July 2021

MONTHLY AGENDA - HEALTH CHECK - GLOBAL EQUITIES

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PARTNERS

As the global economy passes through peak economic growth and peak policy stimulus the business cycle is transitioning from an early to a mid-cycle setting. This necessarily requires an adjustment of focus for asset allocators away from directional, tactical investment decisions toward quality, active manager selection.

Less about tactical asset allocation

Early-cycle (which is what we saw for the 12-15 months post the March low last year) is all about tactical asset allocation. That is, tilting the portfolio to a particular country or asset class for short periods of time (typically 6-12 months) to take advantage of temporary dislocations in the market.

As can be seen in our Trade Tracker below, six of our eight tactical trades were put on last year during this early phase of the cycle. As can be seen most of them were directional trades – that is, outright long or short markets. This reflects the high conviction levels that typical come with early cycle investing – the direction of travel is more clear in early cycle.

Table 1: CIO Trade Tracker

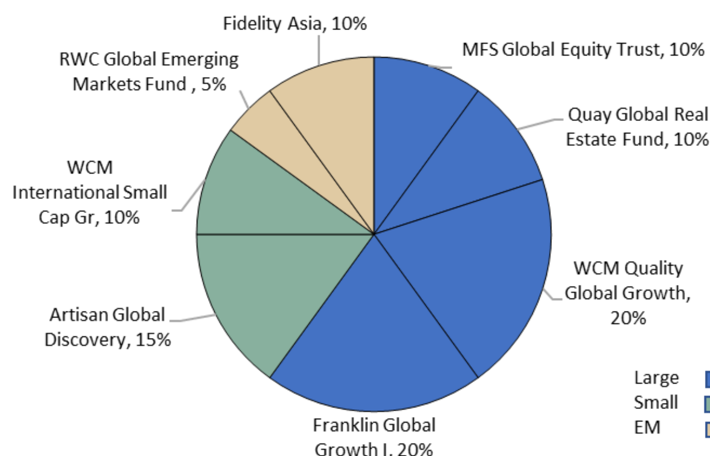
Trade Tracker - Trade Summary									
Last updated	20/07/2021								
Position	Long	Short	Sponsor/Co-	Inception	End Date	Open/Closed	Time Horrizo	Current level	Profit Review
Linear strategies									
S Duration	Cash	Jamison Coote / WAM AFI	TM/EB	16/03/2020	7/07/2021	Closed	106%	1.37	1.40
L EM Asia	Fidelity Asia	Cash	TM/EB	17/11/2020	21/04/2021	Closed	79%	884.06	850.00
L AU Eq	VAS	Cash	TM / DB	6/10/2020	16/03/2021	Closed	91%	6778.10	6856.38
L Alts	Alts model p	Cash	TM/DK	28/07/2020	21/10/2021	Open	79%	1092.79	1100.00
Relative strategies									
L IE v AE	S&P Index	ASX 200 Index	TM/DB	28/01/2020	30/03/2020	Closed	34%	0.52	0.51
L Hed v Unhed	MFS Hedged	MFS Unhedged Global Equit	TM / DK	17/03/2020	29/09/2020	Closed	75%	0.50	0.53
S EM v Sm Cap	Artisan Glob	RWC Global EM	TM/DB	21/06/2021	18/12/2021	Open	16%	0.88	0.95
L Liq v Duration	Realm HI	WAM ABF	TM/EB	7/07/2021	24/03/2022	Open	5%	0.81	0.87

Source: Escala Partners

We expect to implement fewer tactical trades over the next 12-18 months – particularly directional trades. This reflects the fact that uncertainty is higher in mid-cycle and conviction levels therefore are lower. Year-to-date we have implemented just two tactical trades – both of which are relative value (that is, tilting toward one market versus another).

Mid-cycle investing is the most challenging for asset allocators because it tests your ability to be disciplined. Adding value to a portfolio when markets are directional is easier to do than when markets are directionless or when the direction is uncertain. It is around mid-cycle when performance hit rates on tactical positions tends to decline.

