



WILSONS

# Looking Through a Volatile Start to the Year

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Our second quarter asset allocation strategy.

04 April 2022

# Trimming Equity Allocation but Retaining Constructive View

After a strong and relatively smooth run in 2021, this year has been a volatile ride for investors.

Markets corrected in January as the US Federal Reserve (the Fed) began to send more hawkish policy signals. This caused bond yields to rise and equities to retrace sharply.

Equities began to regain their footing in early February before Russia invaded Ukraine later in the month, causing a renewed spike in risk aversion.

This second equity correction for the year in the space of 2 months proved to be short-lived, with March ushering in a significant bounce in global and domestic equities. Interestingly, the rebound has occurred in the face of an even more hawkish Fed and ongoing uncertainty around the end game for the Russia-Ukraine war.

We are not sure that equities are out of the woods just yet, but we still see the 12-month outlook for equities as being supported by a reasonably robust global growth backdrop and what are still very low interest rates in a historical context. However, with stock markets higher than at our last quarterly outlook (January 31), the Fed more hawkish, and the Russia-Ukraine conflict a fresh source of risk, **we have trimmed our equity position.**

Read [Navigating a Year of Cross Currents](#)

We believe global recession risk over the coming 12 months is relatively low. Our base case is that the world (led by the US) continues to grow at an above-average pace, supporting an ongoing corporate earnings expansion.

**Figure 1: 2022 has been a rougher ride for equity investors but a correction was overdue**



## Risks and Signposts to Watch

US inflation is undoubtedly proving more problematic than first thought, and the Fed is seemingly becoming more and more hawkish in response. This does raise risks for the investment outlook.

While bond yields continue to rise, equities have been taking the most recent shift in interest rates in their stride. The interest rate market is aggressively repricing the near-term path of interest rates; however, long-term bond yields and the market's peak cash rate projections remain relatively moderate. It appears the market still does not think there is a high risk of the Fed tipping the US economy into recession. Long-term inflation expectations also remain well-anchored despite the current inflation spike.

While our base case is still reasonably constructive, there is enough tail risk in the current environment to trim some equity exposure. We have begun to edge up our fixed interest exposure and add to our defensive alternatives position.

Bonds still do not look like a particularly compelling destination, particularly with inflation so high, but yields have moved a long way in a short period of time. Australian yields in particular look to have reasonable value now, and we have started to edge back into (domestic) fixed interest from a very underweight position.

We still expect higher 10-year US yields in this cycle (potentially moving local yields slightly higher), so the move is relatively small. Bonds do fulfill a portfolio insurance role, so they have the capacity to rally if one or more of our risk case scenarios (e.g. a Russia-Ukraine escalation) comes to pass.

We do not feel we are giving up too much in terms of 6-12 month returns by taking the portfolio more defensive at the margin. We are watching the following key signposts to move either more cautiously or more positively on risk assets:

1. Is the peak in US inflation close at hand or will it prove more stubborn? Our base case is another CPI increase in the March reading (April 12), but we expect that will be the peak.
2. US reporting season – more upside surprise or margin pressure? Our central case is another good reporting season.
3. Escalation in Russia-Ukraine hostilities or a negotiated truce? We see a settlement in coming weeks or months as a logical outcome, but tail risks remain significant.
4. European economic data – rolling over or resilient? Europe looks resilient at present, but this resilience has its limits. A Russian energy embargo into Europe is unlikely but cannot be completely discounted.
5. Will the Fed be more or less hawkish than priced at its May 3 meeting? The Fed's guidance come May is hard to call, though we expect some inflation relief to calm the Fed and the front end of the curve over the balance of 2022.

**Figure 2: US interest rates have moved up quite sharply this year led by the "front end"**



Source: Refinitiv, Wilsons.

6. Will COVID derail Chinese growth? The Omicron variant has spread to multiple regions across China in March, leading to tightened mobility restrictions, mass testing, and lockdowns in multiple cities. China's strict COVID policy is likely to stay in force for some time. The negative impact on growth is likely to be offset by policy support, but near-term growth estimates likely have some downside risk. At the same time, these recurrent outbreaks represent another challenge for the global supply chain.

So there is plenty to digest over the next few months. While we have edged down our risk allocation a little, we continue to stay cautiously constructive but are prepared to adapt our portfolio to the macro and geopolitical backdrop.

We outline our views in more detail below.

