Pre Select commentaries

Quarter ended 30 September 2020

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Economic and market commentary

Asset class summary: 30 September 2020

	CYTD Sep 2020	1 Month to Sep 2020	3 Month to Sep 2020	1 year to Sep 2020 % p.a.	3 years to Sep 2020 % p.a.	5 years to Sep 2020 % p.a.	10 years to Sep 2020 % p.a.	FYTD Sep 2020 % p.a.
Australian shares	-10.8%	-3.7%	-0.4%	-10.2%	4.8%	7.3%	6.9%	-0.4%
Global shares (hedged)	-1.1%	-2.8%	6.5%	6.3%	6.4%	10.0%	10.7%	6.5%
Global shares (unhedged)	-0.6%	-0.1%	3.9%	3.9%	10.4%	9.9%	11.9%	3.9%
Emerging markets (unhedged)	-3.1%	1.5%	5.2%	4.0%	5.6%	8.5%	5.6%	5.2%
Australian property securities	-15.2%	-1.1%	7.4%	-15.8%	4.1%	6.0%	9.7%	7.4%
Global property securities (hedged)	-22.0%	-2.6%	0.6%	-21.5%	-2.0%	1.8%	6.8%	0.6%
Australian bonds	4.6%	1.1%	1.0%	3.2%	6.0%	4.5%	5.6%	1.0%
Global bonds (hedged)	4.3%	0.4%	0.7%	3.5%	4.7%	4.5%	5.7%	0.7%
Global high yield bonds (hedged)	-1.4%	1.2%	4.4%	0.2%	2.5%	0.0%	0.0%	4.4%
Australian Inflation-linked bonds	2.5%	0.0%	1.8%	2.3%	4.1%	2.9%	4.5%	1.8%
Cash	0.3%	0.0%	0.0%	0.6%	1.4%	1.6%	2.6%	0.0%
AUD/USD	2.0%	-3.1%	4.1%	6.3%	-3.0%	0.4%	-3.0%	0.4%

Index data sources: Australian shares - S&P/ASX 200 Total Return Index; Global shares (hedged) - MSCI All Countries World (A$ hedged) ; Global shares (unhedged) - MSCI All Countries World; Emerging markets - MSCI Emerging Markets; Australian property securities - S&P/ASX 300 LPT Accumulation Index; Global property securities - FTSE EPRA/NAREIT Developed (A$ hedged); Australian bonds - Bloomberg AusBond Composite 0+ Yr Index; Global bonds (A$ hedged) - BCGA Global Agg (A$ hedged); Global high yield bonds (A$ hedged) - Composite of BCGA US Corp HY BB/B (A$ hedged) & S&P LSTA BB/B Leveraged Loan Index; Australian inflation-linked bonds - Bloomberg AusBond Inflation Government 0+ Yr Index; Cash - Bloomberg AusBond Bank Bill Index, WM/Reuters Daily (4 pm GMT).

Global

Global shares (unhedged) continued their recovery with a strong 3.9% return in the three months to September 2020. Wall Street surged to record highs in early September given vaccine hopes as well as assertive fiscal and monetary stimulus.

However, these share gains were restrained by September's correction as well as a rising Australian dollar. Various factors weighed on global shares during September. Firstly and primarily, the virus remains a troubling global threat with new infection cases rising towards 300,000 per day. Secondly, political risk is becoming more prominent. The US Presidential election as well as US-China tension over human rights and technology were key concerns during September.

Emerging market shares (unhedged) delivered a very strong 5.2% gain for the quarter. This encouraging recovery was led by China's share market with a 12% gain. China's assertive stimulus measures and the strong revival in industrial production have been key positives for the global financial markets and commodity prices.

Global bonds (hedged) delivered a 0.7% return for the quarter. Government bond yields were essentially stable as investors willingly financed the larger stimulus packages.

Global high yield bonds (hedged) made a strong gain of 4.4% for the quarter. Credit spreads have narrowed given improving risk appetites.

