ESCALA
PARTNERS

AGENDA 2021

Chief Investment Office

Welcome

It is my pleasure to present our annual investment publication, Agenda 2021. This publication is compiled by our investment team headed by our Chief Investment Officer, Tracey McNaughton.

2020 was a "Year of Extremes", when the world was thrown into chaos and confusion. While it is tempting to allow our depth of field to shorten after such a year it is important to remain focused on the longer-term strategy. If nothing else, 2020 reminded us of the importance of diversification, of setting an investment strategy and being disciplined in staying true to it.

Having a clear investment process guards against many of the behavioural biases that were a daily tease for investors in 2020. Recency bias, over-confidence, loss-aversion, crowd-following, the illusion of control. These biases were as evident in human behavior through the year as the pandemic itself. Information was everywhere but much of it detracted from the ability to make rational decisions. Why did we flock to the supermarket to buy toilet paper?

Like radar cruise-control on your car, a good investment process will filter relevant information from white noise and will correct for what can be faulty decision-making. This is particularly important when travelling through times of crisis.

In 2021, we will see a world that is returning to normal while also rapidly accelerating into a transformed future – both technologically and environmentally. The integration of the virtual into the real world; robotic process automation; artificial intelligence as a service; quantum and edge computing; the movement toward net-zero emissions. All will gather pace in the post-pandemic world.

As always, we will be on the journey with our clients helping them navigate the path to not only achieving their investment goals but also leaving the world in a better place for their future generations to enjoy.

Our key views for what may lie ahead are presented in the pages that follow. I hope you will find them interesting, informative and relevant.

I, and the entire Escala team, look forward to our continued partnership in the year ahead.

Pep Perry
Chief Executive Officer

Escala Partners Pty Ltd (EPPL) (ACN 155 884 236) is a Corporate Authorised Representative (No. 439722) of Escala Wealth Management Pty Ltd ((EWM) ACN 162 573 828) holder of AFSL 456207. EWM is 100% owned by EPPL.

This document has been prepared without consideration of specific client investment objectives, financial situation or needs.

Before you make any investment decisions, EPPL recommends that you obtain a copy of the Product Disclosure Statement (if applicable) and speak to an EPPL investment advisor.

This document has been prepared using information from reliable sources. EPPL makes no representations, warranties or gives any undertaking in relation to the accuracy or completeness of the information presented. Any conclusions, recommendations and advice contained herein are reasonably held at the time of completion of this publication but are subject to change without notice. EPPL does not accept any responsibility to inform you of any matter that subsequently comes to its notice, which may affect any of the information contained in this document and assumes no obligation to update and reissue this document following its publication.

EPPL, its directors, employees and agents disclaim all liability for any errors in, or omission from, this document or for any resulting loss or damage suffered by the recipient or any other person as a consequence of relying upon this document.

Historical performance is often not a reliable indicator of future performance. You should not rely solely on historical performance to make investment decisions.

This publication has been issued for general information purposes only and is not intended to be relied upon. It does not constitute an offer of any financial product or an invitation or solicitation to buy or sell financial products. You must seek independent financial and taxation advice before making any investment decision. This publication is not intended to be a complete document and should not be relied upon for any purpose.

EPPL may receive commissions and fees from transactions involving securities referred to in this document. EPPL, its directors, employees and agents may from time to time hold interests in the securities referred to in this document.

This document is a private client communication and is not intended for public circulation or for the use of any third party.

Contents

Our Views in Brief

Global Growth

The world will go from synchronised crisis in 2020 to synchronised recovery in 2021. Sizeable fiscal and monetary stimulus globally will feed into consumer and business investment spending in developed markets and support export-led growth in emerging market economies.

Inflation

Inflation pressures will remain contained in 2021 though with fiscal policy now pulling in the same direction as monetary policy, the upside risks to inflation are growing. We think this plays out more over the medium term. Key to keeping inflation contained is the policy response from authorities around the world to subjugate the business cycle and keep as much productive capacity alive as possible.

Interest Rates

Interest rates globally are at record lows and are expected to remain so for some time. Conventional monetary policy is all but exhausted with policy rates in no fewer than eighteen central banks cut to zero. Forward guidance from the major central banks suggests interest rates will remain low for several years to come.

Fiscal Policy

The pandemic recession has triggered the adoption of fiscal stimulus, particularly in developed markets where conventional monetary policy was all but exhausted. The fiscal tailwind is likely to ease in 2021 as economic growth becomes more self-sustaining.

Bond Yields

We see government bonds as universally expensive and offering little in the way of income or diversification. Low inflation and reflationary central banks should limit the rise in bond yields during the economic recovery in 2021. We have a more positive view on high-yield and investment-grade credit given the low default risk implied by central bank bond purchases.

Equities

The global economy is in the early recovery phase of the business cycle following the COVID-19 recession. This is an environment that usually favors equities over bonds. We like the value in emerging markets equities. China's early exit from COVID-19 lockdowns and stimulus measures should benefit emerging markets more broadly.

Currencies

Given its counter-cyclical nature, we expect the U.S. dollar to weaken in 2021. The dollar typically rises during downturns and falls in the recovery phase. The main beneficiaries should be the economically sensitive commodity currencies – the Australian dollar, the New Zealand dollar and the Canadian dollar.

Alternatives

The lower for much longer environment, made more challenging by central bank crowding out the private sector in the bond market, is increasing the attractiveness of private markets for risk-adjusted returns. We particularly like private debt, private equity and unlisted infrastructure.

Extremis

Tracey McNaughton
Chief Investment Officer

2020 was a year of extremes. The COVID-19 crisis took the world's economic, financial and social infrastructure to the limit. Economies fell into a deep recession. Financial markets were sent into a tail-spin drawing governments and central banks into action like never before. And while our hospitals were overflowing our cities were empty. What does the world look like after such a year?

Perversely, we expect 2021 to be exceptionally strong. Economies and financial markets were taken to their extremes by an event that for the most part will be addressed by vaccine development. The global recession will be remembered as the deepest, but shortest recession on record.

