WEALTH MANAGEMENT RESEARCH

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Wealth Management
Asset Allocation - Remain Positioned for Growth

KEVIN STIRRAT
kevin.stirrat@forsythbarr.co.nz
+64 9 368 0069

MATT NOLAND
matt.noland@forsythbarr.co.nz
+64 9 368 0134

WEALTH MANAGEMENT RESEARCH
wmr@forsythbarr.co.nz
+64 4 499 7464

Record levels of proposed government spending at the same time as central banks remain committed to allowing economies to run above potential sets up a powerful stimulus partnership. Progress with vaccinations should see a gradual normalisation of activity, with the sectors hardest hit by the pandemic potentially recovering strongly by year-end.

New Zealand border and travel restrictions are likely to remain for most of 2021, which also underpins our view that record levels of monetary support will continue until the pandemic is perceived to be under control.

Portfolio tilts

- Reduce exposure to bonds and increase cash. Upside inflation risks are a negative for bonds while the value of holding more cash increases if equity markets correct. While equities remain less expensive than bonds, overheated markets increase correction risks.
- Reduce exposure to New Zealand equities and listed property. Steeper yield curves are a headwind for defensive sectors while the earnings outlook for domestic companies is less positive than global comparisons.
- Maintain small overweight to Australia which remains leveraged into a global recovery.
- Increase overweight to global equities. We expect a strong global earnings recovery in 2021 with demand boosted by record fiscal stimulus and historically low funding costs. USD exposure remains a volatility hedge in the event of equity market corrections.

Macro outlook

- Continued success (base case) in the global vaccination programmes along with the strong monetary and fiscal partnership should underpin medium-term global growth as economies reopen and consumption of services accelerate. We acknowledge the highly uncertain nature of the path of the virus and the success or otherwise of vaccination programmes.
- Inflationary expectations are increasing, consistent with ongoing monetary support, record levels of fiscal stimulus, and a stronger growth outlook. Short-term real rates should remain negative despite steepening yield curves as official cash rates remain anchored.

Figure 1. Portfolio Position — Balanced

	Benchmark weights %	Tactical weights %	Risk measure (5yr std. dev, % p.a.)
Cash	10	6	0.20
Fixed Interest	33	31	2.06
Property	7	5	12.80
Equity NZ	15	17	11.45
Equity AU	15	16	16.77
Equity International	20	25	11.69
Total Equity/Property	57	63	
Max Equity/Property	57	65	

Source: Forsyth Barr analysis

Fixed Income

- Risks remain asymmetric. Monetary settings entrenching negative real yields with limited capital gain potential.
- Inflation surprise could hurt total return.
- Our positive outlook for global growth is consistent with higher nominal 10-year yields. Maintain short duration risk.

Equities

- A return to record-high earnings during 2021 is expected as the economic tailwind takes hold. This assumes successful vaccination outcomes.
- Current preferred sectors include Consumer Discretionary, Technology, Healthcare, and Consumer Staples.

Asset Allocation

	Benchmark weights %	Tactical weights %	Risk measure (5yr std. dev, % p.a.)
Defensive			
Cash	15	13	0.20
Fixed Interest	70	68	2.06
Property	5	6	12.80
Equity NZ	5	3	11.45
Equity AU	5	6	16.77
Equity International	0	4	11.69
Total Equity/Property	15	19	
Max Equity/Property	15	20	
Conservative			
Cash	15	11	0.20
Fixed Interest	50	48	2.06
Property	10	11	12.80
Equity NZ	5	3	11.45
Equity AU	10	12	16.77
Equity International	10	15	11.69
Total Equity/Property	35	41	
Max Equity/Property	35	45	
Balanced			
Cash	10	6	0.20
Fixed Interest	33	31	2.06
Property	7	5	12.80
Equity NZ	15	17	11.45
Equity AU	15	16	16.77
Equity International	20	25	11.69
Total Equity/Property	57	63	
Max Equity/Property	57	65	
Growth			
Cash	5	3	0.20
Fixed Interest	18	14	2.06
Property	10	8	12.80
Equity NZ	19	21	11.45
Equity AU	18	19	16.77
Equity International	30	35	11.69
Total Equity/Property	77	83	
Max Equity/Property	77	85	
Growth Plus			
Cash	5	3	0.20
Fixed Interest	0	0	2.06
Property	10	8	12.80
Equity NZ	23	24	11.45
Equity AU	22	22	16.77
Equity International	40	43	11.69
Total Equity/Property	95	97	
Max Equity/Property	95	97.5	

Macro backdrop

Impending fiscal tsunami

While the global recovery may have slowed in recent months due to resurgent viral infections in the northern hemisphere, an economic tailwind is building due to:

- Clear signs of a peak in viral infections from mid-January
- An accelerating pace of vaccinations globally
- Central banks remaining committed to allowing economies to run "hot" before thinking about reducing support
- Most major governments announcing significant fiscal programmes to supplement incomes and increase investment

The European Union (EU) has signed its largest fiscal stimulus package ever. A total of EUR1.8 trillion has been approved to help rebuild post-COVID Europe while President Biden's administration has proposed a US$1.9 trillion 'American Rescue Plan' that includes another round of stimulus cheques to most Americans on top of the cheques sent during January.

