Invest for Reflation not Inflation

Jason Todd, Head of Investment Strategy

March 2021

MACQUARIE

The Private Bank

Outline

1. Team
2. Macro update
3. Manager selection
4. Stock selection

Wealth Investment Strategy team

Head of Investment Strategy
Jason Todd, CFA
23 years industry experience

M Com (Hons)

Global & US Equity Strategist JPMorgan & Morgan Stanley

Head of Australian Macroeconomics Macquarie Group

Investment Strategist
Leah Kelly, PhD
19 years industry experience

B. MathFin (Hons 1st)

Senior Portfolio Manager Multi-asset solutions CFSGAM, Portfolio Manager, Credit CFSGAM, Risk Analyst, Reserve Bank of Australia

Investment Strategist
Stephen Ross, CFA
26 years industry experience

B.Math (Distinction), GradDip Applied Finance and Investment

PM/Senior PM Equities at CFS, IAG and Northward Capital. Multi-asset portfolio solutions

Investment Strategist
Dean Dusanic
26 years industry experience

BEc (Actuarial Studies & Finance)

Strategist, UBS Securities Australia

Strategist, JPMorgan Securities Australia

Senior Research Analyst
Aaron Lewis, CFA
11 years industry experience

Research analyst Macquarie Wealth Management

Research Analyst
Sukeetha Sunil Raj
10 years industry experience

B.Com (Finance), B.Law

Portfolio Analyst, JP Morgan Australia

Research Analyst, Macquarie Private Wealth

Research Analyst
Shirley Huang
3 years industry experience

B. Com (Finance)

Macquarie Private Bank

Reflation will prevail and faster than expected….

The global reflation trade to be stronger than expected and will prevail despite concerns around COVID-19. 2021 remains a year of recovery.

Global policy support – both fiscal and monetary – remains set at extraordinary levels. Easy policy settings will underpin the economic recovery as social restrictions are gradually unwound.

The Australian economy is recovering…and more quickly than most expected. The outlook is positive both with economic growth set to rebound to >4.0% (from -2.7%).

Households with jobs are in very good shape. Savings are up, a lot supported by government programs and diminished spending options. Confidence is being supported by rising asset prices.

Fiscal & monetary policy support has been huge. Fears of fiscal cliff are overdone as supports have been reduced for some time. Monetary policy will remain "easy" for years to come.

Established housing is in a multi-year upswing, supported by very low interest rates, rising demand and (still) modest supply.

Risks to growth appear modest…permanent decline in migration, weaker commodity prices, a structural decline in growth, declining productivity and fiscal repair.

The rotation trade is not over…stay fully invested

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Reflation (alongside modest inflation) is positive for equities vis-à-vis bonds. We expect rising yields to drive elevated volatility as well as slow absolute gains for equity markets, but to drive rotation rather than capitulation of the equity trade. Stay underweight cash and overweight risk assets.

2020 (COVID-19) losers will become 2021 (re-opening) winners. Stronger growth and the removal of social restrictions will drive a rotation into under owned cyclical and financials and out of over owned high multiples stocks as the global earnings upgrade cycle gathers momentum. However, much of the valuation normalisation has already occurred.

A normalisation of inflation expectations coupled with rising fears of an inflation overshoot will see ongoing support for inflation hedges. Commodities have the benefit of the industrial cycle providing a strong tailwind to rising financial (investor) demand. Property and Gold are lower risk hedges than crypto currencies.

Emerging equities are on the cusp of a new upcycle with COVID-19 finally allowing policy makers to unshackle themselves from the fiscal and monetary policy restraint. A strong reflationary pulse alongside a weaker US$ and low rates has traditionally been a powerful cocktail of positives for EM's versus DM's.

Credit to outperform. Despite tight spreads, improving fundamentals are likely to drive further tightening through 2021. Remain underweight sovereign bonds.

Global Economics

A significant boost from US fiscal spending will underpin a global recovery. Inflation is normalizing.

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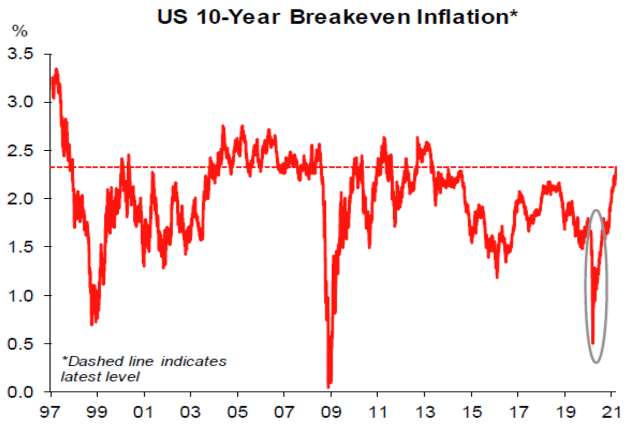
Global growth will normalise in 2021 – falling 3.7% in 2020 and rising 6.9% in 2021

Source: Macquarie Macro Strategy, March 2020

Vaccine delays should be minor in DM's but risks of shortages rising in EM's



Source: Macrobond, Macquarie Macro Strategy, March 2021

US Politics

Executive Orders are easy, passing Legislation is not….

President Biden's election policy proposals

Biden Policy Promises
Corporate tax hikes
Personal tax hikes (high income earners)
Rejoin the TPP and Paris Climate Accord
Build on Obamacare
100% clean energy by 2025
Anti-trust legislation
Financial transactions tax
$1.3tn Infrastructure plan
End family separation and protect DACA
Raise minimum wage to $15/hr

Source: BCA Research, February 2021

Top priorities as surveyed

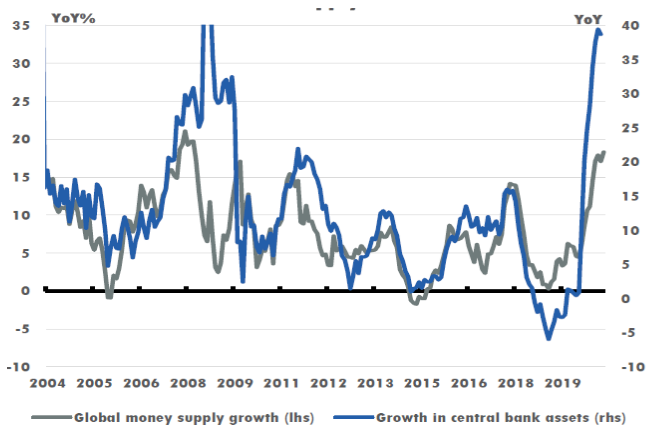
Top priorities for Biden and the new Congress		
Total Adults	Democrats	Republicans
1. Pass COVID-19 stimulus	3. Pass COVID-19 stimulus	1. Pass COVID-19 stimulus
4. Pass major economy-focused stimulus	4. Pass major economy-focused stimulus	2. Pass major economy-focused stimulus

Source: BCA Research, February 2021

Policy support will remain strong

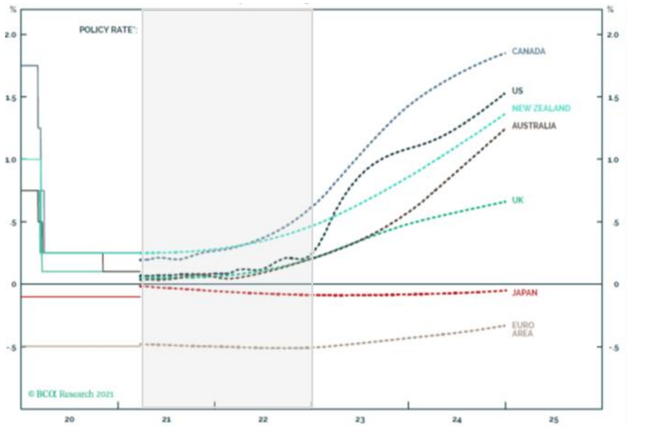
Despite inflation concerns, we don’t expect central banks to back away from higher stimulatory policy setting