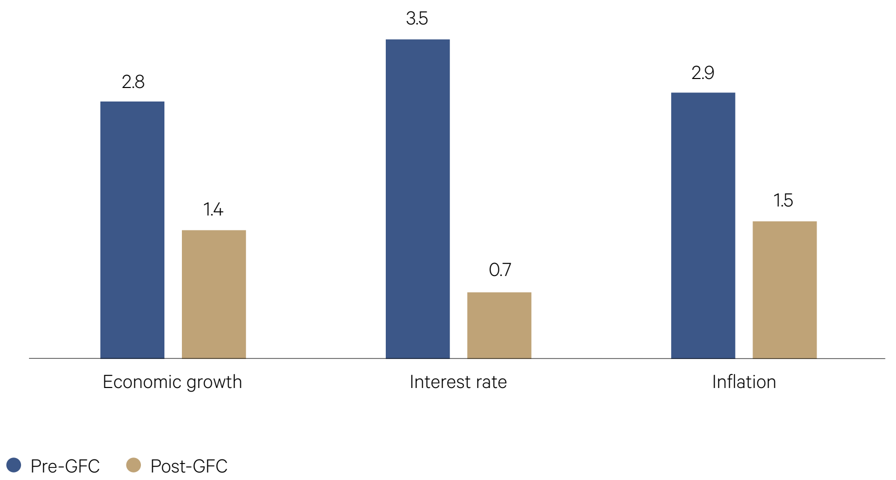
Given this, we expect small cap companies, cyclical sectors and emerging markets to outperform in 2021. In particular, we expect the Asian region to benefit the most. While 165 countries fell into recession in 2020, China was not one of them.

While economies and financial markets will snap back in 2021, the year of extremities will leave its mark. The Global Financial Crisis (GFC) in 2008 had already pushed the world into the "New Normal" – lower interest rates, lower inflation and lower economic growth. The 2020 policy response will take us even further in that direction.

We are now entering the "New-New Normal". Cyclically, we are expecting an economic recovery in 2021.

Structurally, however, we remain in a lower for much longer environment. The Japanese experience offers valuable lessons. A loose monetary policy can stabilize a recession for the short term, but a persistent flood of cheap money paralyzes productivity gains and growth. This means investors need to look further and think smarter to achieve target returns.

The New-New Normal in the US (10-year average %)



Source: Bloomberg

> *While 165 countries fell into recession in 2020, China was not one of them.*

How the year of extremes will shape the future:

1. Extreme fiscal debt

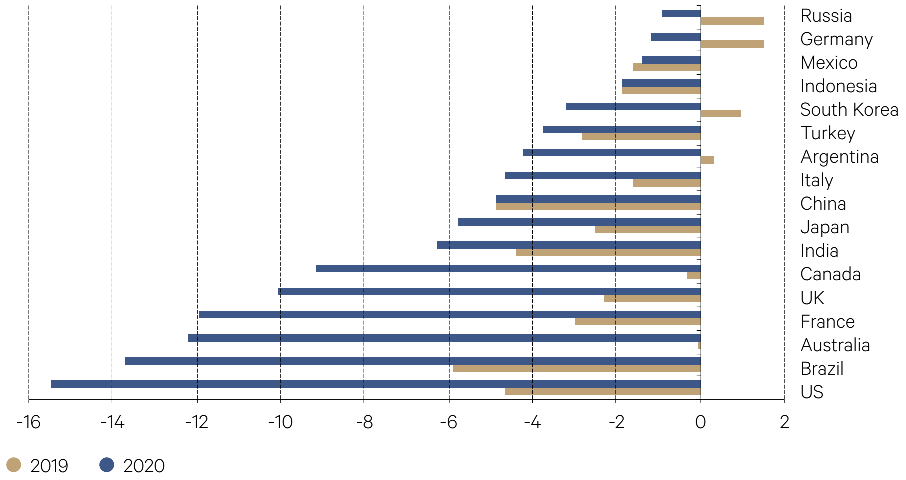
Most recessions are caused by excessive tightening of monetary policy that hits household and corporate balance sheets hard. Subsequent balance sheet repair retards the recovery process. The 2009 recession in the US was a drawn-out affair because of this.

To quote Paul Keating, the recession we had in 2020 was "a recession we had to have". But not for the usual reasons. Interest rates were not lifted to 17.5%. Inflation wasn't running at 10%. The recession in 2020 was caused by the closing of the economy to deal with a health crisis. There was nothing economic or financial about it. There were economic and financial consequences of course but for the first time since the Spanish flu, the global economy was in recession literally for health reasons. Quite unusually, government balance sheets were hit the hardest in this recession. US household debt is actually down and corporate debt is up only slightly.

With the health crisis now dealt with, economies can start to re-open again. This re-opening will be super-charged by the sheer size of government stimulus and the fact that household and corporate balance sheets were for the most part insulated.

Where the damage has been done, on government balance sheets, the repair will take years. But because it is government, the hard work can be delayed until the economy is firmly back on its feet.

Fiscal Balance (latest, %GDP)