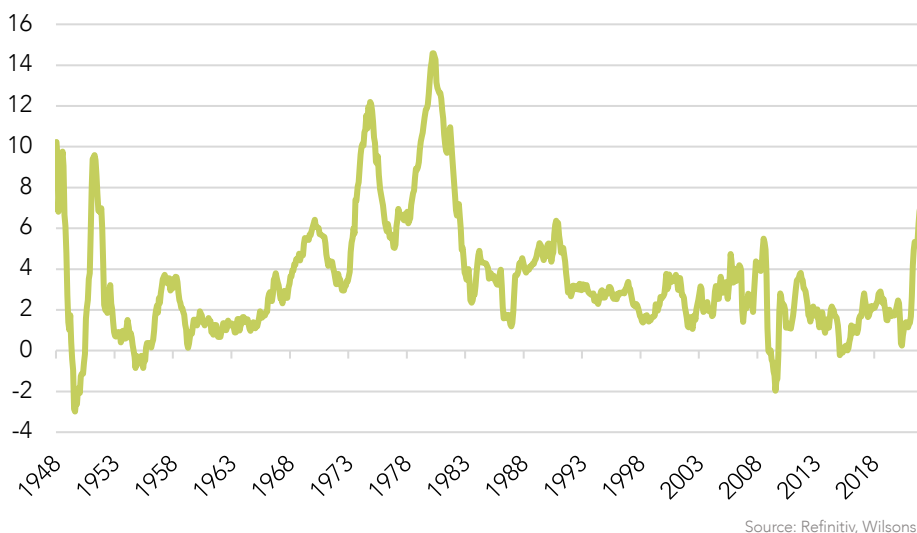
**Figure 3: Asset allocation weightings and key views**

Asset Class	Tactical Tilt	Movement	Wilson's View
Cash	Neutral	no change	Neutral weighting reflects residual risk that recent correction extends balanced by relatively positive 6-12 month central case view on risk assets.
Fixed income (Domestic & Global)	Underweight -7%	1%	We retain a significant underweight in fixed interest due to what are still low yields and our view of a continued global and domestic recovery over the coming year. Australian bond yields are now looking reasonably attractive so we begin to add some exposure. Credit preferred over government debt given solid growth outlook.
Equities - Domestic	Overweight +2%	-2%	Australia still preferred on 12-month view given strong economy and commodity skew but edging down exposure after the recent strong rebound.
Equities - International	Neutral	no change	While we are still constructive on global equities we see better relative upside in Australian equities while (long duration) US equities may need to digest a further rise in bond yields. UK (value) and EM at overweight (China easing). We retain our 40% hedge back to the A\$ as we still believe the A\$ has medium-term upside, particularly against the US\$.
Alternatives	Overweight +5%	1%	We retain our significant tactical overweight given above average economic and policy uncertainty and unattractive valuations in gov't. bonds. A range of growth and defensive alternative strategies appeal i.e. private equity, infrastructure, real property, long short global hedge funds and private credit (adding). Gold still appeals as a portfolio hedge against worse than expected inflation outcomes and heightened geopolitical tensions but could be cyclically vulnerable to a rise in global real interest rates.

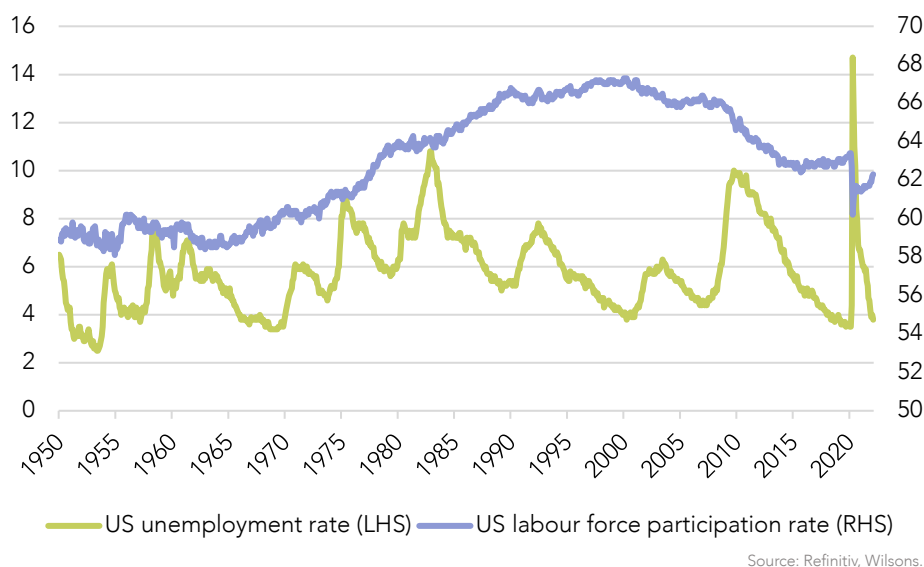
\*Our tactical tilts represent our view over the next 6-12 months though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments. See exhibit 18 for additional asset allocation detail.