Chart 1: Global equities CIO model of managed funds



Source: Escala Partners

All about being active in manager selection and in stock selection

Mid-cycle is an important time to be selecting managers who are active so that risk can be refined. There is a time and place for passive ETFs but that time is not in mid-cycle. When uncertainty is high, and direction is less clear, it is important to give your fund manager the opportunity to actively select quality companies and not just invest because that is what is in the benchmark. Blindly investing in companies simply because they are part of a benchmark, as passive funds do, means taking unwanted or unrewarded risk.

The US small cap universe is a good example. The small cap benchmark has a weight of over 16% to financials. In mid-cycle, yield curves tend to flatten which tends to weigh on the performance of financials. An active manager can tilt away from that sector. Both of our active global small cap funds are underweight financials relative to the weight in the index.

Table 2: The business cycle and sector performance

	Early Cycle	Mid-Cycle	Late Cycle	Recession
Financials	✓			
Real Estate	✓✓			××
Cons Disc	✓✓	×	××	
Inf Tech	✓	✓	××	××
Industrials	✓✓			××
Materials	✓	××	✓✓	
Cons Staples			✓✓	✓✓
Health Care	××		✓✓	✓✓
Energy	××		✓✓	
Comm Services		✓		×
Utilities	××	×	✓	✓✓

Early Cycle: There is a clear divide between the winners and losers. Directional tactical asset allocation tends to perform well. The more cyclically sensitive sectors such as consumer discretionary, financials, materials, industrials and real estate tend to perform best. Defensive sectors such as health care, energy and utilities tend to perform worst.

Mid-Cycle: The divide between the winners and losers is less clear so fewer tactical asset allocation opportunities. The focus should be on making slight portfolio allocation changes to protect the downside and quality manager selection within active funds.

Late Cycle and Recession: Directionality returns as does opportunities to add value from tactical asset allocation. Defensive and inflation-protected sectors tend to do better.

Global equities health check

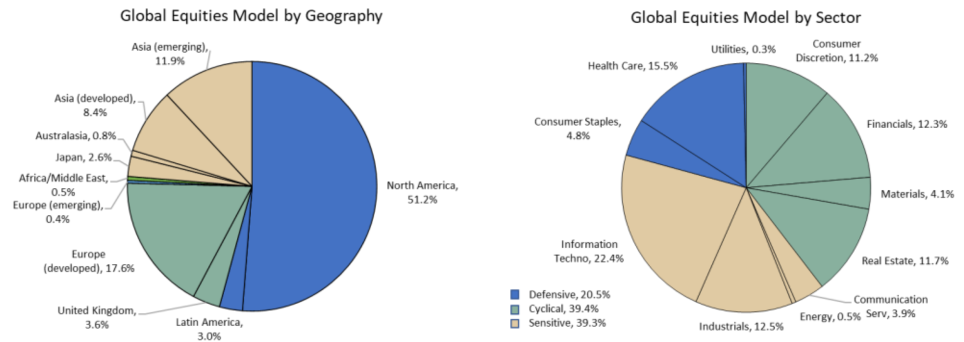
Given this focus on manager selection, mid-cycle is a good time to look under the hood of your portfolio to make sure things are running as we would expect or to make refinements for the road ahead. The health check looks through the funds that we are invested into at a stock level and then it aggregates back up across geography, sector, and style.

The intention is to identify where the risk in the model is coming from and to discuss whether we are happy taking that risk, that we are being rewarded for taking that risk, and if we need to take corrective action to offset the risks that we don't want to take.

Pleasingly, our global equities model has the highest weight to one of the sectors expected to do well in mid-cycle – information technology – and the lowest weight to the two sectors expected to underperform – utilities and materials.

We could argue we have too high a weight to financials given our view of the lower for longer environment. A more forensic look at financials reveals the two model funds with the highest weight to financials are Franklin Global Growth (18%) and WCM Quality Global Growth (15%).

Chart 2: Global equity model health check



Source: Escala Partners

We are happy with this because the financial names that we do have tend to be US based (as in the case of Visa) or emerging market based (as in the case of HDFC Bank). These names tend to be more growth oriented than traditional banking stocks.