Source: Bloomberg

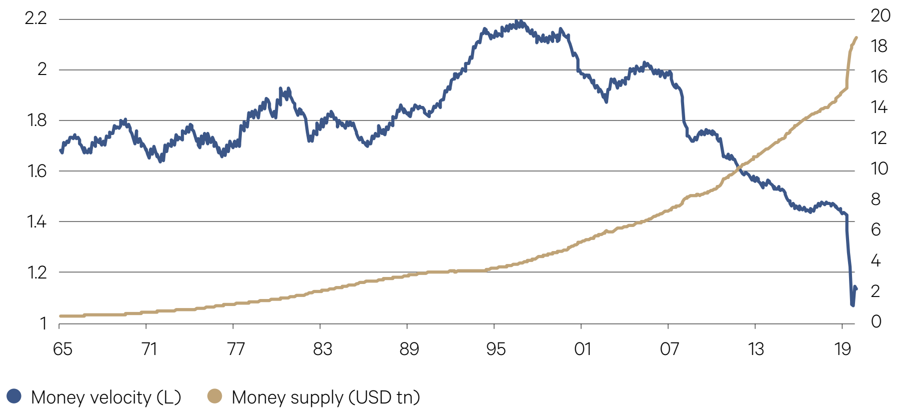
2. Extremely low inflation

While the volume of money in the economy has surged, the speed it circulates has collapsed. This has put downward pressure on inflation and hence interest rates. Growing income inequality is playing a role here. The upper strata of wealthy households spend a far smaller percentage of their income than the less wealthy. An increase in inequality, therefore, correlates with a slower velocity of money. The very policies used to address the effects of the pandemic have led to a rise in inequality, contributing to a decline in velocity and stymying inflation. As was the case following the GFC, policymakers protected Wall St much better than they protected Main St.

Three investment implications that stem from this are:

1. Near term tactical (6–12mths): We favour small cap companies, cyclical sectors and emerging markets
2. Medium term tactical (12–18mths): We still prefer growth sectors and markets over value
3. Medium term strategic (5-years): Increase allocation to private markets to avoid central bank crowding-out.

Money supply up but velocity down



Source: Bloomberg

Extremis (contd.)

3. Extreme market intervention

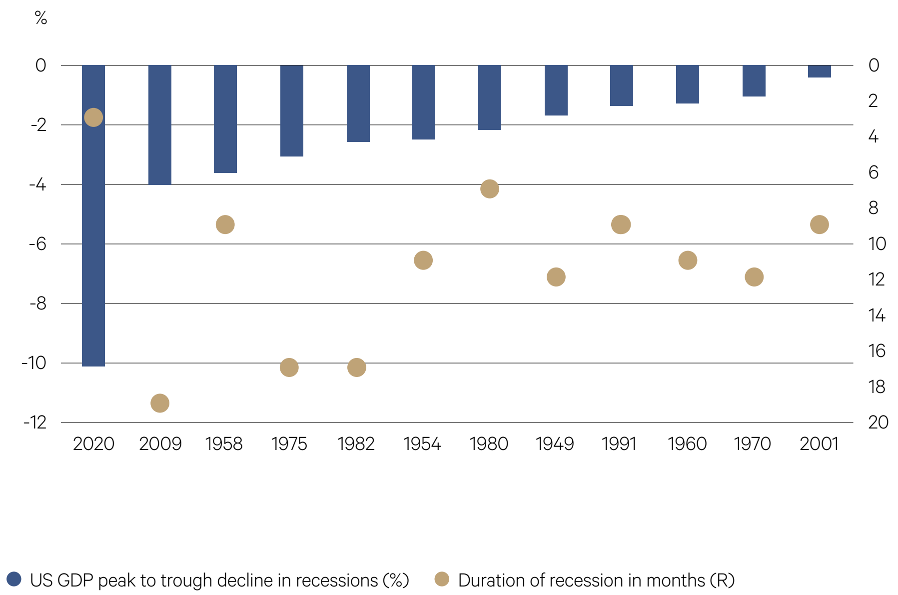
Unconventional monetary policy rapidly became conventional in 2020. No fewer than thirty central banks around the world are now competing with ordinary investors to buy bonds in the secondary market.

This is having at least three effects. First, as central bank ownership increases, turnover and liquidity in the market decreases. The central banks in Japan and Europe now own 40–50% of the market. The Japanese bond market now barely exists. Days go by without a single trade. Some months see only a handful of trades.

The second effect is a crowding-out of investors for attractive risk-adjusted returns. Returns are defined by their risk. Where there is less risk, there is less return. Where there is less return, there is less consumption. Bonds in Japan are regularly issued with a coupon of just 0.1%. For some private-sector employees, this coupon is also the rate of return on their pension savings – one reason, perhaps, that many Japanese are so reluctant to spend.

The third effect is the impairment of price discovery. The share price of Hertz should not have surged by 896% following its filing for bankruptcy in May 2020 but it did because the US Federal Reserve was a buyer of its bonds. Central bank buying of bonds causes risk to be mis-priced, weakening the link between risk and reward.

The COVID-19 recession has been the deepest, but also the shortest



Source: Bloomberg

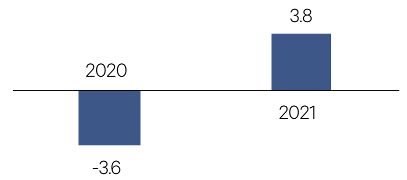
From the longest but weakest recovery on record in 2019, to the deepest but shortest recession in 2020.

Global Economy Breakdown

United States

The business cycle troughed in the US in April when 95% of Americans were ordered to stay-at-home. The subsequent economic re-opening coupled with historic fiscal and monetary support will drive a strong recovery in 2021.

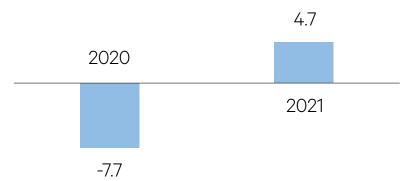
GDP %



Europe

Europe's fiscal policy response to the pandemic was about half the size of that in the U.S. Europe is more exposed to global trade than the U.S. and so will be a beneficiary of a rebound in Chinese demand.

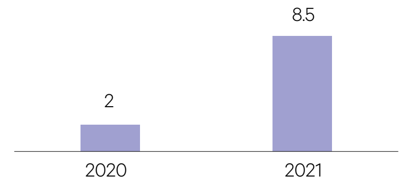
GDP %



China

The world's second-largest economy was the only major economy to grow in 2020, albeit at the slowest annual pace since 1976. Growth is projected to pick up to around 8.5% in 2021, led by exports and strengthening consumption and investment.