Source: Refinitiv, Wilsons.

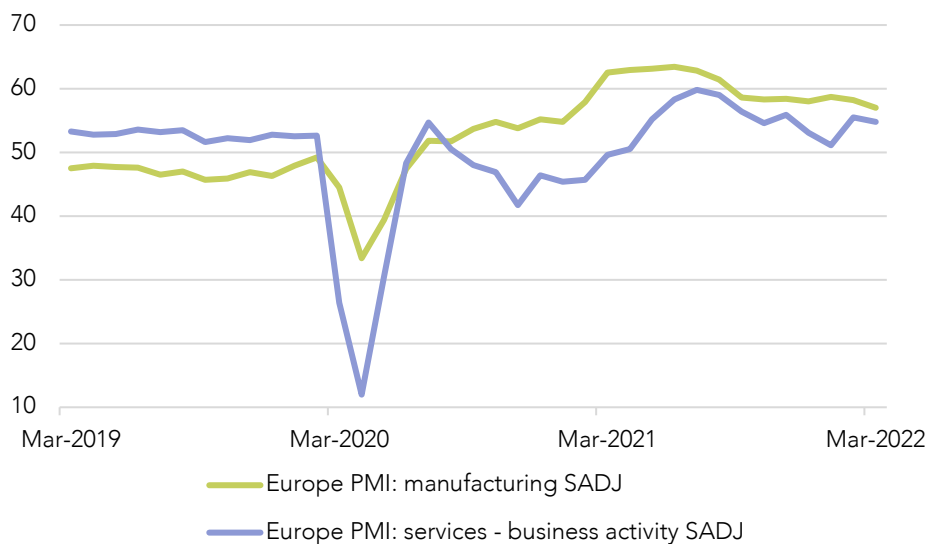
**Figure 4: US inflation has surged to a 40 year high. We see some easing in pressure over 2022**



**Figure 5: US unemployment has fallen dramatically although the participation rate is lagging**



**Figure 6: Eurozone activity indicators are proving resilient so far**



## Global and Domestic Economy – Slowing but not Slow

The global recovery from the pandemic-induced recession of 2020 continues to be impressive. We continue to see decent prospects for global growth over the coming year despite the risk posed by the sharp rise in energy prices and the broad inflationary pulse currently plaguing the global economy.

The US economy continues to grow strongly with unemployment staging a remarkable recovery from its (short-lived) peak of 15% in mid-2020 to now sit at just 3.8%. The US consumer remains reasonably strong despite the lift in inflation as the labour market continues to rebound, wages rise, and unspent pandemic stimulus payments continue to flow back into the economy.

We see the risk of the Fed accidentally engineering a recession as relatively low, though we cannot completely rule out a policy mistake over the coming year. We see enough inflation relief over the next 6 months to stop the Fed from overtightening.

Europe's economy is more of a concern given it is in the eye of the Russia-Ukraine storm and is so dependent on Russian energy. Contemporary indicators of activity remain reasonably solid. However, sentiment has weakened significantly, so a significant loss of momentum could still be forthcoming.

Our base case is that Europe should avoid recession and still manage better than average growth over the coming year. However, risks around the strength of the economy are much greater than in the US and Australia.

The UK economy also looks better placed than the Eurozone, encouraging us to retain our overweight UK equities position. The 9.4% UK GDP decline in 2020 was followed by a surging 7.5% rebound in 2021. We expect GDP to grow at an above-trend pace of around 4% in 2022. We expect the Bank of England (BoE) to deliver only one more 25bp hike in May before an extended pause. However, if growth were to hold up better amid rising energy prices, more hikes later in 2022 would likely be needed. The UK government has announced £18.8bn (0.8% of GDP) in support measures to ease the rising cost of living, which should support the near-term growth outlook.

China's growth is well below the pace of the past 5-10 years as authorities try and rein in the housing sector as well as battling ongoing COVID outbreaks.

Policy has been eased recently (in contrast to much of the world) and we expect growth can improve over 2022, though the Government's 5.5% growth target appears ambitious given ongoing COVID disruptions. Data across January and February showed some improvement, though the recent series of COVID outbreaks is a definite setback for the recovery.