Our consumer discretionary exposure is something we will watch, particularly as the cycle continues and eventually moves into late cycle. The fund in our model with the highest weight to consumer discretionary stocks is Fidelity Asia where the weight is 18%. Half of this weight is allocated to Alibaba. We continue to like Fidelity, particularly for its significant exposure to information technology (35%) and it has just a 3% weight to materials (21% for RWC). As the cycle matures, however, we will likely want to reduce the weight to Fidelity and seek a higher weight to health care and consumer staples.

Alibaba is a name we have been focussed on since the cancellation of the Ant IPO by the Chinese Communist Party in November 2020. The response by our fund managers to this was very different. RWC immediately sold its position. Fidelity bought Alibaba during the November 2020 sell-off on the basis that the increased regulation risk was already priced into the market. UBS, our third emerging market equities fund (not in the CIO model), had an existing holding in Alibaba and added to it in the sell-off. This divergence of view allows us to have deep conversations with our managers.

In part reflecting our concern around the increased regulation risk in China (along with a slowdown in growth) we implemented a tactical asset allocation trade on 21 June to reduce our exposure to emerging markets in favour of small cap funds. Pleasingly, this move reduced the model exposure to Alibaba. We will continue to question our fund managers around the investment thesis for Alibaba and regulation risk more generally in China.

Themes

The largest theme that we are happy to continue to see reflected in our model is tech disruption. One of the observations we make regularly is the extent to which companies across many different sectors are benefiting from new technology. We have seen it as far afield as agriculture where John Deere is making use of robots on their tractors to identify, and only spray pesticide on, weeds.

Financial services is another sector that is being disrupted and is one of the reasons why we are comfortable with our 12% exposure. Our single largest position across the entire global equities model is in Visa and while financials are down since the start of June, Visa is up 10%. This is an example of why it is important to pick good quality managers who can in turn pick good quality stocks.

Visa is at the forefront of disruption in finance. It recently certified CryptoSpend, a start-up created by two University of Technology classmates in Sydney, to issue a physical debit card to facilitate crypto payments. Users will be able to make purchases without the need to convert crypto to fiat first. It will be the first-time customers may use cryptocurrencies on an Australian payments card. Visa has previously authorized the

issuing of spending cards for several worldwide Bitcoin exchanges, including Binance, although these cards are not yet accessible in Australia. In the first half of 2021, Visa reported that more than $US1 billion had been spent on crypto-linked Visa cards. Visa is being touted as the next trillion-dollar stock by Barrons.

Disruption is also happening in consumer cyclicals where we have our second largest holding. MercadoLibre (Spanish for "free market") has changed the way Latin Americans shop. Its e-commerce revenue grew 90% and the number of buyers on its marketplace grew by 40%, to 65 million, in 2020 as Covid accelerated the shift toward online shopping. It is now changing the way Latin Americans pay. Payment volume at MercadoPago, the company's financial tech arm, increased 75% last year, to $US50 billion, as merchants incorporated the ability to pay through smartphone apps or QR codes. In 2018, Goldman Sachs estimated that 40% of MercadoLibre's value came from its financial-services arm; today it's 60%.

Our third largest holding, Shopify, is known as the anti-Amazon. Its cloud-based software allows more than 1.7 million merchants to sell directly to consumers with their own online store management rather than through a third party like Amazon. The ability to buy products via social-media platforms such as Instagram and Pinterest is emerging as the next big sales channel for retailers, which is prompting them to upgrade their software and embrace Shopify, including its added payment feature - Shopify Pay. Shopify now has $14.8B in gross merchandise value making it the third largest retailer behind Amazon and eBay.