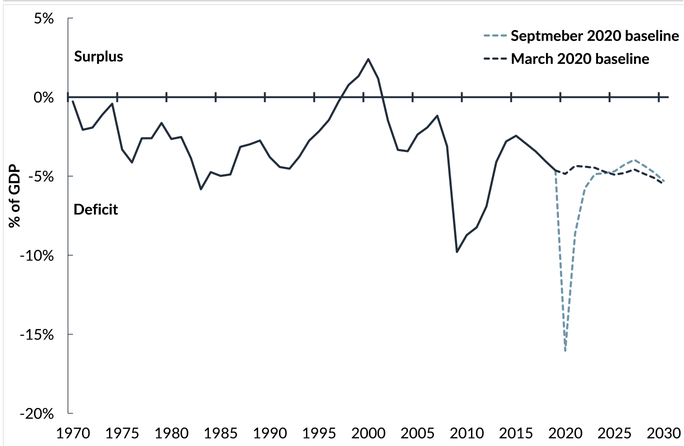
Further spending announcements in the US are expected later in the year targeting infrastructure, clean energy, education and health care (possibly worth an additional US$2 trillion).

All this stimulus sets up the global economy for more economic growth, assuming no setbacks with the virus and/or the vaccination programme. Last year's extraordinary recovery from the pandemic slump in March/April was at least in part caused by pent-up demand while in lockdown. Savings rates were boosted by stimulus cheques at the same time spending was cut back. With the new stimulus to be provided under the proposed Biden package, US domestic demand led by household consumption is expected to surge again. The US economy looks to have started the year with reasonable momentum if the data for January is any indication:

- Retail sales surged +5.3% compared to December (likely boosted by the US$600 stimulus cheques)
- Industrial production jumped +0.9% compared to the month earlier
- Producer prices increased +1.7%

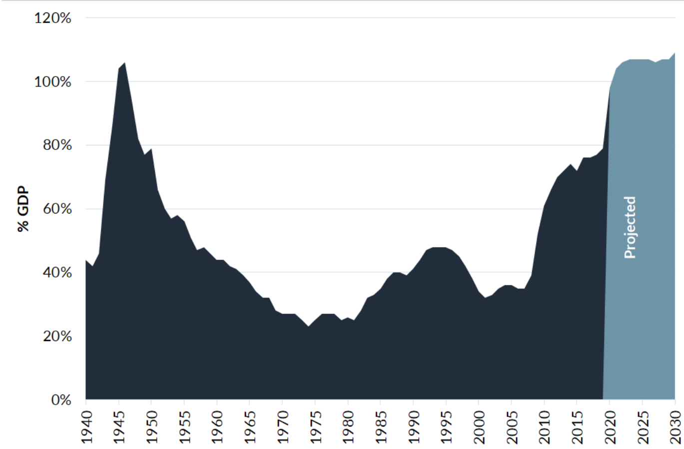
While the recoveries in Europe and Japan look to have suffered setbacks over their winters, the US economy appears to have weathered the latest pandemic wave well. With the recent round of fiscal support already in domestic bank accounts and proposed additional stimulus about to be approved, concerns are growing that the US economy may overheat. But policymakers remain confident that it will take some years of support to absorb the amount of slack still in the economy.

Figure 2. US fiscal deficit % GDP



Source: Congressional Budget Office, Forsyth Barr analysis

Figure 3. US public sector debt % GDP



Source: Congressional Budget Office, Forsyth Barr analysis

Upside risk to interest rates

Long-term bond yields have increased over the past month and global yield curves have steepened — consistent with an improving economic outlook, higher commodity prices, rising inflationary expectations, and an increasing supply of bonds. The proposed level of fiscal expansion should boost global growth through 2021 which would be consistent with higher interest rates. Furthermore, central banks remain committed to extreme monetary support, with ongoing asset purchases, thus removing supply from the market. Central banks are effectively underwriting the additional funding needs of governments as fiscal deficits continue to widen.

Yet the secular forces that have driven inflation down over the past three decades remain. They are:

- Aging and slowing population growth
- Rapidly rising levels of debt in the public and private sectors
- Relative peace throughout the world ensuring global producers and consumers remain connected
- The impact of technology on the quality of goods and cost of doing business

However, as the economic recovery gathers momentum the market is likely to continue leaning on the bond curve and test the resolve of central banks to maintain negative real interest rates. While this could see nominal 10-year government bond yields rising towards 2.0% later this year, it may not be enough to push real yields into positive territory, which should ensure stimulatory financial conditions remain for some time yet.

Most official forecasts are for headline inflation to rise to between 2.0–2.5% by next year. It seems probable though that if the substantial stimulus programmes that have been proposed get enacted, official forecasts for growth, inflation, and interest rates may need to rise further — as will the outlook for the amount of debt governments will need to issue.

Historically low interest rates in an environment of increasing inflationary expectations negate one of the key roles bonds play within diversified portfolios — that of providing a negatively correlated return profile compared to equities during periods of sharemarket corrections.

A stronger growth outlook that may result in higher inflation, as now targeted by the major central banks, underpins our aversion to bonds relative to equities at this stage of the economic cycle.

Equities

New Zealand

It is possible we have now seen the low in nominal bond yields after a rally (fall in yields) that has gone on for over three decades. This removes a valuation tailwind, particularly for markets such as New Zealand which has a a high ratio of defensive yield or dividend stocks. Our positive outlook for global and domestic growth suggests bond yields will continue to push higher as the economic recovery materialises. The return from domestic equities is more likely to be in line with earnings and dividend growth rather than be driven by multiple expansion.