The Australian economy has managed a rapid recovery from last year's Delta and Omicron-induced slowdowns. The recent Federal budget upgraded near-term growth estimates and lowered unemployment forecasts to 3.75%. This would be the lowest rate of unemployment since 1974.

After expanding at a well above-trend pace of 4.25% in FY22, GDP growth is expected to maintain an above-average pace of 3.5% in FY23 before returning to trend growth of 2.5% in FY24.

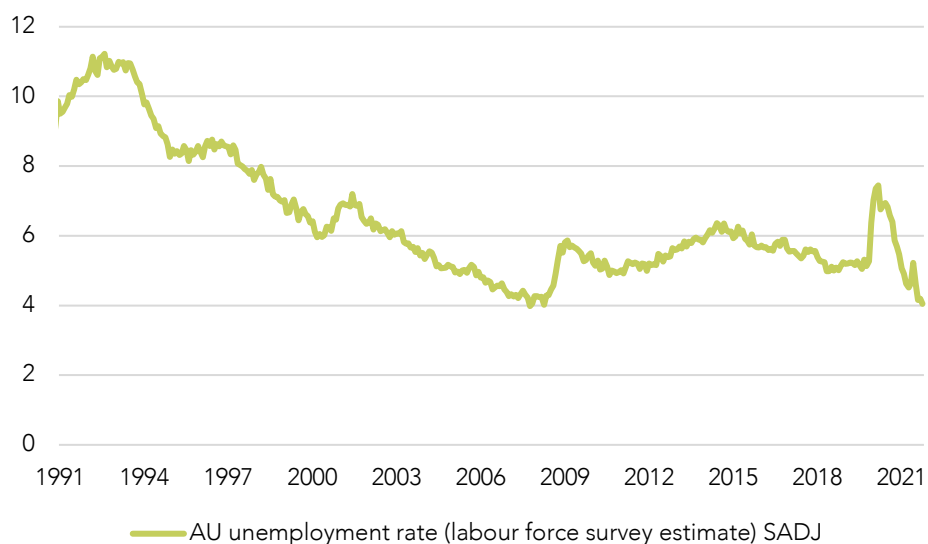
The recent budget was clearly framed with the upcoming May election in mind, and the ~\$9bn of front-loaded cash handouts to pensioners and low and middle-income earners will ensure the economy enters the new financial year with a head of steam.

Much like the US, domestic households already have large unspent cash balances sitting in bank accounts to draw on, so the domestic growth outlook looks relatively robust over the coming year.

**Figure 7: China growth has slowed with the outlook buffeted by COVID lockdowns against easier policy**



**Figure 8: Australian unemployment is remarkably low. Will a wage growth pick-up follow this year?**



Australia's inflation backdrop appears relatively benign compared to overseas trends, but we expect a significant pickup in the first quarter to around 5%. This is well short of the pressure currently being experienced in the US but should be enough to prompt the RBA to begin lifting the cash rate either in June or August. We see market pricing of multiple rate hikes from the RBA this year as too aggressive, but we think 2 or 3 hikes this year is a realistic central case. This is much more benign than current market pricing of roughly six hikes.

Exactly how far the domestic cash rate moves over the next 2 years is an interesting debate. We believe the RBA will proceed gradually and the economy will be able to handle multiple hikes. Still, we are likely to see the local cash rate peak at a lower rate than in the US given much higher levels of household debt. We pencil in a 2% cash rate by the end of 2023, but the RBA will be alert to the potential for overtightening. We see good prospects for ongoing economic expansion in Australia, though household leverage and the resultant sensitivity to rising rates is the key medium-term risk for Australia's economy.



## Fixed Interest – Beginning to Reduce Underweight

The sell-off in global bonds has continued into March with US 10-year bonds rising from 1.52% to 2.35% (at March 31).

The sell-off has been even more pronounced at the short end of the curve (the yield curve has flattened significantly) as the market has priced in more aggressive action from the Fed. Indeed, the market has moved to price 3 rates to hikes in 2022 to 8 in 3 months.

With the market now expecting 8x rises this year, the probability of a 50bp rise at the next Fed meeting on May 3 now sits at 70% (down from a recent peak of 75%).

The Fed's shift in the past couple of weeks from its mid-month meeting commentary is interesting. At a recent business conference Fed Chairman Powell did little to dissuade investors from the notion of a 50-basis point rise in May, albeit the Fed's "dot plot" guidance and commentary just 1 week earlier suggested the Fed was likely to proceed in 25 basis point increments.

