction perspective we continue reducing exposure from the direct property and alternative assets we were using last year and allocating to more traditional listed securities.

Other Regulative Matters

- Under recent legislation clients with superannuation income streams continue to be offered the opportunity to reduce their income levels, thus leaving funds in the potentially beneficial tax environment of superannuation.
- Income tax bands will remain the same this financial year in line with the Government's *Personal Income Tax Plan* legislated in 2018. Personal income tax bands will remain at current levels until 2022 where the next round of tax cut will commence.
- Superannuation contribution time is here - The maximum level of annual superannuation contributions remains at $25,000 for concessional and $100,000 non-concessional contributions.
- The transfer balance cap applying to commencing retirement income streams remains at $1.6m.
- Incentives continue to be provided for those who have had less time to contribute to super, with the largest being a $300,000 non-concessional allowance for those aged over 65 who are downsizing their home if held for over 10 years.
- The work test age restriction has been lifted to 67.
- Superannuation guarantee contributions remain at 9.5% with a scheduled increase to 10% in 2021.

Please feel free to contact us if you wish to discuss any of these matters.

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