That said, we remain reasonably optimistic for the New Zealand economy for the year ahead, despite an expectation of ongoing border restrictions. The domestic economy finished 2020 with relatively strong upward momentum, with our 'COVID-free' status boosting local activity. The strong drivers of growth included the well reported housing/construction boom as well as robust trade pushing net exports into a surplus position. The recovery in commodity prices and demand for our produce and resources lifted our terms of trade to a new record high in the middle of last year. Consensus GDP forecasts project the economy to expand between 5% and 6% for the 2021 year.

This lift in growth should see a recovery in earnings and dividends, which should be supportive of prices, offsetting some potential retracement in PE ratios. While we remain positive about underlying growth, we also expect higher rates to become a headwind for investor sentiment. If 10-year bond yields rise towards 2.0% by the end of the year, we would expect multiple compression to impact on overall market valuation.

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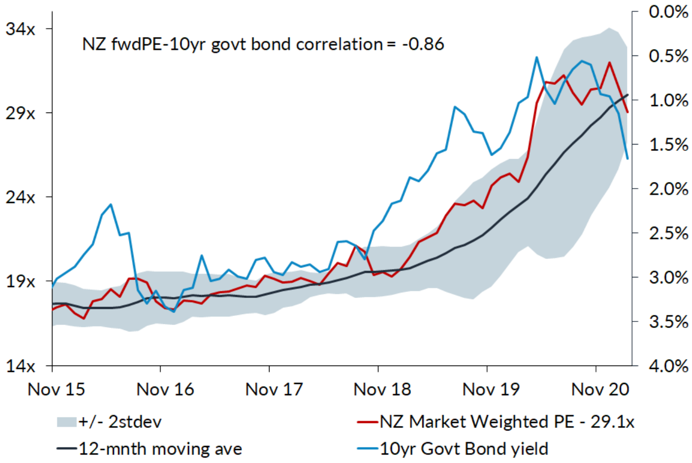
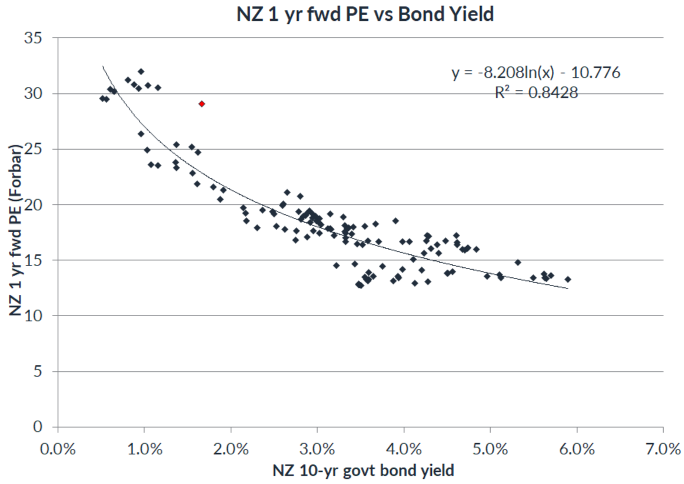
Figure 4. NZX 1-year PE and 10-year govt. bond rate



Source: Thomson Reuters, Forsyth Barr analysis

Figure 5. NZX 1-year PE and 10-year yield regression analysis



Source: Thomson Reuters, Forsyth Barr analysis

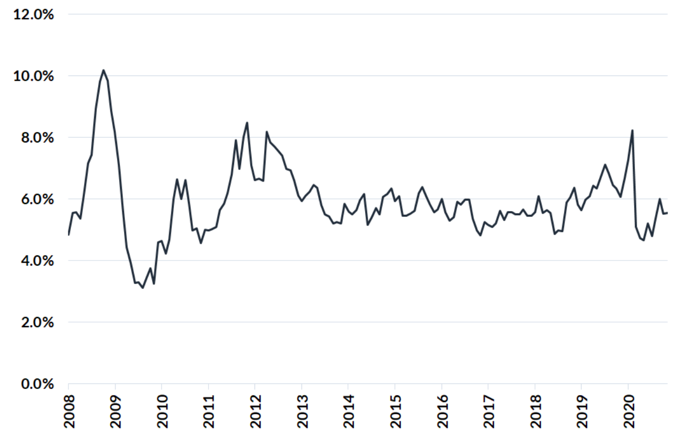
Australia

We expect a stronger relative performance from Australian equities over the next year or so due to higher leverage into the global economy. Australian equities have a lower starting point than New Zealand, primarily due to composition differences and the under-performance of financials in recent years. The V-shaped recovery in industrial activity and manufacturing is clearly benefitting the Australian resource sector while a steeper yield curve and a stronger domestic economy led by a housing boom and consumption should benefit the financial sector. Despite other sectors bearing the brunt of the diplomatic spat between Australia and China, the negative impact is expected to be temporary with expected aggregate earnings growth of +20% in 2021 followed by +10% in 2022. Higher bond yields associated with a strengthening economic recovery is still expected to weigh on valuations.

Figure 6. Australian home loans AUD bn/month

Source: Trading Economics, Forsyth Barr analysis

Figure 7. Australia ERP (EY less 10-year govt bond rate)



Source: Forsyth Barr analysis

Global

US analysts expect one of the fastest returns to record-high earnings for the S&P 500 in 2021. Starting from an already solid base and taking into account a successful vaccination outcome, further significant fiscal stimulus with President Biden's US$1.9 trillion stimulus package, and continuation of historically low interest rates and central bank support, conditions are ripe for a strong recovery in 2021.