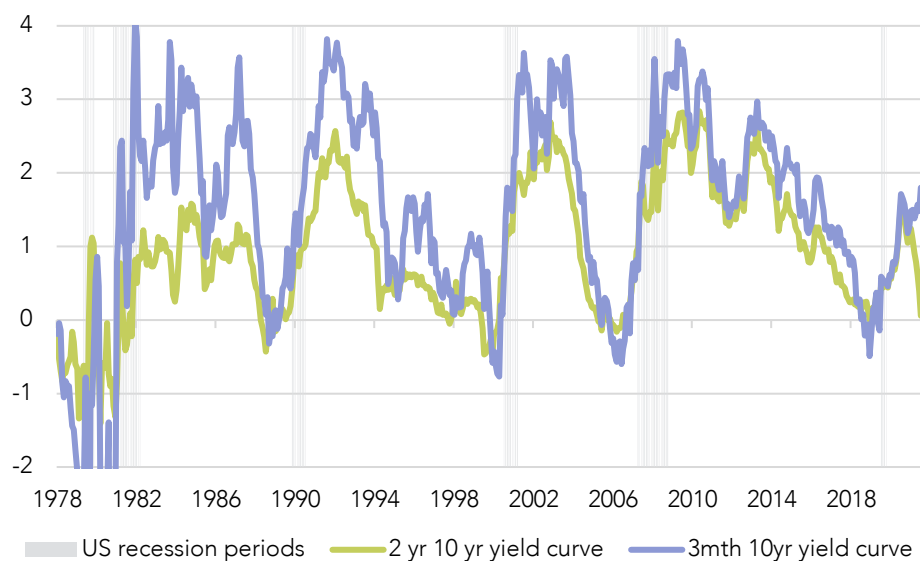
As we have discussed, the yield curve measured by the 2-year to 10-year has flattened considerably, with the curve now threatening to invert. This has been a reasonably reliable, early indicator of a looming recession. However, it is not until the 3-month to 10-year inverts that a recession appears to be "confirmed", and even then there is a significant lag.

Read [The Flattening US Yield Curve - Are Recession Risks Rising?](#)

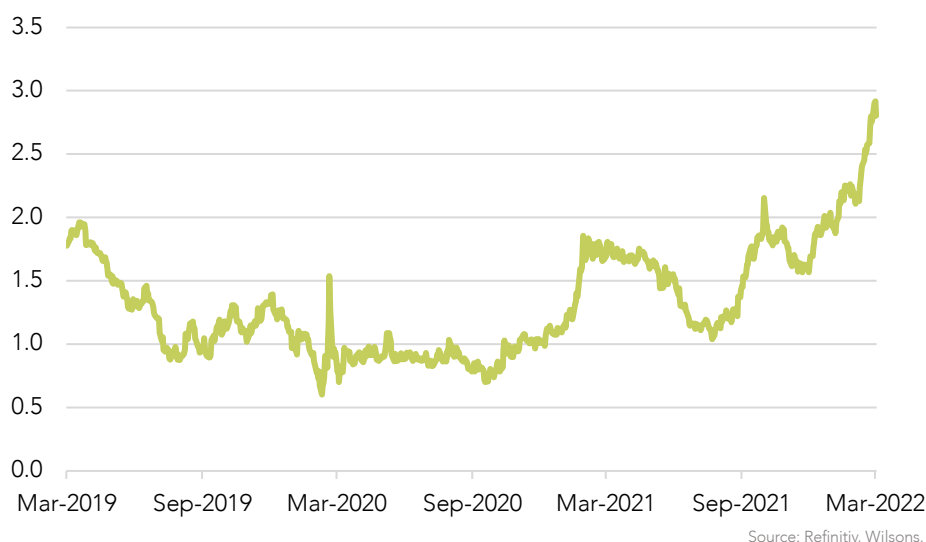
The 3-month to 10-year has actually steepened. We expect ongoing fascination with the yield curve flattening and the possible inversion of 2-year to 10-year, but see a US recession as a long way off.

The fact that 10-year has continued to rise this year (the curve has flattened from the front end) and equities are once again pushing higher suggests the market also continues to see recession risk as relatively remote. We cannot rule out either stubbornly high inflation or Fed reaction to high near-term inflation as spooking the market over the next couple of months.