Monetary and fiscal support will underpin the economic recovery across both EM’s and DM’s



Source: Yarra, February 2021

The market still has central banks on hold for the next few years



Source: BCA Research, March 2021

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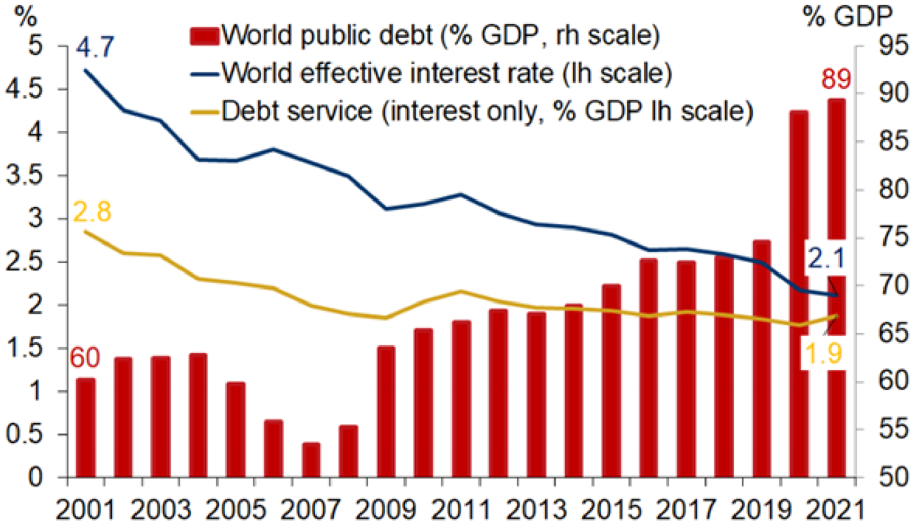
High debt … big problem?

Global debt levels have exploded due to policy supports. Its likely that most governments can stabilize and service debt at 2021/22 levels

Global debt levels have exploded but interest costs continue to decline



Note: the effective interest rate is based on actual interest payments paid as a ratio of debt. So if 10% of the debt stock were refinanced each year with 10-year bonds, it would take 10 years to feed-through fully into the effective rate.
Source : Oxford Economics/Haver Analytics

Source: Oxford Economics, February 2021

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Australia…Its great to be an Island

Growth is set to recover much faster than prior recessions

Global GDP forecast to make a sharp recovery

Source: ABS, Macquarie Macro Strategy, February 2021

…with the Australian economy also on the rebound

Source: ABS, Macquarie Macro Strategy, March 2021

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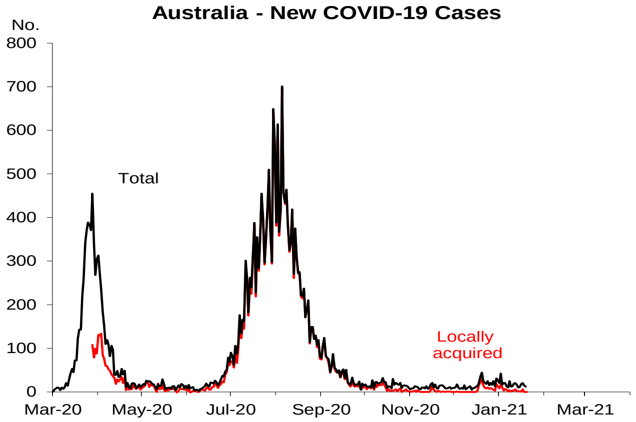
COVID-19 controlled

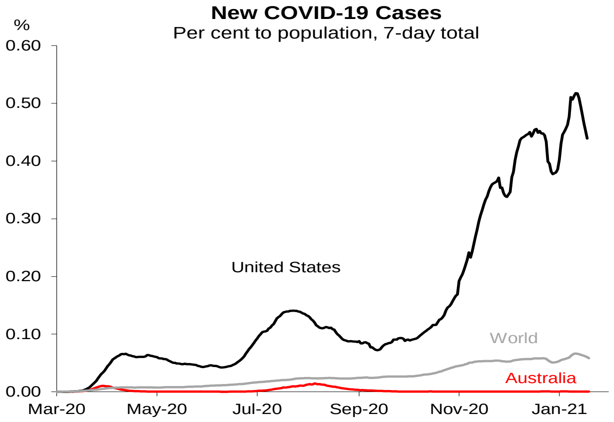
Australia's relatively good economic performance is *somewhat* tied to better outcomes on COVID-19

Australia has been successful in containing the virus



Source: covid19data.com.au, worldometers.info, Macquarie Macro Strategy, February 2021

…compared to the rest of the world



Source: covid19data.com.au, worldometers.info, Macquarie Macro Strategy, February 2021

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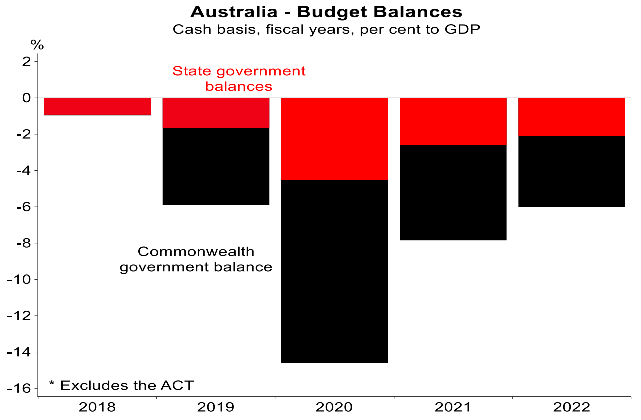
Source: covid19data.com.au, Macrobond, worldometers.info, Macquarie

Policy supports are huge

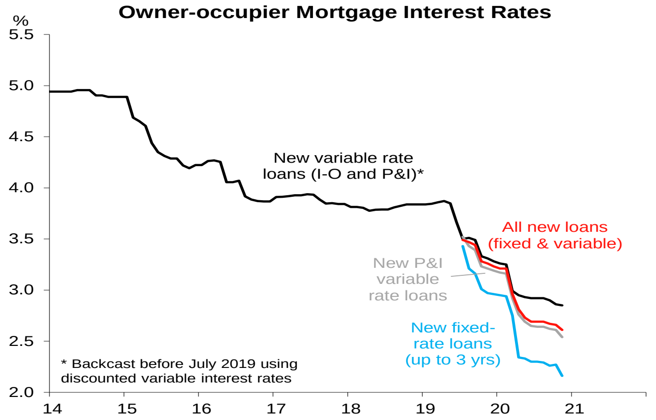
HUGE policy response has helped: fiscal + monetary policy easing; early super access; loan repayment deferrals; bankruptcy changes…