Australia

Australian shares had a disappointing quarter with a -0.4% return. The Energy sector was the weakest link with a -14.1% return given weak oil prices. Financial sector shares (-6.2%) also disappointed with concerns over rising doubtful debts as the 'Jobkeeper' and 'loan repayment deferral' programs are set to be tapered. However, there were some bright spots. The Information Technology sector (+12.6%) benefited from Wall Street's surge. Consumer Discretionary (8.7%) also positively surprised given hopes for a post-virus recovery.

Australia's economy has proven acutely vulnerable to the virus. Australia's economy contracted by 7% in the June quarter. This is the largest decline since data started in 1959. There was further bad news with retail spending falling 4% in August given Melbourne's virus lockdown. Yet there were some promising signs. The recent revival in employment continued with August recording solid job gains and the unemployment rate edging down from 7.5% to 6.8%. Both business surveys and consumer sentiment have also rebounded which is suggestive that an economic recovery has started.

Looking forward…

There are some early encouraging signs that the global economy can recover. Central banks and governments have assertively responded with stimulus measures. These measures include interest rate cuts, business loan guarantees and funding measures for banks. Governments have also responded with wage subsidies to mitigate the immediate downside risks to the global economy. However, the coronavirus threat needs to be contained before a sustainable turning point is achievable.

Investment insights

Prepare for reflation. Yes, you read that right.

It's difficult to imagine now, but there was a time when double-digit inflation gripped the world. Major blame was assigned to the 1973 oil shock for injecting inflation into the economic bloodstream. However, it wasn't the sole culprit. Economists also identify easy monetary policies from central banks to support governments' deficit spending as an important contributor.

In 1980, following years of rising prices with the Consumer Price Index (CPI) hitting a now unfathomable 15%, the US Federal Reserve, led by Chairman Paul Volcker, aggressively fought back by increasing the prime cash rate to 20% by the middle of 1981. Doing so effectively broke the back of US inflation.

Volker's success became the model for central bankers globally, setting in train a trend amongst central banks to manage their economies to inflation targets. Any time inflation was even looking like getting up, central banks would increase interest rates to stomp on it.

In the decades that followed, investors, economists and policymakers have continued to look out for hints of resurgent inflation. But as data has shown, inflation has become 'the dog that didn't bark'.

Deflation trend ending?

Having kept inflation in the cellar for so long, central banks have, since the GFC, unsuccessfully tried to lift the inflation pulse with ultra-low interest rates and quantitative easing.[1] Despite their best efforts, undershoots of inflation targets have become common place. Now, though, there are reasons to think that the deflationary trend may be weakening, or even ending.

The supply of low-cost emerging markets' labour has been a key driver of lower wages and prices. There's been an about-turn in recent years as wages have been rising in these countries, particularly in Asia. The pandemic has also highlighted many companies' and countries' vulnerability to global supply chains.

In response, companies are now looking to bring production closer to home, including on-shoring. Governments are under pressure to ensure security of supply of essentials, such as medical equipment and pharmaceuticals. In other words, we may be transitioning from lowest-cost, 'just in time' production to relatively higher-cost, 'just in case' production. This type of de-globalisation will result in higher wages and prices.

Use inflation to deal with government debt

Countering the economic impact of the COVID-19 pandemic with much-needed support programs has greatly increased government debt and this is raising worry about passing massive liabilities to future generations and crimping their living standards. Still, governments are going to have to remain spenders of first resort until normal social and economic life returns.

How to manage ballooning public debt is occupying policy makers' minds. One solution is to inflate the debt away. If governments can keep inflation higher than interest rates, then all else being equal the 'inflated' taxation revenue pays down the debt faster, essentially inflating the debt away.

All of this adds to our view that global economic trends coupled with the evolution of government and central bank policy towards reflation makes it highly unlikely that real interest rates can rise meaningfully from here. To be clear, 'higher inflation' doesn't have to mean horrendous 1970s type inflation, just inflation that's above current unusually low expectations.

