Pre Select commentaries

Quarter ended 31 March 2021

Contents

Economic and market commentary

Asset class returns to 31 March 2021

	3 Month to	1 Year to % p.a.	3 Years to % p.a.	5 Years to % p.a.	10 Years to % p.a.	FYTD % p.a.
Australian shares	4.3%	37.5%	9.7%	10.2%	8.0%	18.0%
Global shares (hedged)	5.8%	48.5%	11.5%	12.9%	11.2%	26.4%
Global shares (unhedged)	5.9%	24.2%	12.3%	13.4%	12.5%	17.2%
Emerging markets (unhedged)	3.6%	27.3%	6.7%	12.3%	6.9%	21.3%
Australian property securities	-0.6%	45.4%	7.9%	6.0%	10.8%	20.9%
Global property securities (hedged)	7.3%	29.7%	4.4%	3.6%	7.7%	19.4%
Australian bonds	-3.2%	-1.8%	4.0%	3.5%	5.0%	-2.3%
Global bonds (hedged)	-2.5%	1.1%	3.8%	3.3%	5.5%	-1.1%
Global high yield bonds (hedged)	1.3%	19.0%	3.0%	4.6%	0.0%	8.6%
Australian Inflation-linked bonds	-0.8%	5.0%	3.7%	2.9%	4.4%	3.0%
Cash	0.0%	0.1%	1.1%	1.4%	2.3%	0.0%
AUD/USD	-1.3%	24.4%	-0.2%	-0.2%	-3.0%	1.0%

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 strong recovery with a 5.9% return in the three months to March 2021. Promising news on vaccines as well as supportive budget and monetary measures from governments and central banks were the key driver of share returns. These positive signals outweighed concerns on continued virus infection cases across the globe.

Wall Street surged to record highs with the S&P 500 Index making a 6.1% quarterly gain. While the 6 January riot in Washington was disturbing, investors drew comfort that Congress finally ratified the election results. US shares were also buoyed by the expectation that the new President would promote more fiscal spending measures. This was enhanced by President Biden announcing a US$1.9 trillion ‘rescue package’ and a US$2.25 trillion infrastructure program.

Global economic data releases also provided encouragement of better times ahead. Business surveys and employment gains were consistent with a global recovery continuing despite the virus threat.

European shares also made strong gains with the German DAX delivering 9.4% in local currency terms. Despite surging virus cases and activity restrictions being in place across the European continent, markets placed their hopes on the vaccines.

Emerging market shares (unhedged) delivered a strong 3.6% gain for the quarter. This surge was led by very strong gains for Taiwan (12.6%) and Thailand (8.8%). Assertive support measures from central banks and governments has seen emerging markets return to favour.

Global bonds (hedged) delivered a disappointing -2.5% return for the quarter. Government bond yields have risen sharply over recent months as investors have become more confident of a global economic recovery.

Global high yield bonds (hedged) made a positive gain of 1.3% for the quarter. Credit spreads have narrowed given improving risk appetites due to the gains in global share markets and more promising economic indicators.

Australia

Australian shares provided an encouraging 4.3% return for the past three months. Apart from the positive global vaccine news, further support from the Reserve Bank of Australia (RBA) was a tailwind to Australian shares. The RBA provided guidance that the cash interest rate is expected to remain steady at 0.1% until 2024.

Australia’s Financial sector delivered a robust gain of 12.2% with confidence that the economic recovery would reduce loan deferrals and revive credit growth. The Consumer Discretionary and Communication Services (8.8% respectively) sectors also benefitted. However both the Health Care (-2.3%) and Utilities (-1.8%) sectors disappointed given their sensitivity to rising long term bond yields.

Australia’s economy is showing optimistic signs that a strong recovery has started. The economy has experienced a welcome revival in jobs and working hours. Encouraging signs from business and consumer confidence surveys also suggests that a sustainable economic recovery has started.

Prospects…

The global economy is making a recovery although some countries are doing much better than others. Central banks and governments have assertively responded with extensive support measures including lower interest rates, asset purchases and wage subsidies. However, the coronavirus remains a major threat that needs to be contained. Vaccines need to be rapidly made available to ensure the ‘green shoots’ of this global recovery prosper in 2021.

Investment insights

An end to the long holiday from inflation?

The world has had a long holiday from inflation, but like any vacation, this one too must eventually end, with important bond and share market implications.