Size of policy response has been unprecedented



Source: RBA, Treasury, Macquarie Macro Strategy, February 2021

Home owners are also benefitting from low rates



Source: RBA, Macquarie Macro Strategy, February 2021

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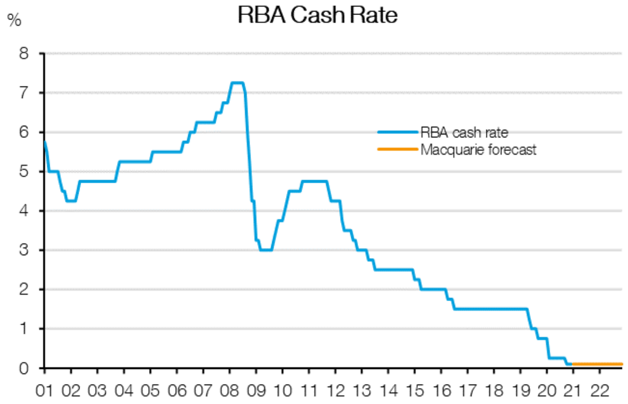
RBA to remain on hold for years

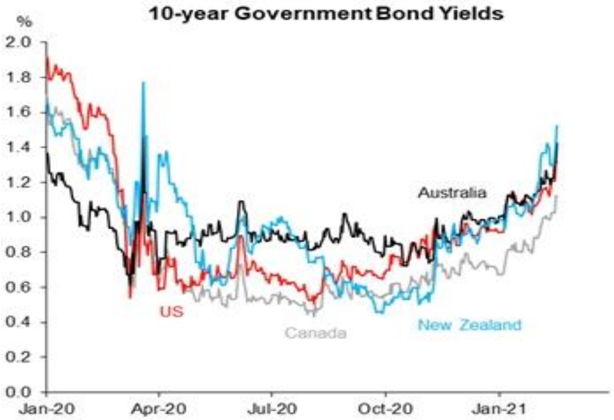
The RBA is committed to low rates for years to come. While long rates are rising, the short end is anchored

RBA to keep cash rate flat out through 2024



Source: Macrobond, Macquarie Macro Strategy, February 2021

Long rates will gradually creep higher but will not undermine the recovery



Source: Macrobond, Macquarie Macro Strategy, February 2021

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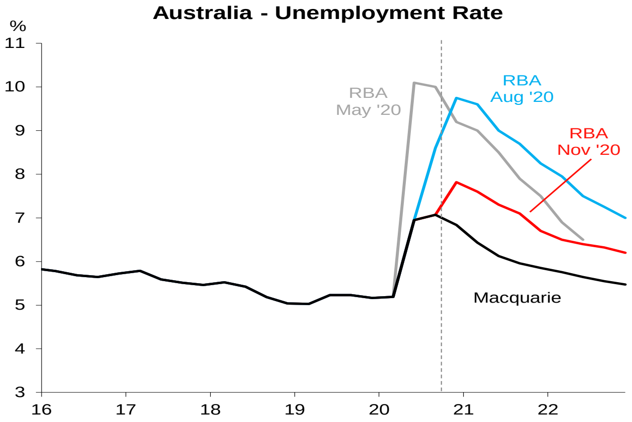
Spare capacity to linger

The economy is recovering but is likely to operate with ample spare capacity for the next couple of years

Australian GDP and employment on the uptick

Source: ABS, RBA, Macquarie Macro Strategy, February 2021

…but unemployment is expected to linger



Source: ABS, RBA, Macquarie Macro Strategy, February 2021

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No fiscal cliff coming

The economy will experience some difficulties when policy supports are removed, but they should be relatively small

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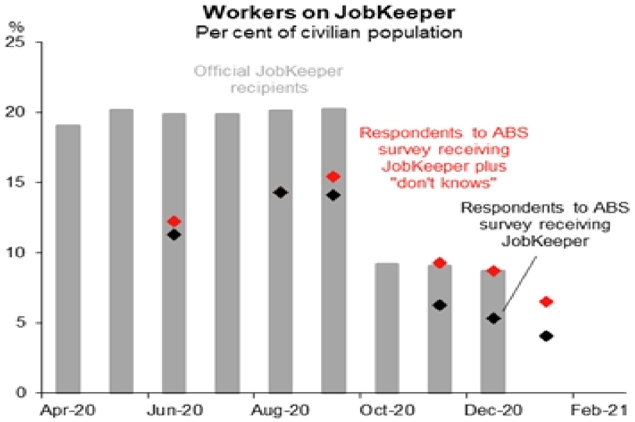
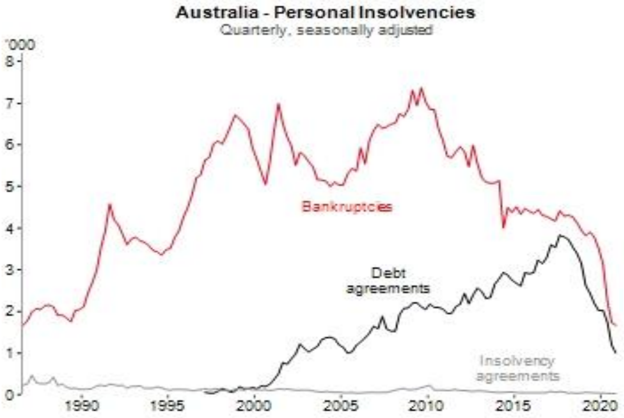
Job Keeper supports have fallen significantly in recent months



Source: ABS, Treasury, Macquarie Macro Strategy, February 2021

This is not a “normal” recession

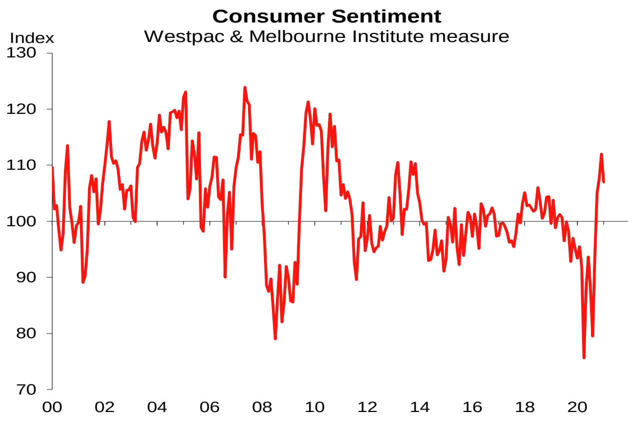


Source: AFSA, Macrobond, Macquarie Macro Strategy, February 2021

Confidence surprisingly strong

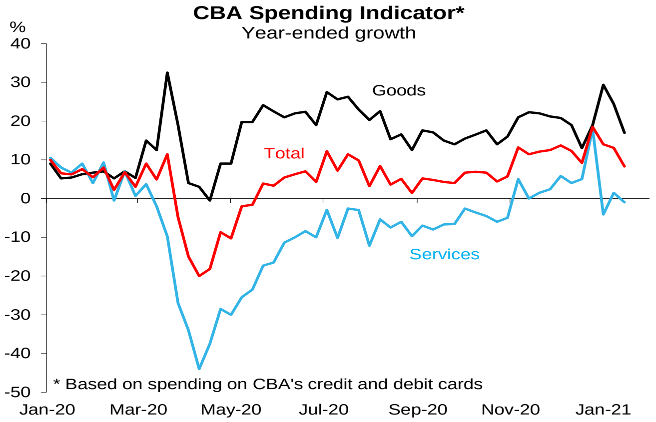
…with consumer and business confidence improving and spending growth remaining very solid

Consumer sentiment has recovered strongly and remains resilient



Source: CBA, Westpac & Melbourne Institute, Macquarie Macro Strategy, February 2021