Table 3: Top 10 positions

Stock	% Holding	Sector	Country	CIO Model Funds
Visa	1.48%	Financials	US	WCM, Franklin, MFS
MercadoLibre	1.33%	Cons Cyclical	Brazil	WCM, Franklin
Shopify	1.25%	Technology	Canada	WCM, Franklin
TSM	1.23%	Technology	Taiwan	Fidelity, RWC
HDFC Bank	1.15%	Financials	India	Franklin, WCM, Fidelity
First Republic Bank	1.04%	Financials	US	WCM, Artisan
Techtronic Industries	1.02%	Industrials	HK	Fidelity, Artisan
Synopsys	1.02%	Technology	US	Franklin, WCM
Stryker Corp	0.97%	Healthcare	US	WCM, MFS
LVMH	0.97%	Cons Cyclical	France	WCM, MFS

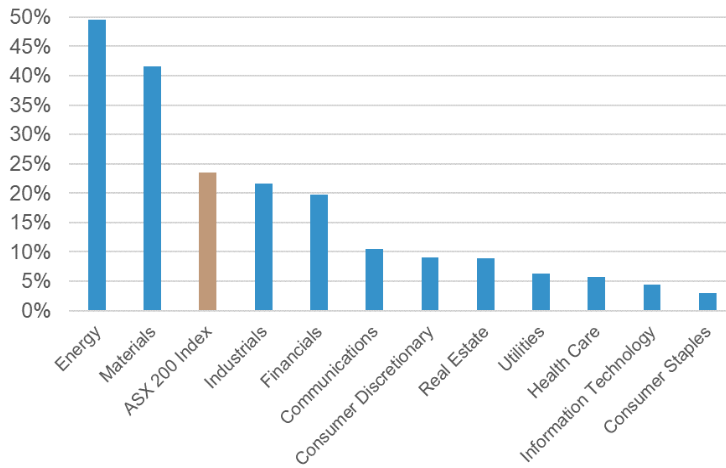
Source: Escala Partners

Table 4: Top holding in each sector

Sector	Top Holding	% Weight	Country	CIO Model Funds
Consumer Cyclicals	MercardoLibre	1.33%	Brazil	WCM, Franklin
Financials	Visa	1.48%	US	WCM, Franklin, MFS
Materials	Koninklijke DSM	0.93%	Netherlands	Franklin, Artisan
Real Estate	CoStar Group	0.51%	US	Franklin
Communication Serv	Tencent	0.74%	China	WCM, RWC
Industrials	Techtronic Industries	1.02%	Hong Kong	Fidelity, Artisan
Information Techno	Shopify	1.25%	Canada	WCM, Franklin
Consumer Defensive	Kweichow Moutai	0.76%	China	Fidelity
Health Care	Stryker	0.97%	US	WCM, MFS

Source: Escala Partners

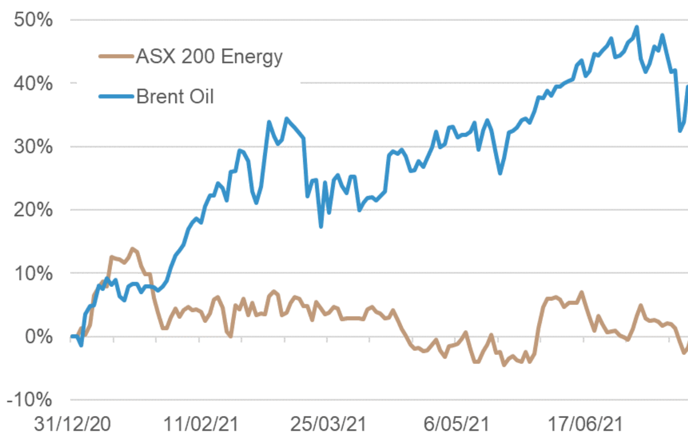
Chart 3: ASX 200: Cyclicals lead upgrades in the first half of 2021



Source: Bloomberg

The first half of 2021 has been notable for the significant rebound in earnings for the ASX 200, with aggregate earnings for the benchmark up an incredible 24% for the six months. Analysing the change in the sectors of the market, however, reveals an uneven contribution across the board. Cyclicals have been the key beneficiaries this year, particularly the resources sector (on the back of commodity price strength), along with industrials and financials. Meanwhile, the winners of 2020, being structural growth sectors and defensives, have lagged though have still seen earnings expansion. These include health care, IT and consumer staples.

