DYNAMIC

Multi-asset review Q2 2020

RUSSELL INVESTMENTS' DYNAMIC APPROACH DELIVERS STRONG ABSOLUTE RETURNS FOR INVESTORS

Here our Multi-Asset Solutions team discusses Russell Investments' performance in the June quarter and their outlook for 2020.

What drove markets during the second quarter of 2020?

The second quarter of 2020 saw growth assets significantly outperform their defensive counterparts as investors adopted a more 'risk on' tone amid hopes the worst of the coronavirus pandemic had passed and further fiscal and monetary policy support globally.

Two key events helped shape market movements over the quarter:

1. **Central banks unleash further stimulus**. The June quarter saw central banks ramp up their stimulus efforts in a further bid to support growth and encourage confidence in financial markets. We saw additional stimulus in China, Japan, the UK and Europe; where most recently the European Central Bank (ECB) increased its Pandemic Emergency Purchase Program by EUR600 billion and extended the Program's duration to June 2021. This came on top of the EUR750 billion in bond purchases the ECB announced back in March and takes the Program's total to EUR1.35 trillion. We also saw the US Federal Reserve (Fed) commit to using its full range of tools to combat the economic impact of the coronavirus pandemic, including the decision to begin buying corporate bonds; a move which will see the Fed bypass the banks and lend directly to the private sector. Moreover, Fed chairman, Jerome Powell, noted that the Bank will keep its "foot on the gas" as it continues to navigate the US economy through the current crisis. It's estimated that asset purchases by the world's five largest central banks now stands at around USD5 trillion. And it seems to be working, with recent data pointing to improving business activity in China, Europe and the US, while some share markets are already trading at pre-pandemic levels.

2. **Commodity prices rally**. Commodities performed well in the second quarter, with the Refinitiv/CoreCommodity CRB Commodity Index closing the period up 13.3%. Oil led the gains, with the price for West Texas Intermediate crude jumping 91.7% on optimism growth would pick up amid a further loosening of coronavirus containment measures and ongoing fiscal and monetary policy support globally. It was oil's best quarterly performance since the 142% gain we saw in the third quarter of 1990 when the first Gulf War began. Base metals were also stronger for the quarter, with copper (21.6%), iron ore (19.8%), nickel (11.6%), zinc (7.5%), aluminium (7.3%) and lead (1.7%) all recording gains. Base metals benefited in part from expectations Chinese demand will increase as officials there implement more policies aimed at boosting growth. Meanwhile, gold continued to climb over the quarter; the precious metal returning 12.9% amid concerns massive central bank stimulus could drive up inflation and fears a potential second wave of coronavirus infections could derail the global recovery.

Global shares rose 5.9%[1] in the June quarter. Australian shares were also positive, returning 16.8%[2] on expectations economic activity would continue to pick up as federal and state officials rolled back more of the coronavirus-induced restrictions that brought the economy to a near standstill in recent months. Limiting the local market's advance was a series of disappointing economic data, including a contraction in first-quarter growth and rising unemployment. Sentiment was also impacted by concerns over a second wave of coronavirus infections after a late spike in new cases in Victoria. Emerging markets equities narrowly underperformed their developed counterparts over the period, closing the quarter 5.0%[3] higher.

[1] Global shares measured by the MSCI World ex Australia Net Accumulation Index (in AUD)

[2] Australian shares measured by the S&P/ASX 300 Accumulation Index

[3] Emerging markets measured by the MSCI Emerging Markets Index Net (in AUD)

The Australian dollar (AUD) made strong gains over the period, with the Australian Trade-Weighted Index closing the quarter up 9.7%[4]. The currency benefited largely from improving risk appetites, stronger commodity prices and general US dollar (USD) weakness. Limiting the advance were a series of disappointing domestic economic data, heightened US-China frictions and second wave virus fears.

Interest rate sensitive assets were positive for the quarter. Global listed infrastructure and global and Australian listed property gained amid the broader equity market rally we saw over the period, while mixed bond yields saw more modest returns from global and domestic bonds.

In credit markets, spreads on US and European investment-grade and high-yield debt narrowed over the quarter as investors favoured riskier assets amid easing lockdown measures, additional central bank stimulus and a strong rebound in oil prices. Hard currency, local currency and corporate emerging markets debt were also stronger for the period.

How did Russell Investments' active multi-asset portfolios perform in the June quarter? What was rewarded by the market and what wasn't?

Absolute returns. The Russell Investments Balanced Fund returned 8.5% for the quarter on a net of fees and tax basis. Performance was driven primarily by positive absolute returns from the Fund's equity and credit exposures.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Fund underperformed by 0.4% on a net of fees and tax basis.

Positive contributors included:

- Positive absolute returns from Australian and global equity exposures.
- An overweight exposure to credit, including global high-yield debt and floating rate credit.

Negative contributors included:

- Negative excess returns from Australian and global equity sector funds.
- Currency positioning; notably an underweight to the AUD and an overweight to the Japanese yen.

What is Russell Investments' outlook for 2020? How is it impacting your active multi-asset positioning?

Markets have rallied on hopes of an economic recovery and easing lockdown measures globally, while the cycle outlook has improved amid vast fiscal and monetary stimulus. However, the market rebound means value is no longer compelling for global equities or credit. Though markets may be vulnerable to negative headlines in the near term, in our view, the supportive cycle outlook should allow equities to continue to outperform bonds over the medium-term. We believe the recovery from the recession will lead to a long period of low-inflationary growth, with central banks likely to keep interest rates low once inflation rises.

We maintain our preference for non-US equities over US equities; a view driven largely by expensive relative valuations. However, we also believe the post-coronavirus recovery will see corporate profits improve. This scenario could favour cyclical and value stocks over defensive and growth names, which would be more supportive for stocks outside of the US. We believe emerging markets equities should benefit from China's early exit from lockdown and additional stimulus measures.

For fixed income assets, we continue to see government bonds as universally expensive. Low inflation and dovish central banks should limit rises in bond yields during the recovery phase. In terms of credit, we have a neutral view on high-yield and investment-grade debt. Since their levels in mid-March, credit spreads have compressed and, in our view, only now adequately compensate for the likely rise in default rates following the recession.

In the currency space, we expect the USD to weaken into the global economic recovery due to its counter-cyclical behaviour, which has historically seen it decline in the recovery phase. Economically sensitive 'commodity currencies' like the Australian, New Zealand and Canadian dollars should be the main beneficiaries of this.

Moving forward, the major risks to our outlook include a second wave of virus infections and the US elections in November. In the next few months, we're likely to know if a second wave is underway. Most countries appear to be better placed to manage a second wave in terms of treatment and healthcare capacity. The US elections will become a bigger focus for markets if the Democratic presidential nominee, Joe Biden, sustains a commanding lead in the polls. Biden plans to reverse some of the Trump Administration's corporate tax cuts from 2017, which could deliver a negative hit to earnings in 2021. One of the key watchpoints of the election outcome will be if the Democrats seize control of the White House, Senate and House of Representatives, which would make corporate tax hikes more likely and increase the risk of further corporate regulation. The other risk is a re-escalation of the US-China trade war, though with President Trump's re-election chances tied to a recovery in the stock market and the US economy, we expect he will not endanger this by rebooting trade hostilities. We remain alert to risks and volatility as we enter the recovery phase of the global economic cycle. Importantly, we believe this is an environment that will favour our active management approach.

[4] The trade-weighted index for the AUD is an indicator of movements in the average value of the AUD against the currencies of our trading partners. Source: RBA.

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