Services spending will pick up as social restrictions are removed



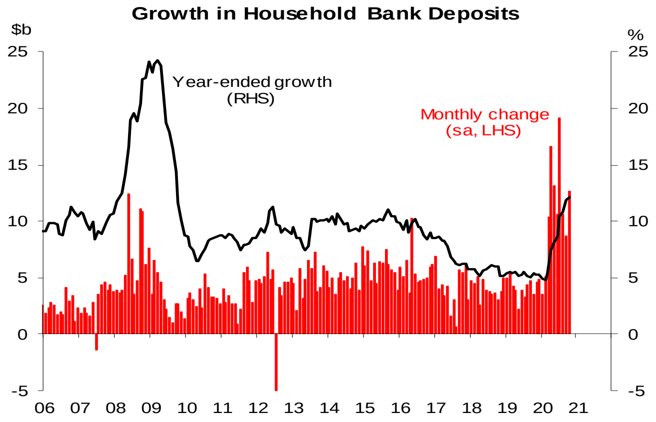
Source: CBA, Westpac & Melbourne Institute, Macquarie Macro Strategy, February 2021

Source: CBA, Westpac & Melbourne Institute, Macquarie

Households are cashed up

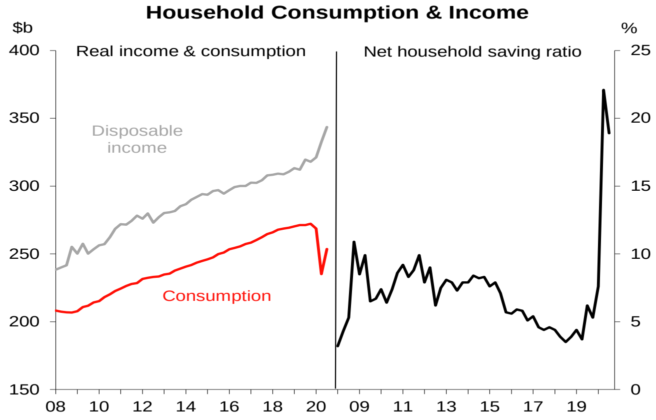
Importantly, households (in aggregate) are sitting on a lot of cash as they saved a lot more (plus super withdrawals)

Household savings have increased dramatically



Source: ABS, APRA, Macquarie Macro Strategy, February 2021

…as income supports have risen and consumption has slowed

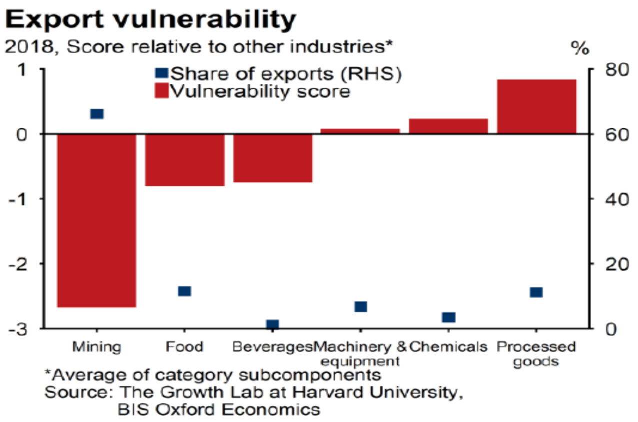


Source: ABS, APRA, Macquarie Macro Strategy, February 2021

Trade tensions remain

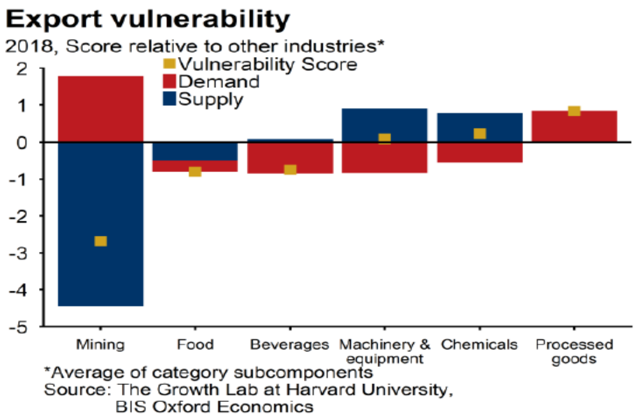
Trade tensions with China will now disappear. To date they are apply to minor industry but the risk is that this does broaden out

Mining and major industries are more invulnerable to trade tensions



Source: Oxford Economics, February 2021

…with demand supporting supplies



Source: Oxford Economics, February 2021

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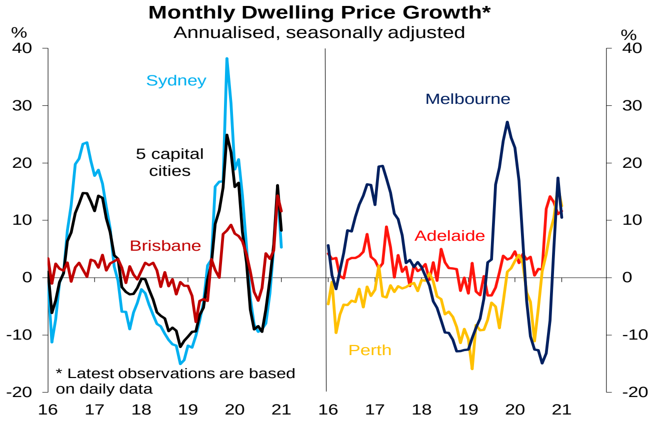
Housing is an area of strength

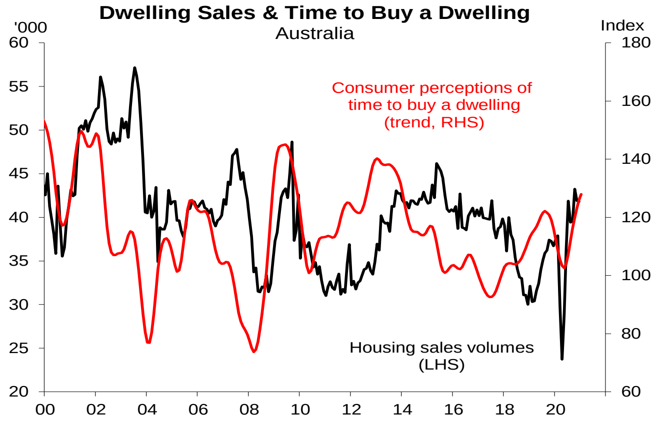
Housing prices are now growing strongly and established sales volumes have picked up…

Monthly dwelling prices are again growing



Source: CoreLogic, Macquarie Macro Strategy, February 2021

…as are housing sales volumes time to buy perceptions



Source: CoreLogic, Macquarie Macro Strategy, February 2021

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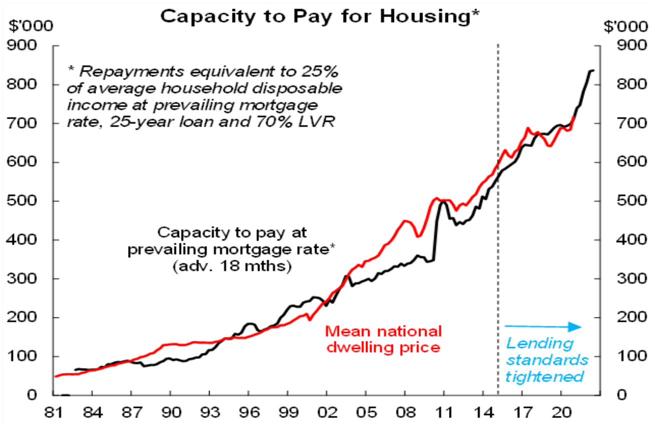
20% house price growth