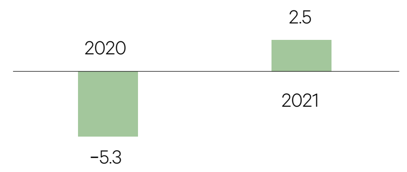
GDP %



Japan

Japan's recovery will likely lag other developed economies. Despite recording just 2–3% of the number of cases in the US or Europe, the weak bounce back in consumption suggests the virus has left more scarring in Japan. A boost to spending and tourism will come from hosting the delayed Olympics in 2021.

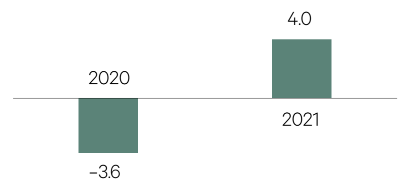
GDP %



Australia

Pent up demand and the easing of restrictions on domestic tourism, hospitality, and retail are likely to support growth. Forward guidance from both the Reserve Bank and the Federal Government suggests monetary and fiscal stimulus will remain in place for several more years at least.

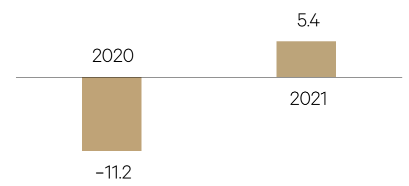
GDP %



United Kingdom

A no-deal Brexit crisis was averted but the UK still faces the biggest reset of an advanced economy's trade relations since World War II. Growth is expected to rebound as the UK finished 2020 further below pre-crisis growth levels than any other G7 economy.

GDP %



Source: Bloomberg

Theme 1:
The Income Challenge

Income investors have never had it so tough. Not only are the yields on everything from term deposits to bank stocks plumbing new lows, but volatility is rising making the prospect of taking on more risk to meet objectives all the more daunting. There is a solution, but it requires income investors to re-tool.

A decade ago, the task of an income investor was straight forward. A simple deposit into a one-year term deposit at a local bank generated 6% in income. One asset; one manager; no active fees. That 6% has now turned into 0.7%. Suddenly, the passive, single strategy road to income is no longer accessible.

Navigating an alternative path to a higher income will require two critical tools – diversification and active management – two things income investors probably didn't need to think too much about previously. But the more challenging path will require these two tools if income investors are to avoid falling short of their target.

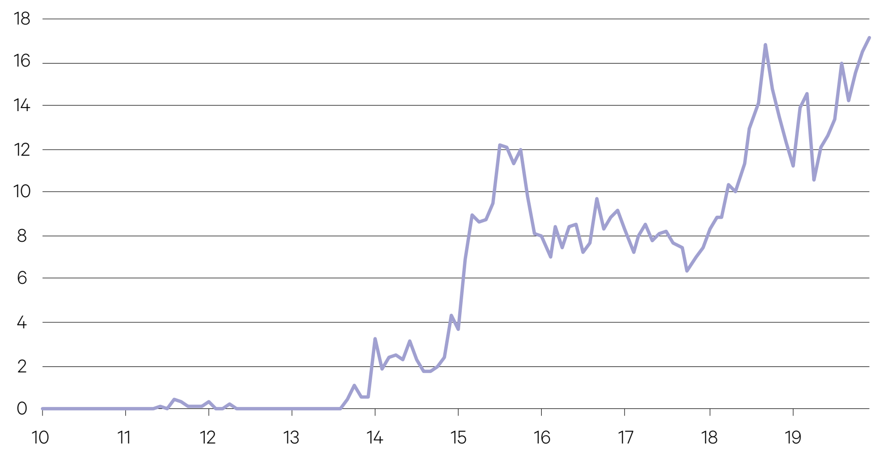
CHALLENGE #1

Negative yielding bonds

The world's pile of debt with a negative yield, that is, bonds that cost investors money simply by holding them, has reached a new record of $17 trillion (equivalent to one quarter of all bonds outstanding). For the first time, Australia joins New Zealand, Japan and most of Europe in selling short-term government securities at a negative yield.

Potential returns across the bond market have become increasingly scarce following the coronavirus crisis and record asset purchases by central banks. With central bank buying set to remain a feature of monetary policy for several years to come, the mountain of negative-yielding debt will likely climb further.

Amount of negative yielding debt globally (USD tn)



Source: Bloomberg. Data as at 30 November 2020

Suddenly, the passive, single strategy road to income is no longer accessible.

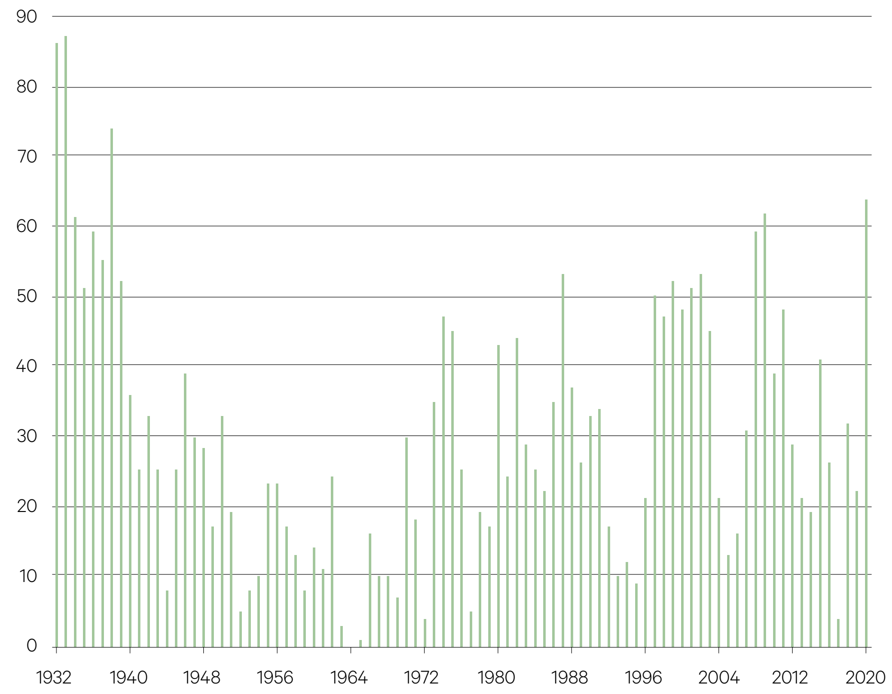
CHALLENGE #2

A volatile year

2020 saw financial market volatility rise significantly. This can best be seen in the percentage of trading days in US equities that generated a return greater than 1%. In 2020 this percentage rose to 63% from 22% in 2019. Measured on this basis, volatility hasn't been this high since 1938.