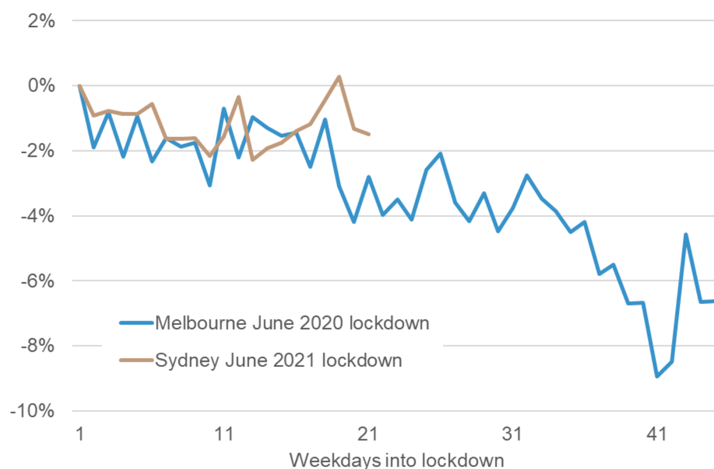
Chart 4: Energy sector not responding to oil price strength



Source: Bloomberg

While commodity price strength has helped to underpin the earnings of the ASX 200 this year, this has clearly not been reflected in the performance of the energy sector. Benchmark Brent oil prices are up around 40% year to date, yet the domestic energy index is little changed from the end of 2020. Several stock-specific issues have no doubt contributed to this outcome, though a growing focus on ESG has also been highlighted, with the energy sector facing much higher climate policy risks than much of the rest of the market.

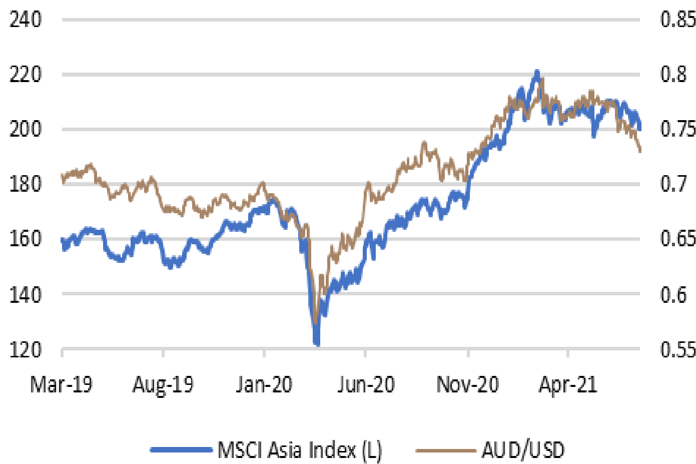
Chart 5: Lockdown risk to Australian market: ASX 200 relative performance to MSCI Developed Markets



Source: Bloomberg

With Sydney under lockdown for more than a month now and Victoria also facing similar measures, there are obvious earnings risks for the domestic market the longer these persist, despite the broad expectation of an economic bounce once restrictions are lifted. The current situation is likely to yet again lead to a cautious approach by companies in relation to guidance in the upcoming reporting season. While the Australian market rebounded strongly once the Melbourne lockdown was lifted in October last year, the ASX 200 lagged global equity markets by more than 6% in the first two months once it was announced. So far for the current Sydney lockdown, the ASX 200 has underperformed developed equity markets by just under 2%.