Complicating assessments of how bond markets may behave is the realisation that ‘price discovery’ – the process by which market prices adjust in response to information changes – has been absent from the bond market for some time.

Instead, bonds have traded on ‘forward guidance’ (where the US Federal Reserve (the Fed) charts what they believe, on *current* information, will be the path for future interest rates), and been heavily influenced by central bank intervention through Quantitative Easing (QE).[1]

[1] Quantitative easing (QE) is a form of unconventional monetary policy in which a central bank, such as the Reserve Bank of Australia or US Federal Reserve, purchases longer-term securities, such as government bonds, from the open market in order to increase the money supply and encourage lending and investment. QE has the effect of reducing interest rates (yields).

For the record, current Fed guidance is for no increase in official US interest rates until 2024. To be clear, 'guidance' doesn't equal a guarantee.

Nevertheless, all this has subdued price discovery and resulted in bond market instability. Unexpected changes in forward guidance (or dialling down QE) could have outsized impacts on bond prices as investors have been unable to work out the 'fair' price for bonds due to these interventions and policies.

This matters, as central banks are about to face-off against an uptick in inflation. What happens then?

Will higher inflation be transitory or persistent?

Annual US inflation, as measured by Consumer Price Index (CPI) movements, is poised to blow through the 2% mark; 2% typically being the level considered consistent with price stability. The pandemic caused an abrupt price decline last year as the global economy came to a halt. This created an artificially low base from which prices can rise as the vaccine rollout and government stimulus reignites activity.

Annual US inflation pushed through 2% in March 2021, and even if prices don't increase from March to April 2021, inflation for April 2021 will be 3.3%, all because of the base effect stemming from last year's price collapse.

Base effects, however, are not the only explanation for inflationary pressures. Supply constraints arising from the pandemic have seen shortages in certain sectors, resulting in price increases also. For example, there's a global shortage of microchips, which affects industries from autos to TVs.

No doubt, some shortages will be overcome as resources gradually come back online, and so some price increases will be transient in nature. However, some companies and industries will aim to address their supply vulnerabilities – perhaps by looking for suppliers closer to home – to avoid being caught out again and this will come at a cost. How much of this cost can be absorbed by companies in lower profit margins or passed on to customers as higher prices, will take time to assess. But these effects will not be temporary.

Another contributor to inflationary pressures has been the level of stimulus provided by governments putting money into people's pockets and increasing disposable incomes by doing so. It means that pent-up demand, as economies reopen, is chasing constrained supply in certain sectors, increasing prices. Again, these could be temporary but once a company has made the decision to put prices up, they tend to be reluctant to lower them again absent an economic shock. Price rises tend to be sticky.

What's ahead for the bond and share market?

Inflation is bad for bond prices as their interest payments become less valuable in an environment where prices are going up. In a normal functioning market with price discovery, we would expect bond prices to adjust lower to reflect the inflationary pressures.

Central banks, led by the Fed, are making reassuring statements that the rise in inflation will be temporary, and inflation will return to a comforting 2%. Based on current information, this may be a valid assessment. However, if the information changes so will investor views and potentially so might central bank actions.

The pending increase in reported US inflation, whether temporary or not, also has implications for shares. This can be done by unpacking what's happened in the US S&P 500 Index; overall earnings are down around 9% since last year yet share prices are up 35% over the same period! This has been made possible by the price-earnings (PE) multiple[2] expanding from 18 to 27 times.

The elevated PE multiple will be at risk if inflation increases. Our research suggests PE multiples are negatively impacted by rising inflation – any increase in inflation results in a decrease in PE multiples. To be clear, the research is not saying **inflation** is bad for shares, but it **is bad for PE multiples**.

Portfolio positioning

Our response in MLC's multi-asset portfolios has been to limit government bond exposure and instead seek protection against interest rate and inflation risk by preferring inflation-linked bonds. The defensive component of our portfolios' is

[2] The P/E multiple is the price of a share, divided by its earnings per share (EPS). It shows what kind of earnings growth investors may expect from a company.

also being strengthened by turning to gold and foreign currency, as well as volatility-related derivatives for managing potential market turbulence.

A deterioration in return potential for global shares prompted a decision to reduce exposures to this asset class in the Pre Select portfolios in favour of increasing exposure to emerging market shares. Valuations in emerging market shares are also relatively more attractive than their global developed market counterparts. The industry decomposition of the Emerging Markets Index, particularly with higher weights in Financials, Energy and Materials, has the potential to perform better in a reflationary, or rising inflation, environment.