**Figure 9: US 2-year 10-year yield curve flashing amber but not the 3-month 10-year**



**Figure 10: Australian 10-year bonds are beginning to look reasonable value**



**Figure 11: US high yield spreads have moved out this year but have tightened recently**



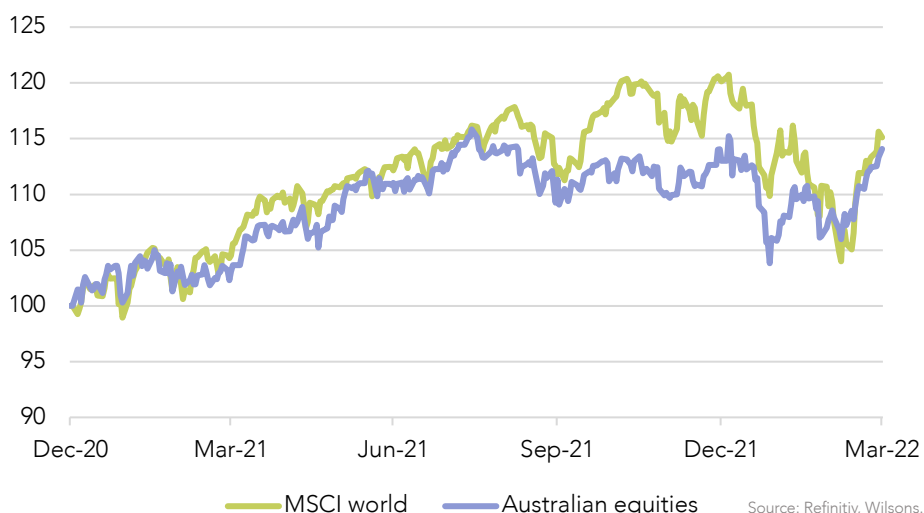
**Figure 12: The total yield on US high yields bonds now looks reasonably attractive**



Credit spreads have widened this year but tightened recently and remain at relatively moderate levels. The implied default rate is way above the current actual level of defaults, so high yields look reasonable value on the basis that the economy stays robust. Like equities, high yields are vulnerable to nervousness around the Fed tightening cycle so we still prefer floating rate credit to fixed interest-based credit.

Australian government bond yields have moved up in lockstep with the US despite the RBA signalling a more dovish approach to policy and inflation remaining well below US inflation. We see Aussie 10s as close to long-term fair value and have therefore begun to add some exposure from an underweight position. There is a risk that yields get dragged higher by US yields but we see current levels as a reasonable long-term entry point and are attracted to edging up portfolio protection in case the market lurches back to a risk-off posture.

**Figure 13: Australia has outperformed global equities this year after underperforming through the second half of last year**

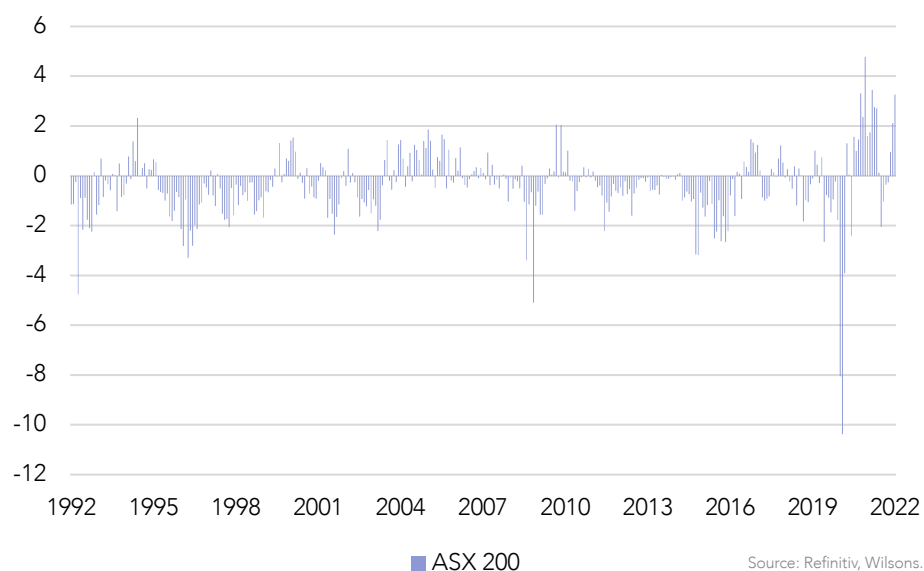


## Australian Equities - Trimming but Staying Moderately Overweight

After the strong recent rebound we have trimmed our allocation to Australia but remain moderately overweight. We still favour Australia over rest of world on a 12-month view.

The Australian economy is in good shape, inflation is picking up but is less of a problem than overseas and commodity prices are booming.