Investment implications

With the above in mind, we are increasingly seeking exposure to a diverse set of assets that offer some degree of inflation protection at a reasonable cost. Gold has a strong relationship to inflation, but is expensive to own outright, at least relative to its own history.

While an elevated gold price does not preclude us from owning the precious metal, it does force us to hedge against a falling gold price. The portfolios have accrued meaningful gains from holding gold over the past several years. By protecting the portfolios from losses while the gold price remains elevated we're able to preserve profits the portfolios have already made, while maintaining exposure to further upward price movements.

While gold can be an expensive inflation hedge, cyclical stocks that rely heavily on economic growth and commodities currently offer cheaper ways of benefiting the portfolios from a reflation scenario. We are very mindful of the potential downside for cyclicals and as such are researching efficient ways of marrying downside protection to strategies that we think fit a 'participate and protect' approach. Emerging markets and miners are examples of sectors where this type of approach makes sense, and we continue to research other investments with similar properties. Chinese government debt is another area that we believe helps the strategies at this point, particularly from interest rate advantage and currency viewpoints.

Portfolio positioning

There were no major changes to the Pre Select funds' positioning during the September 2020 quarter.

[1] Quantitative easing, or QE as it's better known, is a policy in which central banks like the Reserve Bank of Australia, the US Federal Reserve, and the Bank of England, buy financial assets, such as government bonds from the open market to encourage lending and investment.

On the other hand, there was activity in the Inflation Plus portfolios, which Pre Select funds inherit through Inflation Plus.

The changes to the MLC Inflation Plus portfolios included:

- Adding a 'participate and protect' exposure to emerging market shares allowing the portfolio to participate in the first 15% of market rises while limiting capital losses.
- We took advantage of the strong gold price to take profits and restructure downside protection.
- Established a position in Chinese government debt with exposure to the Chinese yuan. The bonds are a source of higher interest rates, and the yuan exposure helps diversify the currency composition of Inflation Plus.

In summary, a prudent approach to building inflation hedges into our multi-asset portfolios is well warranted at this point in time, but attention must be paid to the consequence of further bouts of disinflation or deflation. Rather than betting on reflation by simply buying expensive assets that are linked to inflation and hoping we're right, at MLC we prefer to invest time to identify exposures that are likely to react positively to a reflationary environment but are not as sensitive to a continuation of what is now a very long period of falling and low inflation rates. This obviously brings with it a series of trade-offs that limit the reward of being 'right', but at the same time reduce the consequence of being wrong. Given that it's impossible to have perfect foresight, and that we are ultimately risk managers not gamblers, we believe this is the right way to invest in these highly unusual times.

Contributors to performance

Pre Select Conservative Fund

The Fund increased in value by 0.7% for the quarter (before fees and tax). Strong returns have offset some of the March quarter's falls so the fund is down only 2.6% for the year to 30 September 2020.

Key contributors to performance for the quarter ended 30 September 2020 are:

- Australian property securities delivered a very strong return of 8% in the quarter as the sector continues to recover following a massive decline in the March quarter, the sector's worst quarterly performance on record. The positive September quarter return was recorded despite a challenging reporting season. There was a wide dispersion in reported earnings growth as many Australian Real Estate Investment Trust (A-REITs) have experienced disrupted income streams due to the financial difficulties of some tenants, especially in retail.
- The global shares strategy delivered a solid return in the September quarter of 2.5%. While Wall Street surged to record highs in early September given vaccine hopes, various factors weighed on global shares later in September. Firstly, and primarily, the virus remains a troubling global threat with new infection cases rising again. Secondly, political risk is becoming more prominent, in particular the US Presidential election. Global share markets continue to be narrowly led, with those companies delivering on earnings growth being handsomely rewarded, while those stocks with any economic sensitivity are being punished.
- The fixed income strategy delivered a positive return of 0.9%. Global government and corporate bonds have delivered solid returns over the past quarter. Assertive central bank bond buying and hopes for a virus vaccine has seen investors become more comfortable with credit risk. The revival in global share markets has also contributed to improving risk appetites. With the extraordinarily low levels of government bond yields across the developed world (most notably Germany and Japan which are below 0% for long maturities), we have tilted the strategy modestly towards credit assets where yields are higher and the interest rate risk (duration) is lower.