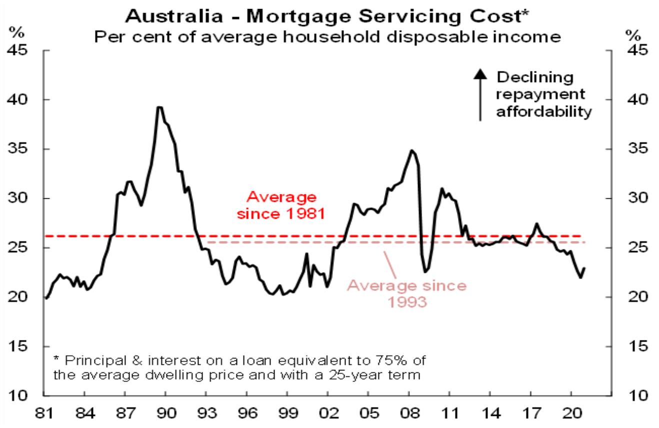
Easy and cheap credit, pent up demand and limited supply will underpin a broad housing recovery

Low mortgage rates are boosting the ability to pay for housing



Source: ABS, CoreLogic, Macquarie Macro Strategy, February 2021

Mortgage rates are at all time lows



Source: ABS, CoreLogic, Macquarie Macro Strategy, February 2021

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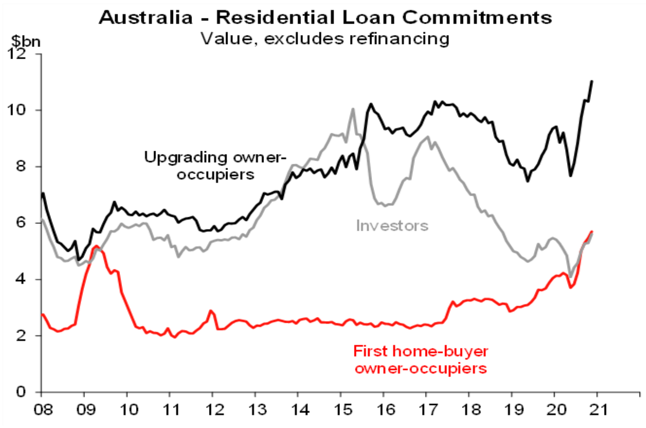
Loan demand is strong

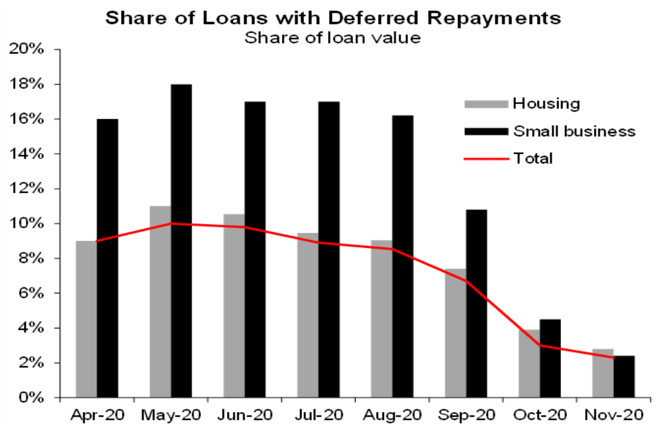
Low rates and FOMO is driving a strong rebound in credit demand. Investor demand will follow

Loan commitments have recovered to new highs



Source: CoreLogic, Macquarie Macro Strategy, February 2021

Deferred loans have fallen dramatically



Source: APRA, Macquarie Macro Strategy, February 2021

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Australian Economic Forecasts

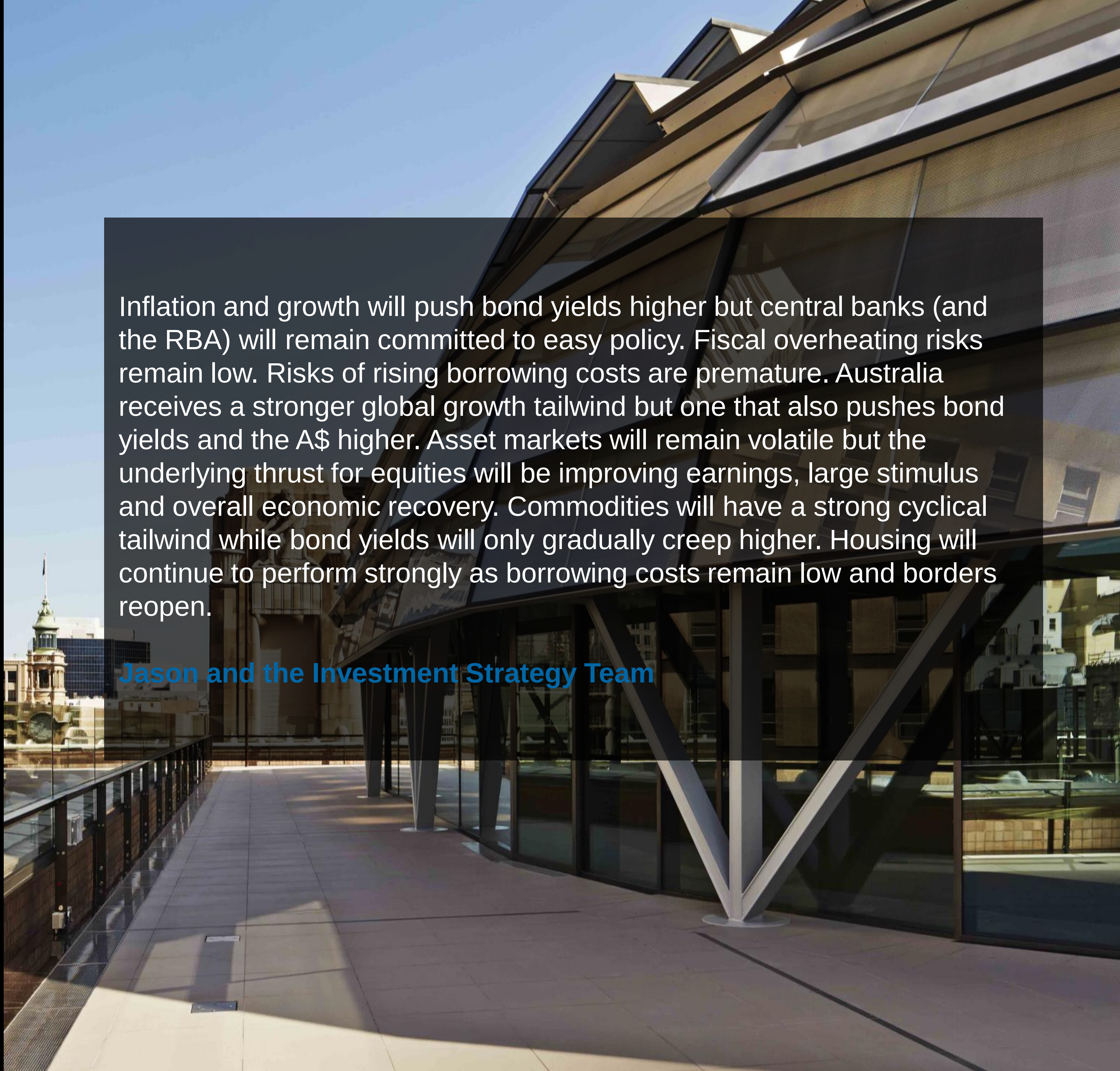
		Quarterly										Annual*			
		Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	2019	2020	2021	2022
GDP	q/q	3.3	2.2	1.3	1.0	0.9	0.8	0.6	0.5	0.5	0.5				
	y/y	(3.8)	(2.1)	(0.6)	7.9	5.4	4.0	3.4	2.9	2.5	2.2	1.9	(2.7)	4.1	2.7
CPI	y/y	0.7	0.5	0.5	2.8	1.6	1.5	1.6	1.6	1.7	1.7	1.6	0.8	1.6	1.6
Core CPI**	q/q	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4				
	y/y	1.2	1.1	0.9	1.3	1.2	1.4	1.5	1.6	1.7	1.7	1.4	1.3	1.2	1.6
A$/US$		0.72	0.74	0.75	0.76	0.77	0.75	0.74	0.76	0.76	0.76	0.70	0.74	0.75	0.76
Policy rate	%	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.75	0.10	0.10	0.10
3-yr yield	%	0.16	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.90	0.10	0.10	0.10
10-yr yield	%	0.79	0.95	1.10	1.50	1.80	1.90	1.90	1.90	1.90	1.90	1.37	0.95	1.90	1.90

* Year-average terms for GDP and CPI and year-end for FX and rates ** Average of trimmed mean and weighted median
Source: ABS, Bloomberg, RBA, Macquarie Macro Strategy

Source: Macquarie Macro Strategy, January 2021

How do you invest against this backdrop?