There was activity in the Inflation Plus portfolios, which the Pre Select portfolios inherit through investments in Inflation Plus.

Consistent with our 'participate and protect' strategy, we introduced a protected US share market exposure. The structure allows for cheap participation in US share market rallies (up to a point) while avoiding exposure to falls beyond a lower bound. We also purchased a currency option to buy US dollars and sell Japanese yen to help protect the portfolios against the possibility of share markets falling at the same time as interest rates rise. The option allows us to sell Japanese yen exposure from the portfolios in this scenario, because it performs poorly.

Contributors to performance

Pre Select Conservative Fund

The Fund increased in value by 1.8% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 11.1% for the year to 31 March 2021.

Key contributors to performance for the quarter ended 31 March 2021 are:

- The global shares strategy delivered an exceptionally strong return in the March quarter of 8.9%. Global share markets were driven by positivity about the recovery from the COVID crisis. While there was an increase in COVID cases and a large number of countries, particularly in Europe, under lock-down conditions, an end to the pandemic is in sight with populations becoming increasingly vaccinated. The rotation from 'growth stocks' to 'value stocks' which began in November 2020 when the efficacy of the vaccines was first announced, continued in the March 2021 quarter. Our value managers have continued to participate in this rally strongly outperforming the share market.
- The global shares strategy, that's hedged to the Australian dollar, was also a key contributor, delivering what was also an exceptionally strong return of 8.5%. The return was lower than unhedged global shares because the Australian dollar declined relative to the US dollar and British pound sterling and increased relative to the euro, Japanese yen and trade weighted currencies. As a result, not being hedged to the Australian dollar was a small benefit for global share investors.
- Australian shares produced a strong return of 4.8% for the March quarter, due to a number of factors. The successful containment of the virus in Australia and commencement of the national vaccination program helped underpin confidence in the sustainability of the economic recovery. This optimism was supported by the release of good economic data including positive economic growth in the December quarter, improvement in the labour market and continued strength in housing activity. The share market was also encouraged by the February profit reporting period which exceeded expectations, resulting in generally higher company earnings forecasts. Our investment managers also outperformed the market by 0.6%.

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

Pre Select Balanced Fund

The Fund increased in value by 3.0% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 17.3% for the year to 31 March 2021.

Key contributors to performance for the quarter ended 31 March 2021 are:

- The global shares strategy delivered an exceptionally strong return in the March quarter of 8.9%. Global share markets were driven by positivity about the recovery from the COVID crisis. While there was an increase in COVID cases and a large number of countries, particularly in Europe, under lock-down conditions, an end to the pandemic is in sight with populations becoming increasingly vaccinated. The rotation from 'growth stocks' to 'value stocks' which began in November 2020 when the efficacy of the vaccines was first announced, continued in the March 2021 quarter. Our value managers have continued to participate in this rally strongly outperforming the share market.
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Pre Select Growth Fund

The Fund increased in value by 4.8% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 24.1% for the year to 31 March 2021.

Key contributors to performance for the quarter ended 31 March 2021 are:

- The global shares strategy delivered an exceptionally strong return in the March quarter of 8.9%. Global share markets were driven by positivity about the recovery from the COVID crisis. While there was an increase in COVID cases and a large number of countries, particularly in Europe, under lock-down conditions, an end to the pandemic is in sight with populations becoming increasingly vaccinated. The rotation from 'growth stocks' to 'value stocks' which began in November 2020 when the efficacy of the vaccines was first announced, continued in the March 2021 quarter. Our value managers have continued to participate in this rally strongly outperforming the share market.
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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 5.4% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 28.9% for the year to 31 March 2021.

Key contributors to performance for the quarter ended 31 March 2021 are:

- The global shares strategy delivered an exceptionally strong return in the March quarter of 8.9%. Global share markets were driven by positivity about the recovery from the COVID crisis. While there was an increase in COVID cases and a large number of countries, particularly in Europe, under lock-down conditions, an end to the pandemic is in sight with populations becoming increasingly vaccinated. The rotation from 'growth stocks' to 'value stocks' which began in November 2020 when the efficacy of the vaccines was first announced, continued in the March 2021 quarter. Our value managers have continued to participate in this rally strongly outperforming the share market.
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Note: Returns for the asset classes above are before fees and tax.