Chart 6: Asian equities tend to follow the Aussie

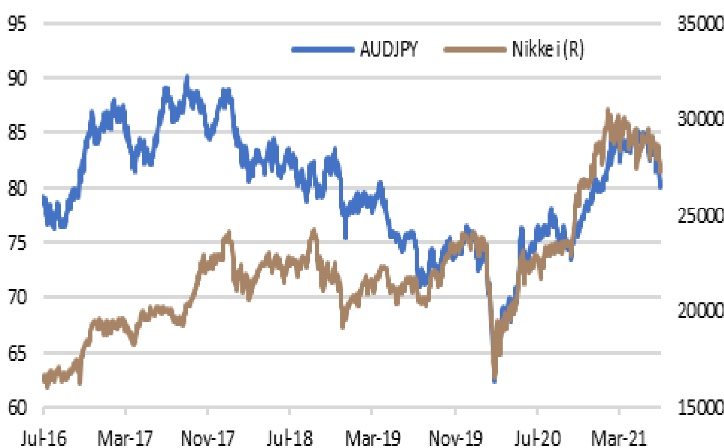


Source: Bloomberg

Weaker commodity prices tend to be associated with a stronger US dollar and a weaker Australian dollar. Despite the increased weight to tech stocks in recent years, Asian equities still tend to be very sensitive to commodity prices. And so it goes, a weaker Aussie is associated with weaker Asian equities.

This only adds to the case for Australian investors in global equities, particularly those into Asia, to be currency unhedged.

Chart 7: Aussie dollar v yen – risk-off barometer



Source: Bloomberg

One of the best barometers of risk-off in the market is the Australian dollar, Japanese yen exchange rate. This is due to the Australian dollar being one of the most cyclically sensitive currencies in the world (being commodity based) and the yen is seen as a safe-haven currency.

Given its exposure to exporters, a stronger yen is bad news for Japanese equities.

Chart 8: US Cyclicals sell-off v defensives

Source: Bloomberg

For the month to date, cyclical sectors, led by energy and materials, are deep in the red relative to defensive sectors like staples and utilities.

The latest Bank of America fund manager survey found the cyclical boom has peaked. A ratio of cyclicals to defensives has fallen and is now flat year-to-date. As fears about peak economic growth and rising inflation dominate the narrative, that ratio has further to fall.

Chart 9: China 10-year bond yield (%)

Source: Bloomberg

Economic growth in China is slowing, reflected in falling bond yields.

The June trade numbers sustain the theme of a robust trade surplus, but also show slowing export and import growth. Not helping the growth outlook is the tightening in financial conditions brought about by a stronger yuan.

The slowing theme was supported by the move to cut interest rates by the Chinese central bank for the first time since the pandemic began last year. The decision frees up 1 trillion yuan of funds banks parked at the central bank, allowing them to lend more. Meanwhile, the credit data surprised to the upside, suggesting the policy bias has shifted more towards supporting growth.

Chart 10: US 2-10yr yield curve flattening (bpts)

Source: Bloomberg

Near-term growth concerns have already dented longer-term inflation expectations. But if the market sees U.S. growth prospects diminishing enough over the longer-term to keep the Federal Reserve on hold indefinitely, it will strip out more future rate hike expectations. The result will be an even flatter U.S. curve.

As financial institutions benefit from a steeper yield curve, that is the sector most vulnerable to flattening.

Chart 11: Inflation expectations fall: 5y5y forward breakeven.

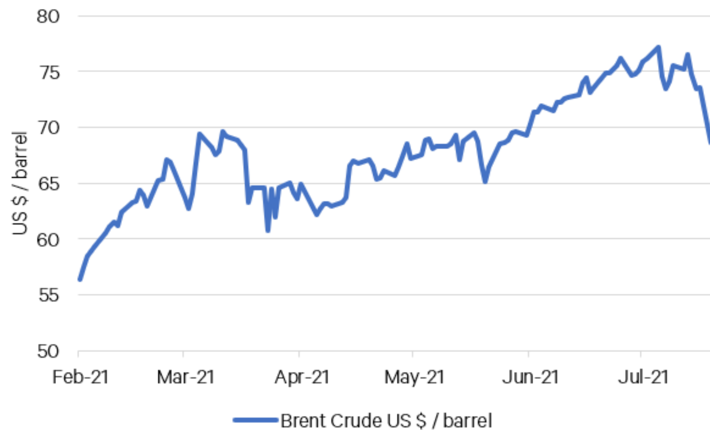
Source: Bloomberg

Inflation expectations, as measured by the 5-year 5-year forward breakevens, are hovering near the lowest level since March.