We are overweight Australian equities and global equities. We are neutral REITs. We are underweight fixed income and cash. We are maximum overweight Alternatives.



Inflation and growth will push bond yields higher but central banks (and the RBA) will remain committed to easy policy. Fiscal overheating risks remain low. Risks of rising borrowing costs are premature. Australia receives a stronger global growth tailwind but one that also pushes bond yields and the A$ higher. Asset markets will remain volatile but the underlying thrust for equities will be improving earnings, large stimulus and overall economic recovery. Commodities will have a strong cyclical tailwind while bond yields will only gradually creep higher. Housing will continue to perform strongly as borrowing costs remain low and borders reopen.

Jason and the Investment Strategy Team

Asset class preference

We are maximum overweight Alternative assets. We are overweight Australian and global equities. We are neutral property. We are underweight fixed income and cash.

Recommendation | Quick takeaway

Underweight ⟷ Overweight

Asset Class	Monthly Change	1	2	3	4	5	Comment
Equities					■		Equities are supported by monetary and fiscal stimulus, vaccine progress, an improving cyclical outlook and strong earnings momentum. Equities are the asset class most leveraged to the global recovery with value and cyclical stocks likely to continue recent outperformance. We expect equities to remain volatile but will ultimately trend higher as confidence builds in the recovery.
Fixed Income			■				We expect bond yields will trade in broad trading range although believe there is upside risk. Credit markets will be supported by the reflationary backdrop and the hunt for yield which will see spreads continue to narrow across all markets and sectors. Our preference is for credit (investment grade, high yield and EM) over DM sovereign bonds.
Property				■			Recent developments around a global vaccine in combination with the reopening of the Australian economy and where the sector is now trading suggest downside is limited and that the sector should gradually perform in line with an improving cyclical outlook. We expect REITs to outperform bonds, but to underperform equities, which offer more cyclical earnings and valuation upside.
Alternatives						■	We believe Alternatives deliver portfolio benefits including diversification, consistent income and alpha. We see multi and macro strategies that can enhance investment returns while offering downside protection against public market volatility and negative tail risks.
Cash		■					We will use cash to fund our pro-cyclical asset allocation.

Asset class preferences

Equity Market Preferences

Equities

Australia	Australian equities are benefiting from a solid domestic recovery, positive earnings revisions and the global shift to value and cyclical stocks. February was the best reporting season in a decade, paving the way for dividends to recover through the year. We do not see higher yields as threatening the equities rally, but portfolios may need to be rebalanced as value continues to outperform
US	The US continues to lead the global earnings recovery with ongoing strength from the technology sector as well as an improving outlook for cyclicals. A stronger fiscal impulse will be positive for US cyclicals while an accelerated vaccine rollout should see restrictions eased ahead of other regions. We continue to like the blend of high-quality growth companies alongside more cyclical exposures US equities provide.
Europe	Europe's economic and earnings recovery is set to lag the US, the vaccine rollout will be slower (ex-UK) and fiscal stimulus will be far less accommodative. However, Europe is leveraged to improving global trade, a steeper yield curve (banks) and the value rotation with the region trading on only 16.5x earnings.
Japan	Japanese equities are benefiting from improving global trade with large weights to industrials and autos. However, Japan's earnings recovery is significantly lagging other regions while trading at a premium to Europe.
Emerging Markets	EM equities will benefit from the stronger US fiscal impulse, weaker US dollar, higher commodity prices, improving global growth and undemanding valuations. The market's embrace of cyclical stocks will be positive for EM flows with a Biden presidency to provide a more stable approach to foreign policy.

Global Fixed Income Preferences

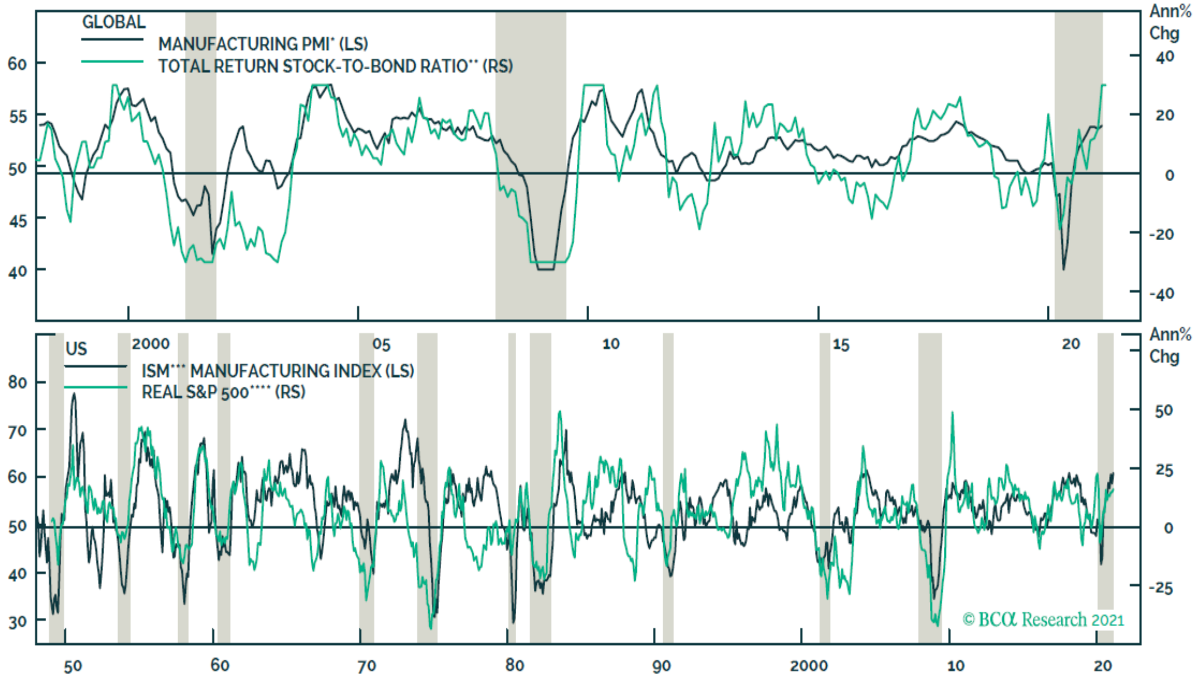
Fixed Income

Government Bonds	
Australia	We expect domestic sovereign bond yields to remain in a broad trading range. The RBA will continue its QE program which will likely see heightened volatility in long end yields as bond markets test the committment of the Central Bank.
Developed Market	Yields are expected to remain in a broad tradaing range for the next 6-12 months. Central Banks globally have reiterated their commitment to ultra-accommodative policy and inflation is likely to continue to undershoot CB targets for the short to medium term.
Global Credit Spread	
Investment Grade	We think it is increasingly likely IG credit spreads will test historical lows. We believe spreads are supported by ongoing Central Bank committment to corporate borrowing markets, as well as the vaccine rollout which should see an improvement in perceived credit-worthiness of bond issuers in the hardest hit sectors (tourism, retail, leisure).
High Yield	High yield bond spreads will be supported by the decreasing risk of default and reasonable valuations providing opportunity for spreads to narrow considerably from here. Expectations of improving credit fundamentals, the yield pick-up and lower interest rate risk relative to sovereigns makes high yield more attractive versus DM bonds.
EM Hard Currency	The rise in US Treasuries will create near term volatility will act as a headwind however, improving global growth prospects, subdued inflation and relatively higher real yields to DM markets all positively support EM debt.
EM Local Currency	Improving global growth prospects, subdued inflation and relatively higher real yields to DM markets all positively support EM debt.