The increase in volatility in 2020 reflects the extreme level of uncertainty the COVID-19 crisis presented to investors. Economic outcomes during the year were a function of how governments responded to rising case numbers which in themselves were difficult to predict. The development of an effective vaccine has significantly addressed this uncertainty so volatility should be lower in 2021.

% Trading days with return greater than 1%



Source: Bloomberg, Escala Partners. Data as at 3 December 2020

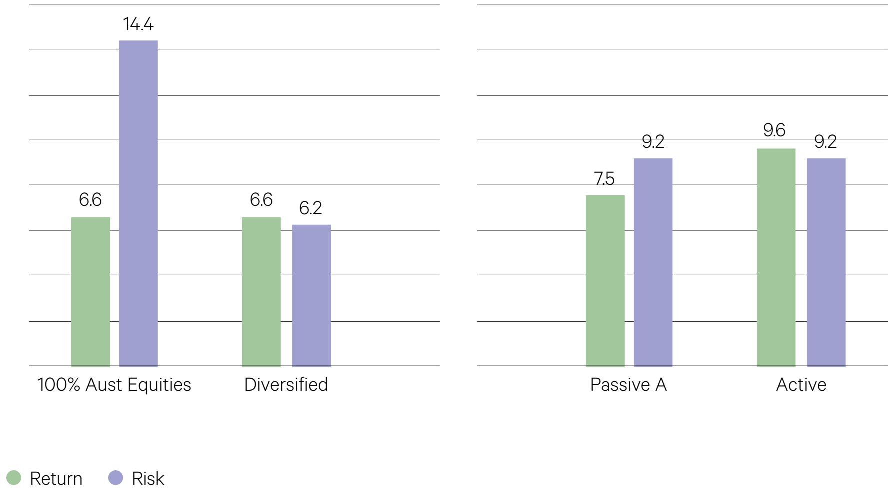
CHALLENGE #3

Tools to meet the challenge: Diversification and Active Management

The path ahead for income investors will require skills in risk management as well as skills in return management. For risk management, the best tool on offer is diversification. A portfolio that is 100% invested in Australian shares will have more than double the volatility of a portfolio that is invested across a diverse range of equities and bonds despite both generating the same return.

For return management, the best tool on offer is active management. After accounting for fees, a portfolio that is invested in active funds will have a 30% higher return than a portfolio invested in passive ETFs despite both portfolios being set at the same level of risk.

Compare the pair (%)



Source: Escala Partners. Data as at 31 October 2020

Low yields are here to stay for some time. The challenge for investors, particularly income investors, will be in achieving target returns without going off course. Being equipped with the right tools will help in meeting that challenge.

Low yields are here to stay for some time.

Theme 2: COVID-Driven Structural Trends

The spread of COVID-19 across the world through this year had a dramatic impact on everyday life for many people as governments imposed restrictions on their citizens to limit the rate of virus transmission.

While the restrictions varied in their length (from a few weeks to several months) and their severity (from mild to draconian), there is no doubt that they have been a catalyst for a fundamental change in the way individuals and businesses operate.

Many of these will be only temporary, such as restrictions on travel (both domestic and international) and capacity limitations in industries which are dependent on face to face interactions, such as hospitality. A number of these, however, will likely be more permanent in nature. Some will be changes that are simply an acceleration of trends that have been occurring over time, or the emergence of new trends. In this section we discuss three of these structural trends.

TREND #1

Work From Home

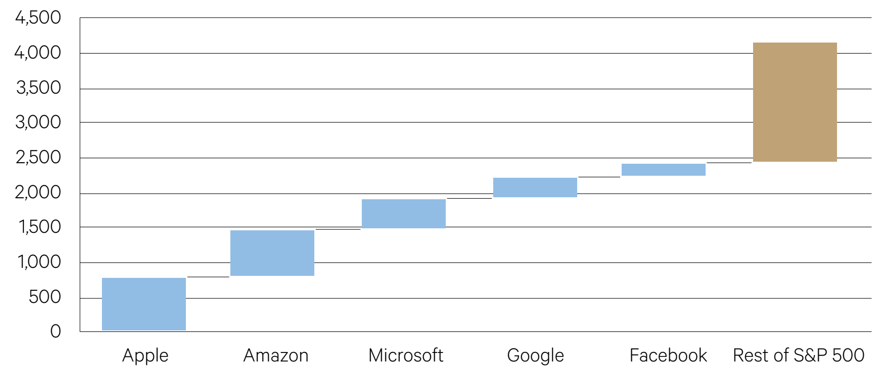
Overnight in March, many companies were forced to abruptly implement emergency work from home procedures. The large-scale exercise proved to be much more successful than many would have anticipated, with the adaption of new technologies allowing businesses to continue operating with minimal disruption and little change in productivity. This raises the obvious question of whether this has caused a more permanent change.

While it is likely that most employees will return to the offices around the world when safety permits, some companies (particularly in the tech industry) have made the transition permanent. For many, however, a hybrid or flexible model may become the norm, whereby employees split their time between the office and home.

So, what are the outcomes of this change? Reduced demand for city office space, a lower premium for real estate located close to work hubs, less traffic and use of public transport in peak hours and bigger houses to accommodate home offices are all likely developments. Business travel also faces an uncertain outlook. Many business meetings and conferences are now being successfully conducted online and hence companies will be reluctant to reinstate pre-crisis travel budgets.