Many companies remain cautious and have kept costs under control which augurs well for an increase in operating leverage as the recovery gains momentum. This dynamic goes some way to justifying existing high valuations. The S&P 500 earnings yield was also relatively stable, around 4.5% during the last few months of 2020. This compares with the 10-year Treasury bond yield that was below 1.0% for most of that time (currently 1.40%) and US inflation of 1.4% (January YoY). The equity market has rallied since the start of the year but the valuation comparisons are pretty much unchanged. The very strong recovery in manufacturing as evidenced by PMI data also suggests revenues per share may surprise on the upside during the first half of 2021.

With ample liquidity and accommodative monetary conditions being maintained by central banks, the equity market should also be supported by M&A activity. Whether looking to expand, consolidate, or improve economies of scale, financial conditions look conducive for plenty more deals in 2021.

Fixed income

Figure 8. NZ interest rates

	Current	12-month forecast
OCR	0.25	0.25
5 year swap	1.14	1.25
10 year govt bond	1.92	2.0

Source: Forsyth Barr analysis

The latest round of fiscal stimulus in the US, to be followed by up to US$1.9 trillion under President Biden's American Recovery Plan, should underpin the recovery in the US economy at the same time as the pandemic starts to ease due to the impact of vaccinations. From a starting point of such low interest rates, stronger growth is bound to be reflected in higher yields as the year progresses. While central banks continue to communicate messages of patience over the timing of monetary support withdrawal, the market will inevitably get ahead of any tapering move. This could see the US 10-year Treasury bond yield rise to between 1.50%–2.0% by the end of the year, consistent with current growth projections and rising commodity prices.

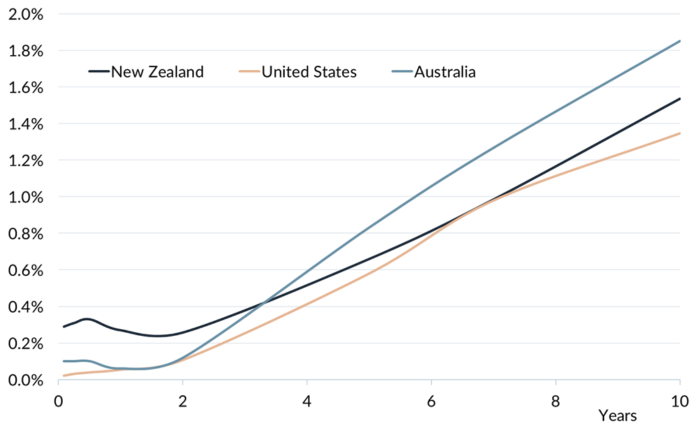
The yield curve is the best predictor of future interest rates as it incorporates all market participants' expectations on inflation and monetary policy. Bond yields are generally predicated on the expected short rates over the life of the bond. These expectations are embedded into the the term structure, or slope of the yield curve. The current yield curve is indicating that short rates are expected to remain flat for the next 1–2 years. This, and central bank commitments to continued asset purchases should create resistance, preventing the curve from steepening too much over the next 12 months.

Consistent with the current shape of the yield curve is that global inflation currently remains subdued. Excess capacity and secular deflationary pressures hinder companies' abilities to raise prices. However, cyclical price pressures are starting to emerge as a result of the unprecedented stimulus and liquidity being provided by policymakers. Price gauges in the most recent manufacturing and services surveys in the US indicate costs rising at the steepest rate in over 10 years. This is starting to result in pass-through costs to customers according to the latest reports.

A cyclical upturn in inflation is also being encouraged by central banks which have now subordinated their price stability goals in favour of full employment. The economic recovery would have to be substantially stronger than current forecasts for policy makers to reverse their current accommodative policy settings until at least sometime in 2022. But that won't necessarily stop the market preempting higher rates.

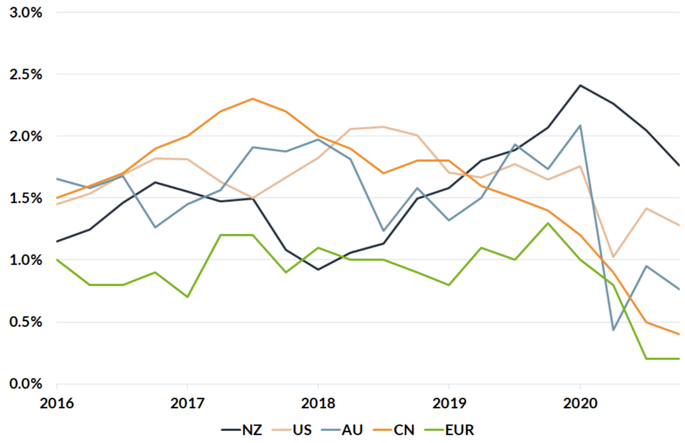
The duration of the New Zealand bond market is less than 4 years. If 5-year interest rates were to double over the next 12 months, investors in 5-year government bonds (which are currently yielding 1.2%) would suffer total return losses of around -3% (before inflation). So the risks for fixed income remains asymmetric — limited capital gain with potential total return losses. If we do start to see cyclical inflationary pressures increase, real yields are likely to fall further into negative territory as central banks hold the line against premature tightening. While bonds are already expensive relative to equities when comparing real yields, this would make them even more expensive.