Global Equities

Equities outperform bonds when the industrial cycle is improving

Equities are pro-cyclical and the cycle is still improving



Source: BCA Research, March 2021

Global Equities

Higher yields will not end the bull market … yet

1 Bond yields are being driven higher by rising real rates and a normalization in inflation expectations. Inflation is only back in-line with the 20 year average.

2 Equities rise during both the recovery and expansion phases of the economic cycle. During the expansion phase, rates are usually rising.

3 Growth stocks will eventually absorb higher rates provided there is some transparency on how far/fast they are rising. We think growth stocks are a hedge against downside risks for market.

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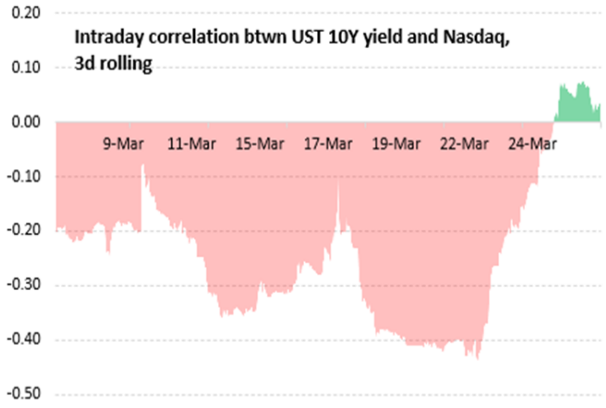
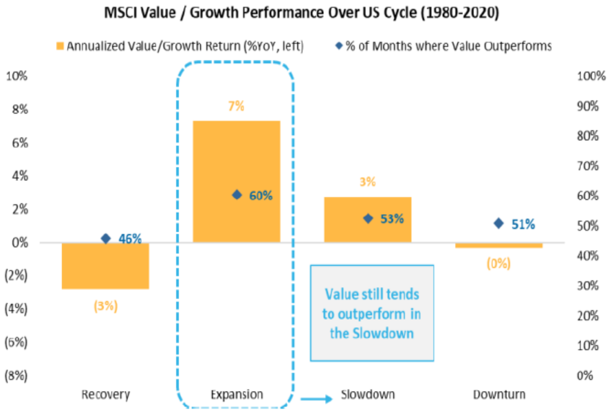
Growth stocks are now rising into higher rates



Source: Vanda, March 2021

Value outperforms during expansion phases



Source: MSCI, MWM Research, March 2021

Global Equities

Equities and bond yields are positively correlated when central banks are not tightening

As long as rates are not in restrictive territory, equities can keep rising

		US 10-Year Treasury Yield (%)			S&P 500		
TROUGH	PEAK	At Trough	At Peak	Change (ppt)	At Trough	At Peak	Change
Oct 15, 1993	Nov 07, 1994	5.19	8.05	2.86	470	463	-1.4%
Jan 18, 1996	Jul 05, 1996	5.53	7.06	1.53	608	657	8.1%
Oct 05, 1998	Jan 20, 2000	4.16	6.79	2.63	989	1446	46.2%
Jun 13, 2003	Jun 12, 2007	3.13	5.26	2.13	989	1493	51.0%
Dec 18, 2008	Apr 05, 2010	2.08	4.01	1.93	885	1187	34.1%
Jul 25, 2012	Dec 31, 2013	1.43	3.04	1.61	1338	1848	38.2%
Jul 05, 2016	Nov 08, 2018	1.37	3.24	1.87	2089	2807	34.4%
Aug 04, 2020	Mar 19, 2021	0.52	1.74	1.22	3307	3913	18.3%

Source: BCA Research, March 2021

Australian Equities

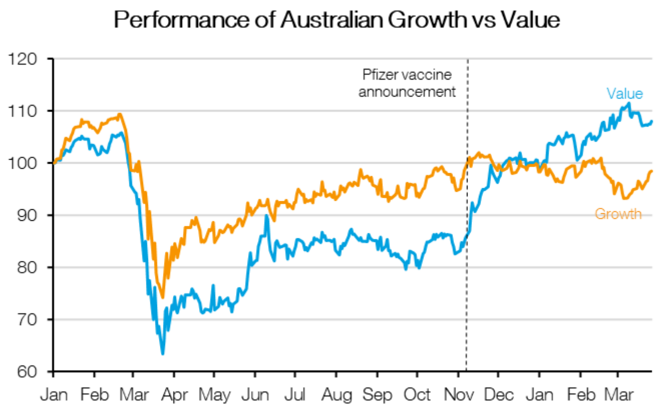
Earnings recovery underway

1. We are overweight Australian equities which should benefit from reflation, easy monetary and fiscal policy, low rates, commodity price strength and the rotation towards value and financial stocks.

2. The February reporting season was the strongest in recent history as pessimistic expectations were exceeded. Banks, miners and COVID-19 winners were highlights while the market looked through weak results for those suffering from social restrictions.

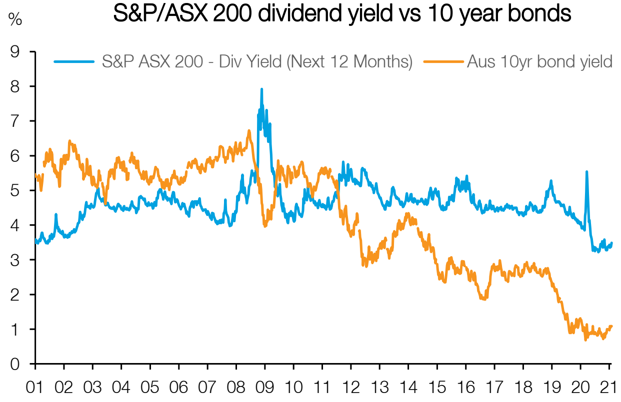
3. Australian bond yields surged during February - in line with global yields – although the RBA did attempt to limit the increase by further QE. We think the market can absorb further upside in bond yields provided they are being driven by stronger growth.