This bears watching as it demonstrates near-term concerns about the delta variant and economic slowing are having an impact on longer-term inflation expectations.

Inflation expectations peaked in May near 2.40%. We are now at 2.07%.

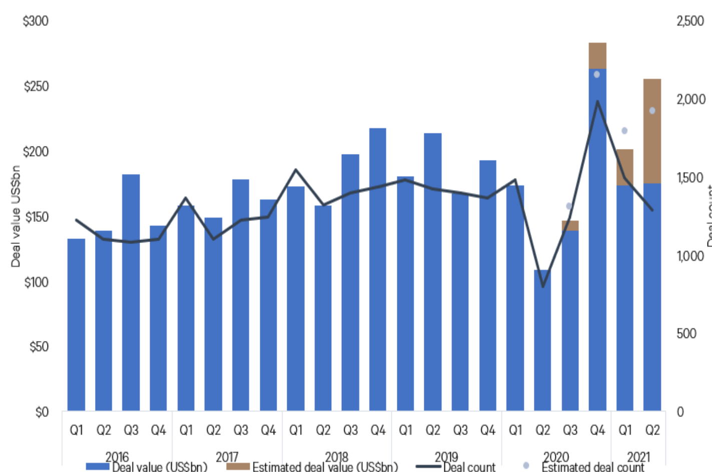
Chart 12: OPEC agreement sends oil lower



Source: Bloomberg

Brent crude prices have fallen 9% since the beginning of the month as OPEC+ members finally agreed to production increases for all members of the cartel. In doing so, the agreement will look to end the tightness in oil supply which has seen prices increase by 35% year to date, hitting the highest levels since October 2018 at $77 per barrel. Also adding to the weakness in current prices is higher inventory levels in the US whilst demand forecasts have softened in the near term from the resurgence of covid-19 cases across the world.

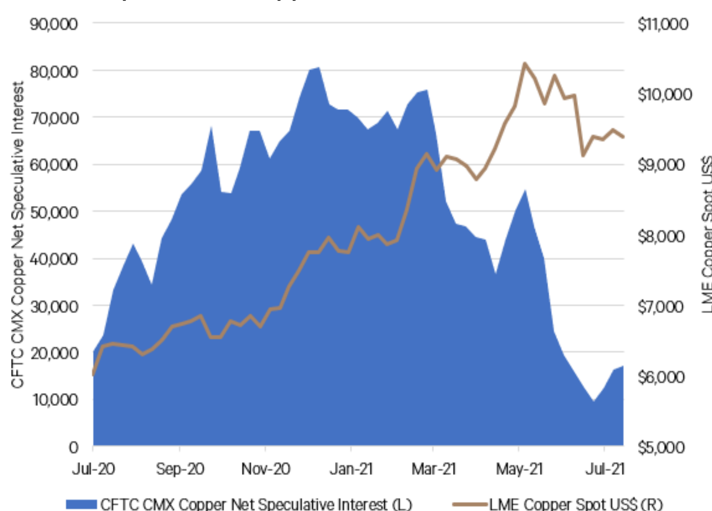
Chart 13: Private Equity deal flow continues to surge



Source: Pitchbook

Activity in private equity (PE) markets continued at record pace as deal flow for Q2 2021 surpassed multi-year average levels for the third quarter in a row. Total PE deal flow for the first half of the year is estimated to have exceeded $450bn as record levels of dry powder continue to get allocated on the buy side whilst elevated market multiples and increased M&A activity continue to drive exit activity for existing PE fund managers.

Chart 14: Speculative copper trades fall



Source: Bloomberg

Speculative positioning in copper has fallen 75% since the beginning of the year following restrictions imposed by China and concerns over softening economic growth as prices in most commodities pull back from recent highs. Despite the collapse in speculative interest, copper prices have fallen just 10% from highs posted in May as the market reverts back to focusing on fundamental drivers of tight supply and new structural demand from electric vehicles and renewable energy production coming on in the near future. Citi see prices rising back above $10,000 before year end.

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