Figure 9. Yield curve



Source: Thomson Reuters, Forsyth Barr analysis

Figure 10. Core inflation (YoY change)



Source: Thomson Reuters, Forsyth Barr analysis

Currencies

Figure 11. Currency outlook

Currency	Current	12 month forecast
NZDUSD	0.7300	Higher
NZDAUD	0.9250	Neutral
NZDGBP	0.5200	Flat/higher
NZD EUR	0.6000	Lower

- Rising terms of trade and a cyclically weak USD are nudging the NZD and AUD higher.
- The direction for the GBP and EUR is dependent on how quickly both regions get control of the pandemic. There is still lots of downside risk for UK economy post Brexit with softer immigration and services exports along with lower levels of foreign direct investment outweighing the benefits of independent policy control.

Bottom line

The combination of large fiscal stimulus, ongoing monetary support, and a successful impact of vaccinations on the pandemic is expected to produce a very strong tailwind to global economic activity through 2021 and into 2022. The main risk to this positive outlook remains the uncertain nature of the virus and the path it takes, along with our responses to it.

While inflationary expectations have already risen, along with long-term nominal bond yields, we sympathise with the major central bank views that higher inflation outcomes will most likely be transitory. After more than a decade of sub-trend growth following the GFC, the global economy will benefit from being allowed to "run hot" for a while. Excess capacity and the glut in global savings will take some time to shrink.

Higher long-term interest rates reflect rising costs (commodity prices) and a welcome return to positive inflationary expectations. Steeper yield curves also signal widespread confidence in the outlook for growth over the next few years. Sectors that have traditionally done well in a steeper yield curve environment include financials and commodities. But a higher interest rate environment is less positive for yield sensitive sectors such as property, utilities, and infrastructure. We have rotated away from the more defensive domestic sectors in favour of global growth. Transitions to a higher yield curve environment often result in market turbulence. Holding higher levels of cash during this period provides the means and opportunity to capitalise on volatility as it arises.

Charts of interest

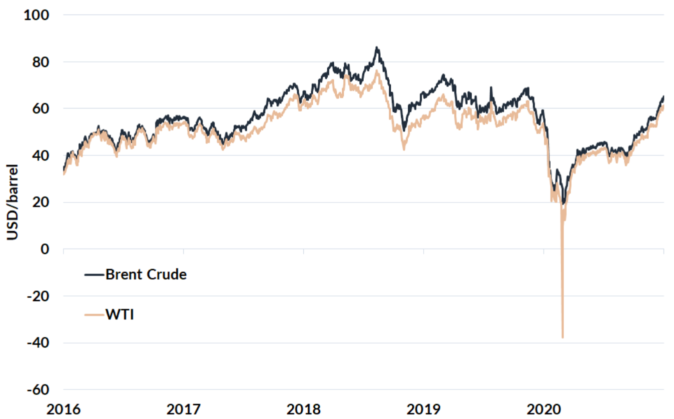
Figure 12. CRB Index of commodity prices

Source: Thomson Reuters, Forsyth Barr analysis

Figure 13. Gold (US$/oz)

Source: Thomson Reuters, Forsyth Barr analysis

Figure 14. WTI and Brent Crude prices (US$/bbl)

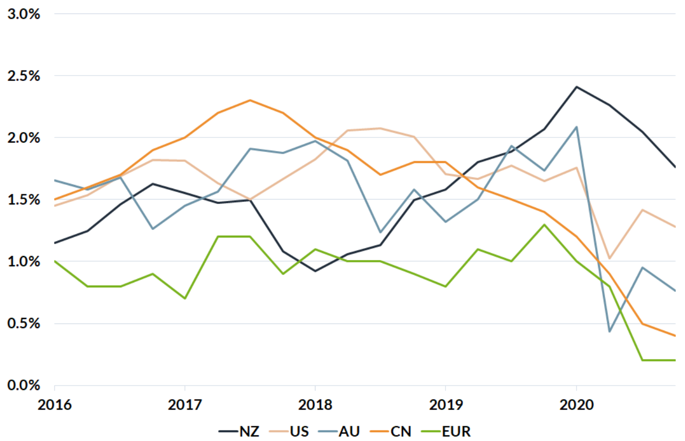


Source: Thomson Reuters, Forsyth Barr analysis

Figure 15. Baltic Dry Index of shipping prices

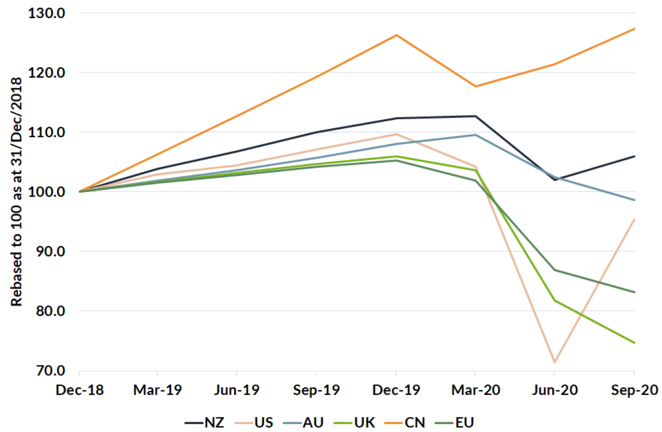
Source: Thomson Reuters, Forsyth Barr analysis

Figure 16. Core inflation (YoY change)