Value stocks continue to outperform



Source: MWM Research, March 2021

Equities remain the obvious choice for income seekers

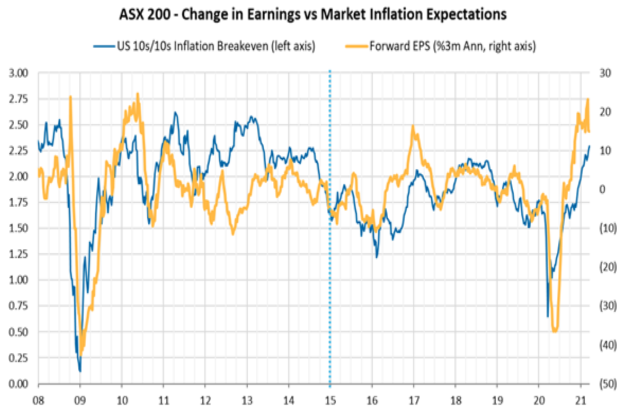


Source: MWM Research, February 2021

Australian Equities

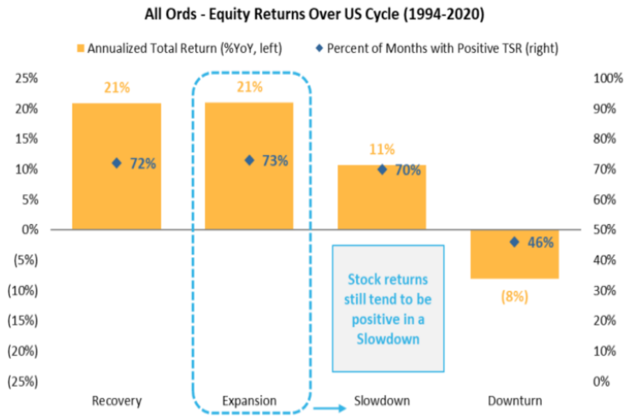
Bottom up earnings expectations have not yet reset to reflect the strength of the economic recovery.

Earnings will continue to be upgraded through 2021



Source: Macquarie Research, March 2021

The expansion phase is strongest for Australian equities given a high "value" allocation



Source: Macquarie Research, March 2021

Fixed interest

Reflation drives yields higher

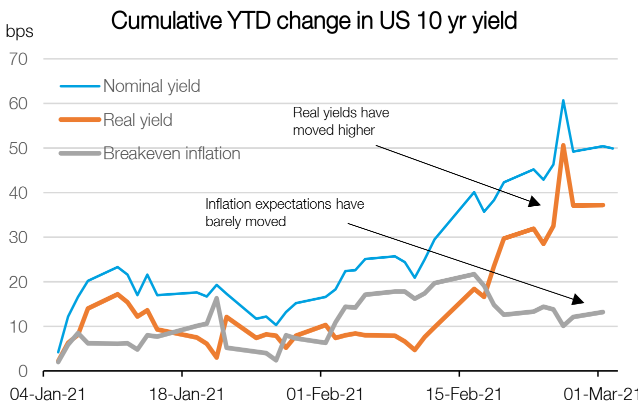
1 We are underweight fixed income. We expect bond yields to move higher throughout 2021. The risk of an overshoot is increasing as bond markets test CB commitment to ultra-accommodative policy settings. Our preference is for credit spread over sovereign bonds.

2 We think it is increasingly likely that spreads will test historical lows. Credit markets will be supported by a reflationary backdrop which should see spreads narrow further across all markets and sectors. High yield is attractive relative to other credit sectors as bond yields rise.

3 Australian and global short rates will remain at the effective lower bound for the foreseeable future given CB quantitative easing programs and forward guidance. We do not expect any meaningful rise in inflation over the near term to drive an early policy tightening.

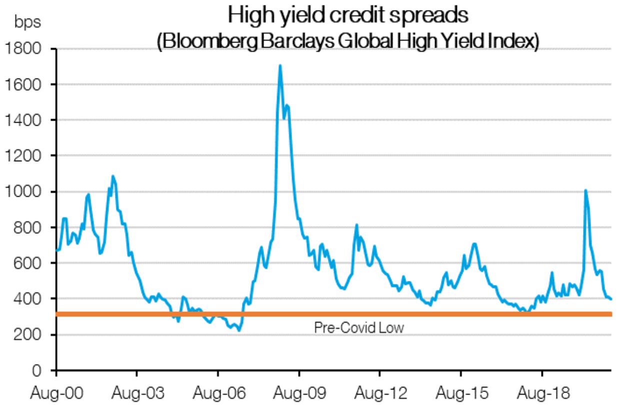
The Private Bank

Real yields drove bond yields higher



Source: Bloomberg, MWM Research, March 2021

Credit spreads have room to narrow



Source: Bloomberg, MWM Research, March 2021

Alternative assets

Enhancing the essentials

1 We are maximum overweight alternative assets, as we believe strategies exist that will deliver enhanced returns, downside protection and diversification to an otherwise traditional equity/bond portfolio allocation.

2 Within private equity, we prefer managers that focus on actively driving organic growth in portfolio companies. For private debt strategies, we like diversified strategies that have strong underwriting to provide stable returns.

3 Within hedge funds, we prefer multi and macro strategies that can act nimbly to take advantage of market disruptions and relative value opportunities, while providing tail risk hedging and protection against volatility.

The Private Bank

Alternative strategies during rising yield periods

	Private Equity	Private Debt	Hedge Funds
Benefits	1. Long-term focus on company fundamentals 2. Captures upside from growth market cycle	1. Additional yield from risk premia versus public markets 2. Uncorrelated, stable returns	1. Stategic-specific advantages 2. Downside/tail risk protection
Risks	1. Illiquidity 2. Exposure to equity markets similar to traditional equities	1. Illiquidity 2. Credit/counterparty risk	1. Manager selection risk 2. Complexity
Rising yield environment	Earnings growth can outweigh rate impact over time	Returns are insensitive to yield movements	Historically strong performance during periods of rising rates, low correlations to traditional asset classes

Source: Neuberger Berman, MWM Research, March 2021

Hedge funds strategies deliver consistent returns

	Average hedge fund monthly returns (2014-2020)	
	Periods of rising yields	Periods of falling yields
Macro multi-strategies	0.15%	0.12%
Equity long/short strategies	0.77%	0.11%
Relative value stratgies	0.44%	0.16%
Event driven strategies	0.73%	0.08%

Source: Bloomberg, MWM Research, February 2021

Real assets

Rising Yields Weigh On REITs

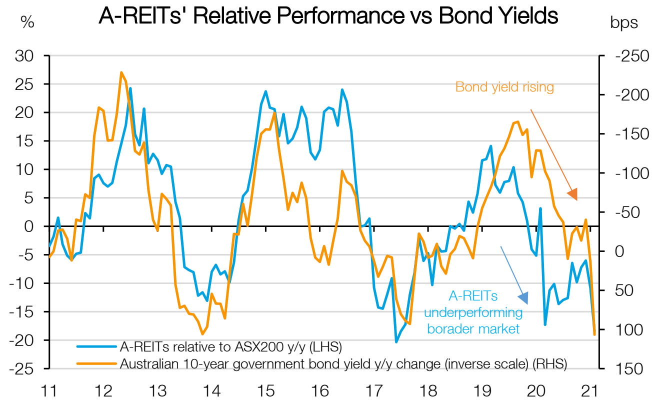
1. The recent back-up in bond yields has weighed on REIT sector relative performance, although near-term downside should be limited given central banks are likely to keep a lid on bond yields.

2. While the earnings and dividend outlook for REITs will continue to improve, Macquarie expects REITs to underperform equities, which offer more cyclical earnings upside.

3. Macquarie's preferred sub-sector of REITs is Residential, which is being driven by stimulus and low interest rates, while Office & Retail remains constrained by structural headwinds.

The Private Bank

REITs underperform equities as bond yields rise



Source: JLL, Macquarie Research, February 2021

Performance during February

	Australia	World-ex-Australia
Broader equity market	1.5%	2.7%
REIT sector	-2.5%	3.4%
Retail sub-sector	3.7%	8.5%
Office sub-sector	-1.5%	4.1%
Industrial sub-sector	-6.1%	-2.2%

Source: Factset, MWM Research, February 2021

Important information

Investment Matters March 2021 was finalised on 4 March 2021.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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