Note: Returns for the asset classes above are before fees and tax.

Pre Select Balanced Fund

The Fund increased in value by 1.2% for the quarter (before fees and tax). Strong returns have offset some of the March quarter's falls so the fund is down only 0.3% for the year to 30 September 2020.

Key contributors to performance for the quarter ended 30 September 2020 are:

- The global shares strategy (hedged to the Australian dollar) delivered a strong return in the September quarter of 4.8%. While Wall Street surged to record highs in early September given vaccine hopes, various factors weighed on global shares later in September. Firstly, and primarily, the virus remains a troubling global threat with new infection cases rising again. Secondly, political risk is becoming more prominent, in particular the US Presidential election. Global share markets continue to be narrowly led, with those companies delivering on earnings growth being handsomely rewarded, while those stocks with any economic sensitivity are being punished. Strength in the Australian dollar also added to this global shares strategy return because it's hedged to the Australian dollar.
- The global shares strategy (not hedged to the Australian dollar) also contributed with a 2.5% return. The return was lower than hedged global shares because the Australian dollar appreciated in value, as it tends to do when global share markets rise.
- The fixed income strategy delivered a positive return of 1.0%. Global government and corporate bonds have delivered solid returns over the past quarter. Assertive central bank bond buying and hopes for a virus vaccine has seen investors become more comfortable with credit risk. The revival in global share markets has also contributed to improving risk appetites. With the extraordinarily low levels of government bond yields across the developed world (most notably Germany and Japan which are below 0% for long maturities), we have tilted the strategy modestly towards credit assets where yields are higher and the interest rate risk (duration) is lower.

Note: Returns for the asset classes above are before fees and tax.

Pre Select Growth Fund

The Fund increased in value by 1.4% for the quarter (before fees and tax). Strong returns have offset some of the March quarter's falls so the fund is down only 1.8% for the year to 30 September 2020.

Key contributors to performance for the quarter ended 30 September 2020 are:

- The global shares strategy (hedged to the Australian dollar) delivered a strong return in the September quarter of 4.8%. While Wall Street surged to record highs in early September given vaccine hopes, various factors weighed on global shares later in September. Firstly, and primarily, the virus remains a troubling global threat with new infection cases rising again. Secondly, political risk is becoming more prominent, in particular the US Presidential election. Global share markets continue to be narrowly led, with those companies delivering on earnings growth being handsomely rewarded, while those stocks with any economic sensitivity are being punished. Strength in the Australian dollar also added to this global shares strategy return because it's hedged to the Australian dollar.
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Note: Returns for the asset classes above are before fees and tax.

Pre Select High Growth Fund

The Fund increased in value by 1.6% for the quarter (before fees and tax). Strong returns have offset some of the March quarter's falls so the fund is down only 2.5% for the year to 30 September 2020.

Key contributors to performance for the quarter ended 30 September 2020 are:

- The global shares strategy (hedged to the Australian dollar) delivered a strong return in the September quarter of 4.8%. While Wall Street surged to record highs in early September given vaccine hopes, various factors weighed on global shares later in September. Firstly, and primarily, the virus remains a troubling global threat with new infection cases rising again. Secondly, political risk is becoming more prominent, in particular the US Presidential election. Global share markets continue to be narrowly led, with those companies delivering on earnings growth being handsomely rewarded, while those stocks with any economic sensitivity are being punished. Strength in the Australian dollar also added to this global shares strategy return because it's hedged to the Australian dollar.
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Note: Returns for the asset classes above are before fees and tax.

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