From the equity market's point of view, the one conclusion that can be drawn is that the changes favour big tech. With demand for many of big tech's services soaring through the crisis, it has further entrenched their respective market positions at the expense of older industries.

Growth in Market Capitlisation in 2020 (US$bn)



In 2020, the big five tech stocks in the S&P 500 added US$2.4tr to their combined market capitalisation; the residual 495 stocks in the benchmark grew by an aggregate US$1.7tr.

Source: Bloomberg

TREND #2

The Rise of Ecommerce and the Demise of Bricks and Mortar Retail

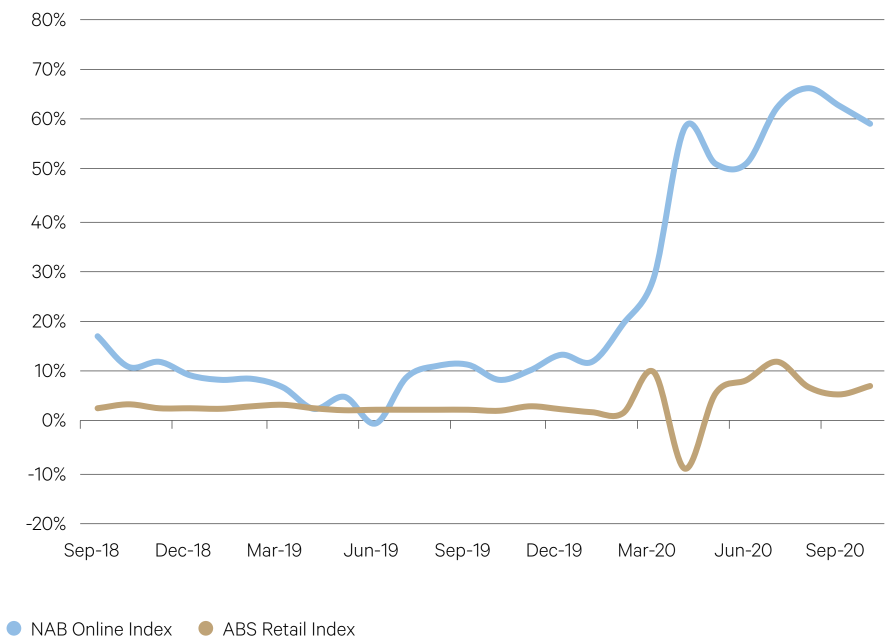
Bricks and mortar retailers have been among the biggest losers of the COVID-19 crisis. Crossing all the boxes of COVID-19 transmission risk factors – non-essential, face to face services and indoors – widespread closure of shops has been a common enforcement measure across the world. With shops closed, online was the only channel that remained open which led to a spike in digital shopping.

Additionally, with many other services industries shut down, much of this budgeted spend was directed to goods and products sold online. Further, while spending typically dips during a recession, unprecedented fiscal stimulus countered this typical pattern.

The crisis period has undoubtedly introduced new consumers to the channel who had previously resisted the trend or who may have been uncomfortable buying online. Shops have eventually reopened and online cannot replicate the physical instore experience. However, the permanent transition of sales from one channel to the other will hurt bricks and mortar retailers who had operated at the margin.

A report by IBM on US retail has concluded that COVID-19 has accelerated the trend from bricks and mortar to online by almost five years.

Online Retail Sales vs ABS Retail Sales (annualised growth)



Online retail sales growth jumped as lockdowns were initiated in Australia, with sales growth still tracking at around 60% year on year.

Source: NAB, ABS

TREND #3

Diversification of Supply Chains

One of the more immediate impacts triggered by the COVID-19 crisis was the abrupt disruption to supply chains worldwide, exposing numerous vulnerabilities.

Sharp changes in demand and multiple links of supply broke down. Factory capacities were reduced while border closures led to delays in transportation. The rise of 'just in time' supply chain management (where inventory is ordered on an as needs basis) over several decades further exacerbated the problem.

There are two likely changes that may occur in response to this shock. Firstly, companies will seek to diversify their supply sources further, reducing the risk of concentration from any country or region. Secondly, economic nationalism, already growing due to the numerous trade wars that have arisen in recent years, will gain further traction, with broader implications for the longer term growth in international trade.

Theme 3:
Toward Net Zero

In December 2015, 55 countries accounting for 55% of the total global greenhouse gas emissions formally agreed to limit global warming to 1.5 degrees celsius this century. Achieving this will require global greenhouse gas emissions to reach net zero by 2050.

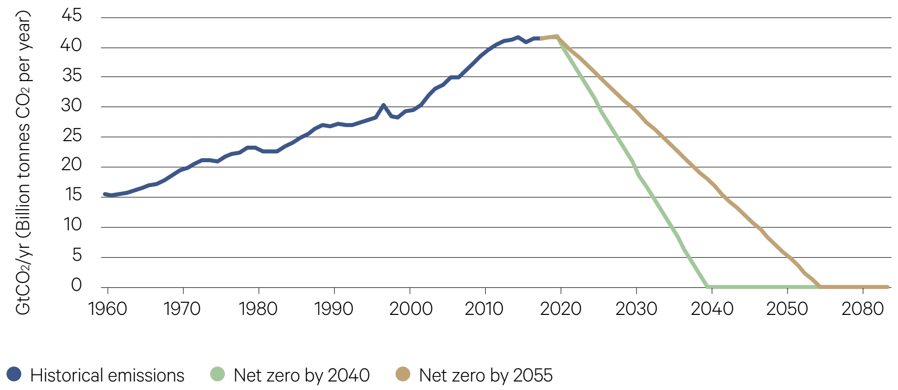
Getting to net zero means we can still produce some emissions as long as they are offset by processes that reduce greenhouse gases already in the atmosphere.

This will require significant amounts of new investment. A report by the Energy Transitions Commission (ETC) estimates a cost of $1–2 trillion per year – equivalent to 1–1.5% of global GDP. The investment is critical. According to Stanford University, global warming has cost the United States and the European Union at least $4 trillion in lost output since 2000.