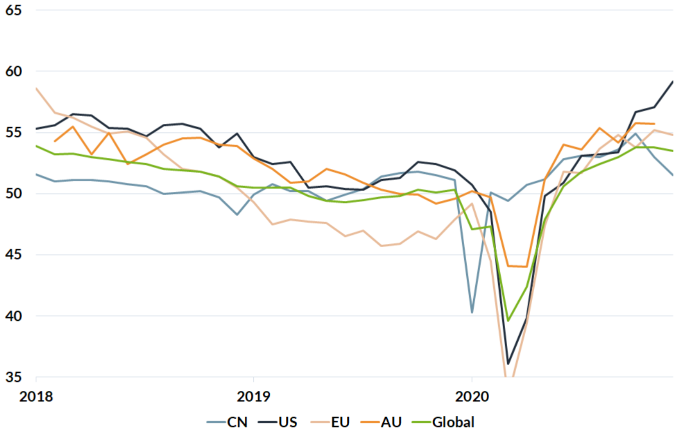
Source: Thomson Reuters, Forsyth Barr analysis

Figure 17. Real GDP



Source: Thomson Reuters, Forsyth Barr analysis

Figure 18. Manufacturing PMI (Purchasing Manager Index)

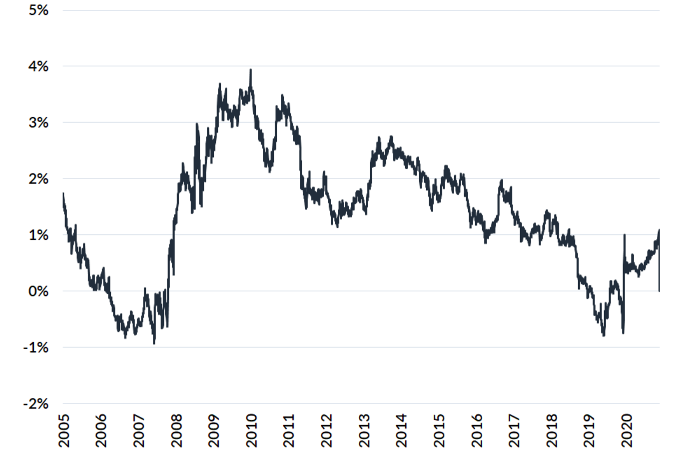


Source: Thomson Reuters, Forsyth Barr analysis

Figure 19. US treasury constant maturity 10-year real rate

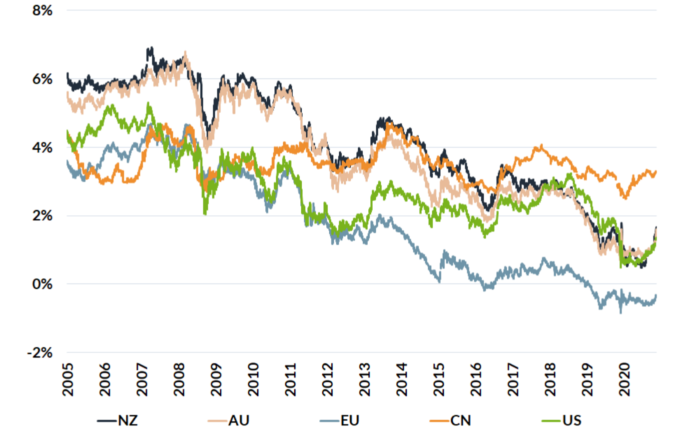
Source: Thomson Reuters, Forsyth Barr analysis

Figure 20. US 10Y govt. bond less Fed target rate



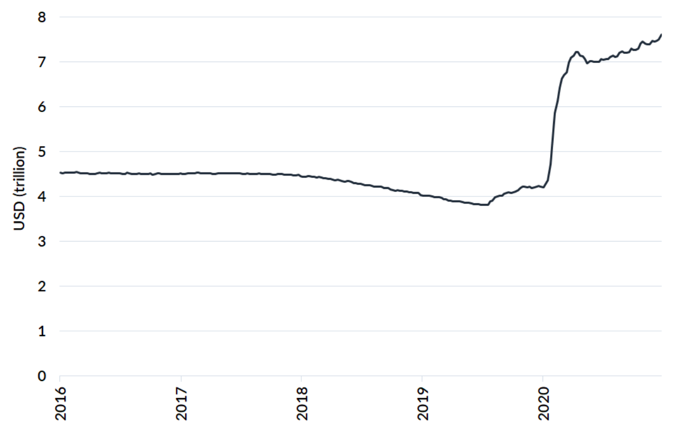
Source: Thomson Reuters, Forsyth Barr analysis