**Figure 14: Australian market earnings still being upgraded**



Australia's market composition being overweight resources and financials and underweight IT is still a superior setup for the current environment. A resolution in respect of Russia-Ukraine could see Australia lag a risk rally, but we still see a better risk-return tradeoff for Australia over the next 12 months. Australia is looking a bit overbought near-term but our recent outperformance is only small in a longer-term context.

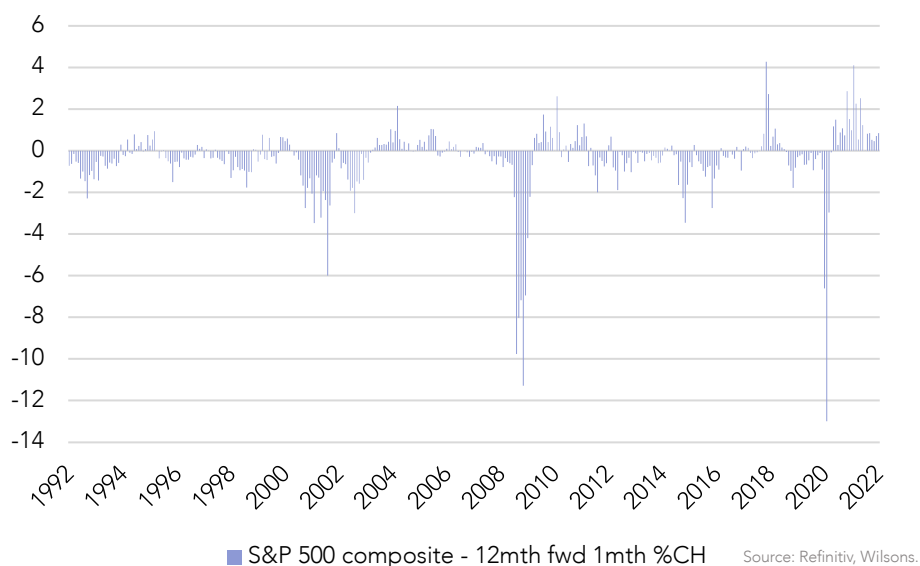
## Global Equities – Neutral for Now with a Value Bias

We still prefer the UK to the US on valuation grounds. We also keep a moderate overweight in emerging markets (EM), again, largely on valuation grounds. EM looks oversold, and we think current levels will represent good long-term value but acknowledge shifting back to overweight at the end of January was premature.

EM underperformance is mostly attributable to another lurch down in Chinese equities on the back of a number of COVID outbreaks and lockdowns in major cities. Russia's invasion of Ukraine has also been a drag on EM. China's zero COVID policy continues to pose a risk to recovery. Still, we see the easing of credit conditions and the authority's friendlier commentary around the Chinese investment landscape as the key reason to stay constructive.

US equities fell hard in January but have staged a significant revival in March despite further rises in US bond yields. We believe US earnings season will, in aggregate terms, still be good with continued evidence of strong top lines and pricing power despite cost pressures. While we believe the profit backdrop remains reasonable and valuations are not in a bubble as suggested by some, we still see US interest rates as a medium-term headwind for the long duration US stock market relative to the tailwinds that drove the US market over the last 5-10 years.

**Figure 15: US market earnings still being upgraded**



**Figure 16: Global equities - consensus valuation and earnings growth outlook**

	PE (12 Mth expected EPS)	CY21 EPS growth	CY22 EPS growth	CY23 EPS growth
US	19.3	51	9	10
Europe	14.7	75	8	9
UK	11.6	92	6	3
GEM	12	54	8	9
Japan	13.8	42	7	5
Australia	16.1	31	15	3

Source: Refinitiv, UBS.



## Alternatives Overweight— Adding to Defensive Alts

Alternatives have the appeal of offering uncorrelated returns to the traditional asset classes of equities and fixed interest. This is appealing from the perspective of potentially enhancing risk-adjusted portfolio returns. Due to their role in supplementing both equities and fixed interest, we have exposure to both growth and defensive alternatives.

Against a backdrop of above-average macroeconomic and geopolitical risk and a still lacklustre base case return expectation for fixed interest, we maintain a solid overweight in alternatives.

Our alternative allocations comprise 4 major subcategories:

1. Private equity
2. Private debt
3. Real assets (infrastructure, real estate and commodities/agriculture)
4. Hedge funds

We add slightly to our (defensive) alternatives position by adding to domestic private credit, where we have a 5-6% return expectation. We still see this as an attractive fixed interest substitute in a world of low rates, albeit the asset class is typically less liquid.