One of the first tasks of the new Biden administration is to re-join the Paris Agreement. There are also intentions for US electricity production to be carbon free by 2035.

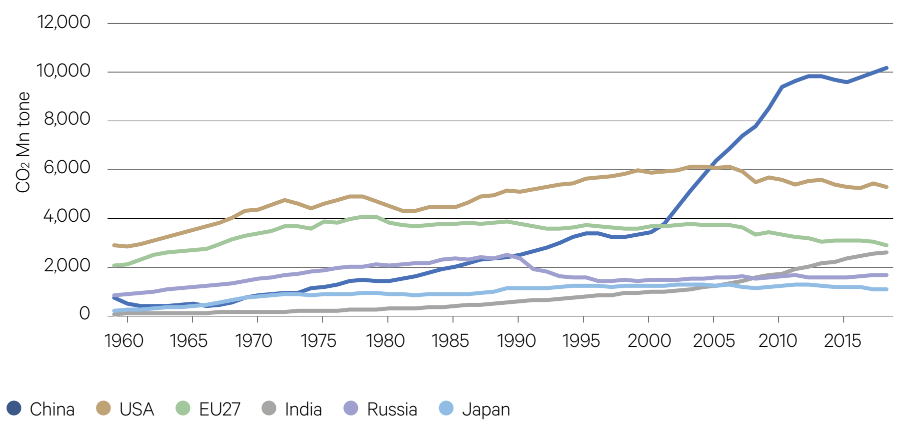
Getting to net zero will require $1–2 trillion in new investment per year.

Immediate action is required...



Source: Intergovernmental Panel on Climate Change Report, October 18

China's share of global CO_2 emissions rising rapidly



Source: globalcarbonatlas.org/en/CO2-emissions

At roughly 27% of global CO_2 emissions, China's commitment to net zero by 2060 could possibly be the biggest boost to tackling climate change to date. Currently renewables make up just 15% of energy consumption whilst coal, widely agreed as the highest polluting of all fossil fuels, still makes up 60%.

The European Union has set a goal of reducing emissions by 55% from 1990 levels by 2030 and aims to be the first carbon neutral continent by 2050.

Five years on, the list of signatories to the Paris Agreement has grown to 189 countries.

Governments tackling the transport sector

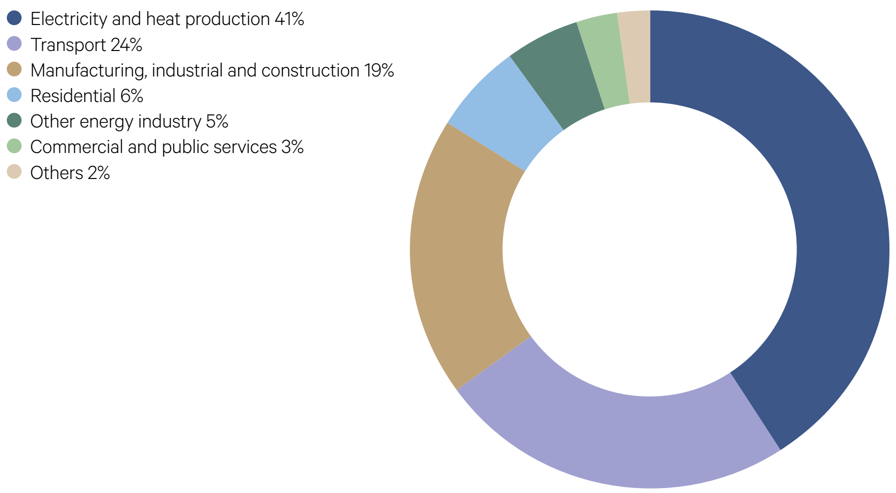
The UK's 10-point plan for a green industrial revolution includes steps such as banning the sale of petrol and diesel cars from 2030. Japan has committed to the same goal by 2035. So far, 23 countries have announced plans to ban fossil fuel vehicle sales. Norway's ban comes into force from 2025.

The impact on oil demand will be substantial with some analysts estimating demand to fall from 100 million barrels per day in 2019 to around 10 million by mid-century.

Corporations are joining the fight. Microsoft recently announced its ambitions to be carbon negative by 2030 and by 2050 the company will remove from the environment all the carbon it has emitted since it was founded in 1975. Consumer goods giants Nestle and Unilever will follow others who have begun labelling their products' carbon footprint. BP has pledged to be net zero emissions by 2050 and recently purchased stakes in US offshore wind farms. Other oil majors are investing in start-ups working on innovative carbon capture techniques.

Experts count over 1,900 pieces of climate legislation around the world, almost two-thirds were enacted in the past ten years.

Electricity & heat produce most emissions, followed by transport



Source: International Energy Agency

Negative Emissions technology can slow climate change

Direct Air Capture is the process of sucking CO_2 directly out of the atmosphere and burying it underground. This is seen as a natural complement to the land availability problems for afforestation and reforestation.

Australia, along with Japan, are at the forefront with recent announcements on the first liquid hydrogen transport ship. Airbus has recently announced plans for hydrogen powered passenger planes.

Experts believe hydrogen could become an $11 trillion industry by 2050.

Fixed Income

Tracey McNaughton
Chief Investment Officer

Fixed income assets had a reasonable year in 2020. Bond yields tumbled and credit spreads tightened in response to the unprecedented monetary stimulus. Over the year interest rates were cut no less than 252 times from 94 central banks around the world. All but 17 of those cuts came from emerging or frontier markets. Argentina took the prize for the most number of rate cuts by a central bank with the count sitting at eight. Developed economies such as the US and Australia were responsible for just 7% of all rate cuts. This reflects the fact that developed markets came into the COVID-19 crisis with policy rates already at very low levels. Before 2020, 2019 stood out as the year with the greatest number of rate cuts since the GFC.