Figure 21. 10-year govt. bond yields



Source: Thomson Reuters, Forsyth Barr analysis

Figure 22. Fed balance sheet



Source: Thomson Reuters, Forsyth Barr analysis

Figure 23. RBNZ balance sheet

Source: Thomson Reuters, Forsyth Barr analysis

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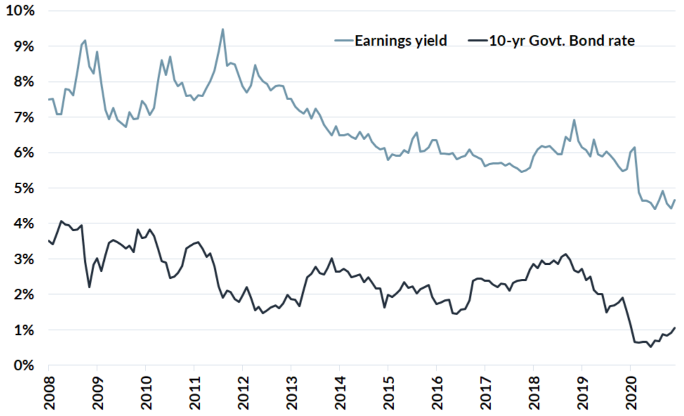
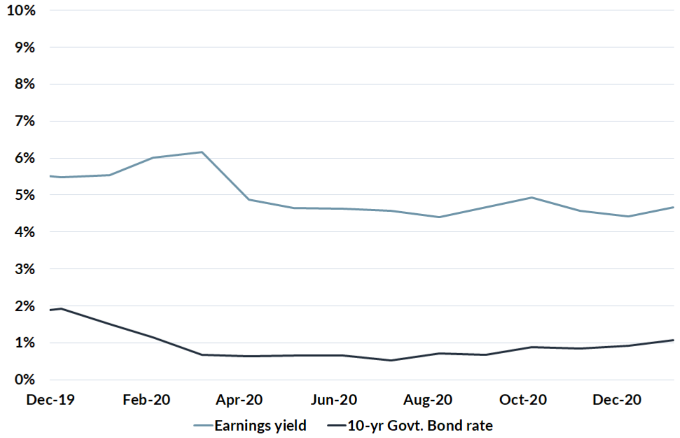
Figure 24. Earnings yield vs 10-year yield — United States



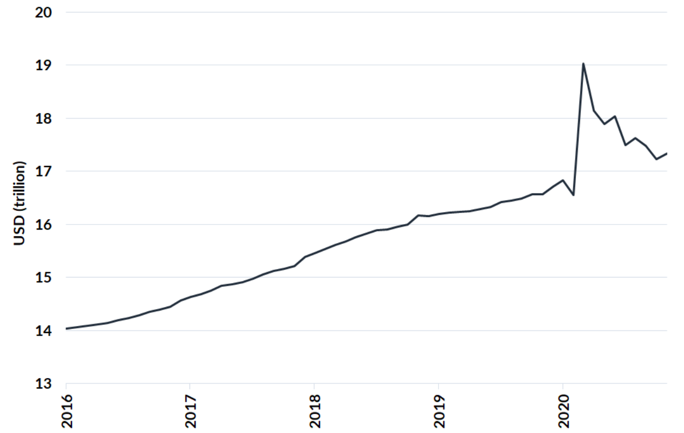
Source: Thomson Reuters, Forsyth Barr analysis

Figure 25. Earnings yield vs 10-year yield — United States



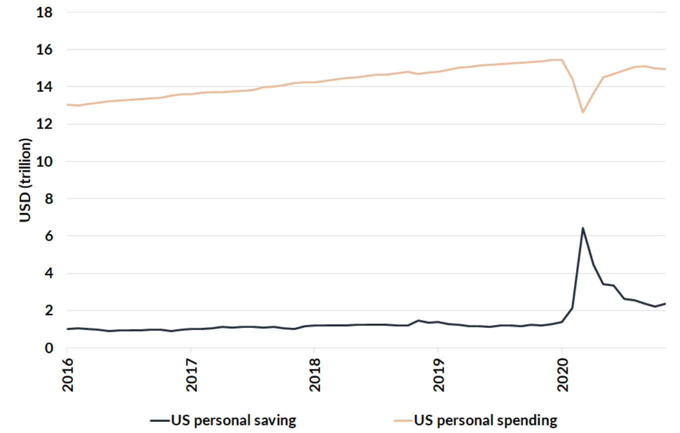
Source: Thomson Reuters, Forsyth Barr analysis

Figure 26. US disposable income



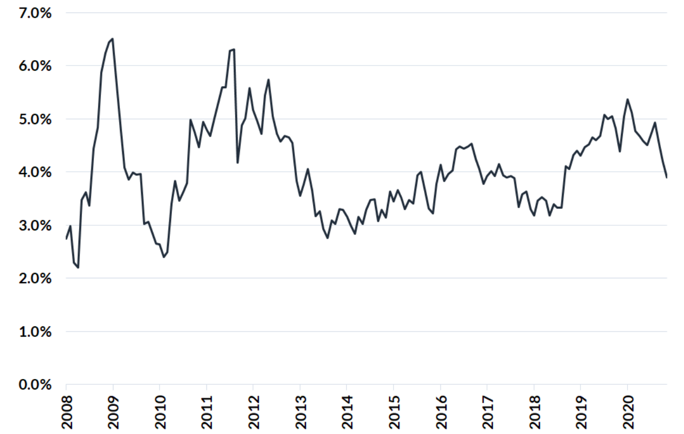
Source: Thomson Reuters, Forsyth Barr analysis