We still see good risk-adjusted return opportunities in growth alternatives such as private equity and inflation hedging “real assets” such as infrastructure and (active) property strategies.

We retain some modest exposure to gold as a tail risk hedge – namely a hedge against stubborn inflation or a significant further spike in market risk aversion. Gold has generally been moving higher this year against a backdrop of higher bond yields, inflation nervousness, and heightened geopolitical risk.

Our central case 6 to 12-month macro view of higher real rates and (eventually) renewed positive sentiment toward risk assets may act as a headwind for gold over the coming year. However, a re-emergence of a weaker US\$ trend could offset this to some extent. While the outlook for gold is buffeted by a number of cross-currents, the tail risk of a genuine inflation regime shift, as well as a potential Russia-Ukraine escalation or China-related geopolitical tensions suggests retaining some exposure.

**Figure 17: Wilsons expected asset class returns**

	Long-Term Expected Returns	12-Month Expected Returns
Domestic Equity	8.0%	7-10%
Int'l Equity	8.0%	5-10%
Fixed Interest	1.5%	-2% - +2%
Cash	1.75%	0.75%
Alternatives	6.5%	6.0-8.0%

\*Long term expected returns are 5 to 10 year passive expected returns based on both historical performance and current pricing/yields. 12 month expected (passive) returns are shown as a range due to the inherent volatility of financial market returns. Performance and risk projections are subject to market influences and contingent upon matters outside the control of Wilsons Advisory and Stockbroking Limited and therefore projections may not be an accurate indicator of future performance and/or risk.

Source: Refinitiv, Wilsons.

**Figure 18: Asset allocation summary**

Asset Class	High Growth			Growth			Balanced			Moderate			Defensive		
	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt	TAA	B'mark	Tilt
<b>Cash</b>	2%	2%	0%	2%	2%	0%	5%	5%	0%	10%	10%	0%	20%	20%	0%
<b>Fixed Interest</b>	1%	4%	-3%	5%	12%	-7%	15%	22%	-7%	25%	32%	-7%	40%	47%	-7%
<b>Equities - Domestic</b>	41%	40%	1%	39%	37%	2%	32%	30%	2%	26%	24%	2%	14%	12%	2%
<b>Equities - International</b>	39%	39%	0%	36%	36%	0%	30%	30%	0%	23%	23%	0%	12%	12%	0%
• United States	22%	25%	-3%	19%	23%	-4%	15%	19%	-4%	11%	15%	-4%	4%	8%	-4%
• Europe/UK	11%	8%	3%	11%	7%	4%	10%	6%	4%	8%	5%	3%	5%	2%	3%
• Emerging Markets	6%	4%	2%	6%	4%	2%	5%	3%	2%	4%	2%	2%	3%	1%	2%
• Japan	0%	2%	-2%	0%	2%	-2%	0%	2%	-2%	0%	1%	-1%	0%	1%	-1%
<b>Equities Total</b>	80%	79%	1%	75%	73%	2%	62%	60%	2%	49%	47%	2%	26%	24%	2%
<b>Alternatives</b>	17%	15%	2%	18%	13%	5%	18%	13%	5%	16%	11%	5%	14%	9%	5%
• Growth	13%	11%	2%	11%	8%	3%	11%	8%	3%	9%	6%	3%	8%	5%	3%
• Defensive	4%	4%	0%	7%	5%	2%	7%	5%	2%	7%	5%	2%	6%	4%	2%
<b>Growth Assets</b>	93%	90%	3%	86%	81%	5%	73%	68%	5%	58%	53%	5%	34%	29%	5%
<b>Defensive Assets</b>	7%	10%	-3%	14%	19%	-5%	27%	32%	-5%	42%	47%	-5%	66%	71%	-5%
<b>Cash + Fixed Interest + Equities + Alternatives</b>	100%	100%		100%	100%		100%	100%		100%	100%		100%	100%	

\*Commentary references our Balanced Portfolio

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at [www.wilsonsadvisory.com.au/disclosures](http://www.wilsonsadvisory.com.au/disclosures).

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### Wilsons contact

[david.cassidy@wilsonsadvisory.com.au](mailto:david.cassidy@wilsonsadvisory.com.au) | +61 2 8247 3149

[john.lockton@wilsonsadvisory.com.au](mailto:john.lockton@wilsonsadvisory.com.au) | +61 2 8247 3118

[rob.crookston@wilsonsadvisory.com.au](mailto:rob.crookston@wilsonsadvisory.com.au) | +61 2 8247 3101

[www.wilsonsadvisory.com.au](http://www.wilsonsadvisory.com.au)