Figure 27. US personal spending vs saving



Source: Thomson Reuters, Forsyth Barr analysis

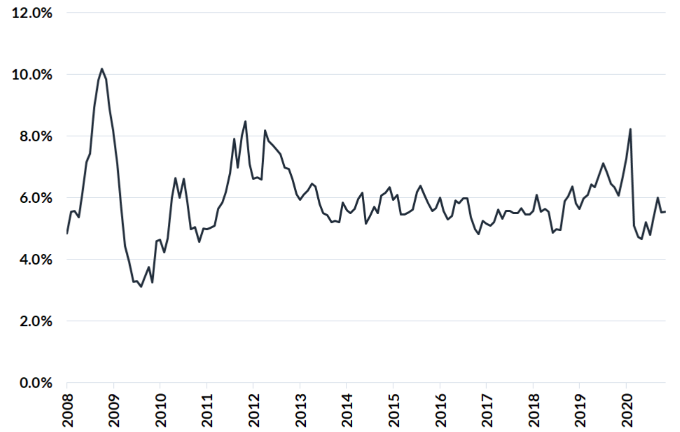
Figure 28. NZ - equity risk premium



Source: Thomson Reuters, Forsyth Barr analysis

ERP estimated as market weighted earnings yield less 10 year govt. bond

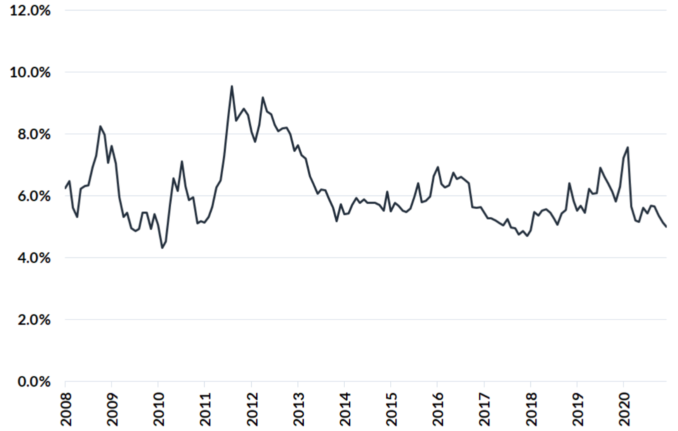
Figure 29. Australia - equity risk premium



Source: Thomson Reuters, Forsyth Barr analysis

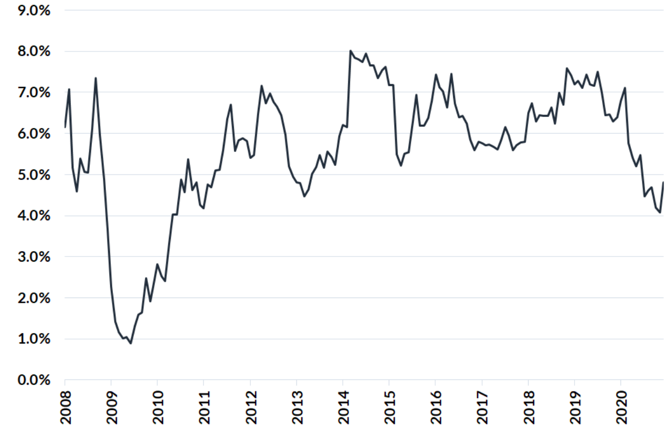
ERP estimated as market weighted earnings yield less 10 year govt. bond

Figure 30. United States - equity risk premium



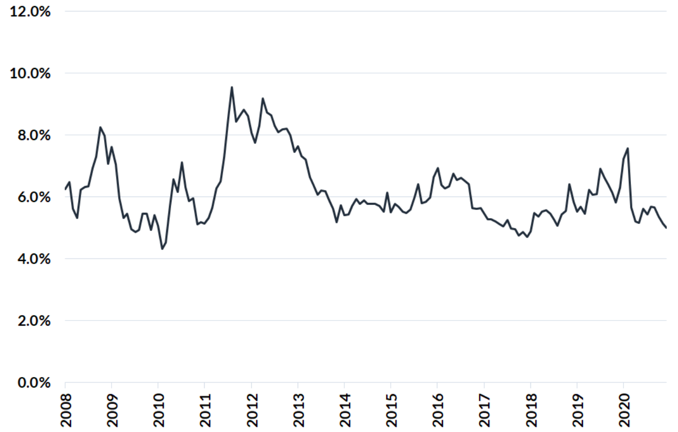
Source: Thomson Reuters, Forsyth Barr analysis
ERP estimated as market weighted earnings yield less 10 year govt. bond

Figure 31. Japan - equity risk premium



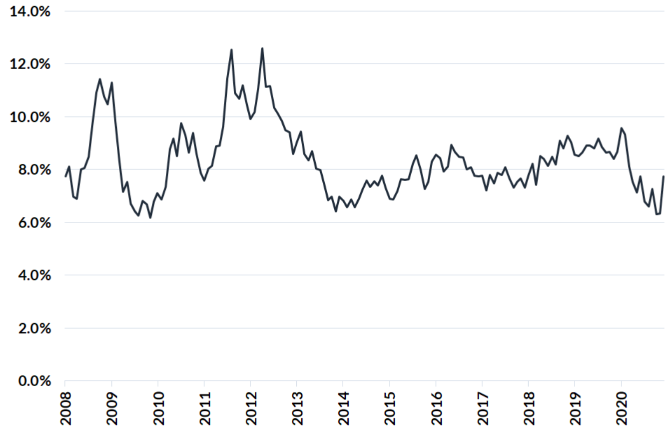
Source: Thomson Reuters, Forsyth Barr analysis
ERP estimated as market weighted earnings yield less 10 year govt. bond

Figure 32. United Kingdom - equity risk premium



Source: Thomson Reuters, Forsyth Barr analysis
ERP estimated as market weighted earnings yield less 10 year govt. bond

Figure 33. Europe - equity risk premium



Source: Thomson Reuters, Forsyth Barr analysis
ERP estimated as market weighted earnings yield less 10 year govt. bond

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