The move lower in yield through the year now makes bonds an expensive asset class and at risk of a negative return. Low inflation and accommodative central banks should limit the rise in bond yields during the recovery but the low starting yield, particularly for government bonds, makes for a paper-thin income cushion to offset a potential negative capital return.

Even credit is now looking expensive. The yield on US high yield is now below the two-decade average for investment grade.

Global indebtedness increased by $15 trillion in 2020 taking the total to $277 trillion. Governments accounted for 60% of that increase. Much of this increased debt has found its way into central bank balance sheets, blurring the boundaries between fiscal and monetary policy.

Not so high yield on high yield bonds (%)

Source: Bloomberg

Portugal's 10-year bond yield fell below 0% for the first time. Recall Portugal was the "P" in PIGS during the European debt crisis in 2012. Italy, Greece and Spain the other. Portugal's debt is 137% of GDP.

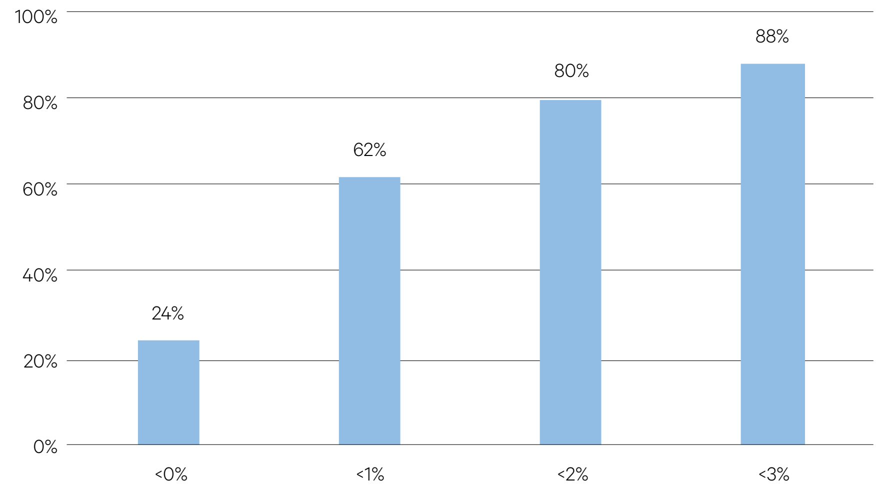
In addition to the risk of a negative return, government bonds no longer offer the diversification or liquidity benefits they once did when yields were higher. The table shows how the diversification benefits of government bonds have decreased in time as yields have moved lower.

Government bonds have lost their mojo

Drawdown period	Global equity drawdown	Global bond return	Starting global bond yield
Nov 07 – Mar 09	-59%	+10%	4%
May 11 – Oct 11	-23%	+3%	2%
May 15 – Feb 16	-19%	+4%	1%
Sep 18 – Dec 18	-18%	+1%	2%
Feb 20 – Mar 20	-34%	-1%	1%

Source: Bloomberg

Share of global bonds comes with a yield less than...



Source: Bloomberg

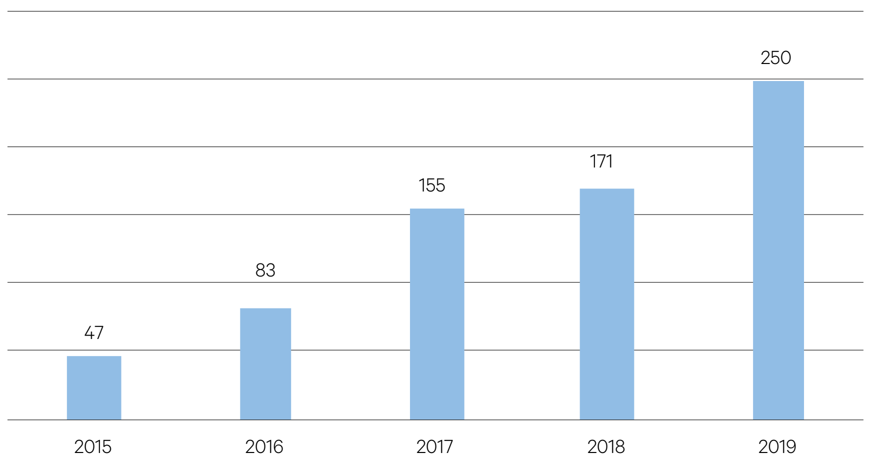
Emerging markets (EM) have scope to reduce interest rates further, and any deterioration in the US dollar will favour local currency bond performance. Liquidity risk should be heeded, however, and active selection paramount.

All of Germany's sovereign debt – typically considered the region's safest asset – has a yield below zero, meaning investors lose money by holding it.

80% of global bonds now come with a yield less than 2%.

The issuance of green bonds is increasing but investors should beware. Green bonds are relatively illiquid yet for most investors they form part of the fixed income allocation. The illiquid nature of the bonds also makes them difficult to trade from a management perspective yet most investors pay active fees to participate in them.

Global green bond issuance (USD bn)



Source: Climate Bond Initiative

Australian Equities

David Bruty
Investment Analyst

After an eventful and challenging year for the domestic equity market, we have a constructive view for 2021.

Underpinning our confidence is the forecast recovery in earnings that is anticipated across the next two years. COVID-19-driven shutdowns led to a sharp contraction in profits in the second half of the FY20 financial year and these extended into the December half, particularly in Victoria.

Australia's success in suppressing COVID-19 has minimised the near-term earnings risk that escalating case counts would entail, while providing a more conducive environment for households and businesses alike.

The decline in earnings across the market has been broad-based in nature, with only a select group of companies benefiting from the enforced lockdown. The structure of the Australian market, however, with large sector weightings to those that are more cyclical in nature, such as financials and resources, also led to weak relative performance compared to many overseas markets.

Through the recovery phase, though, this should ensure a sharper rebound and has been reflected in positive earnings revisions in the last few months. Banks will be supported by falling bad debts and a rebound in lending growth; rising markets help diversified financials; profits in the resources sector will be aided

Australia's success in suppressing COVID-19 has minimised the near-term earnings risk.

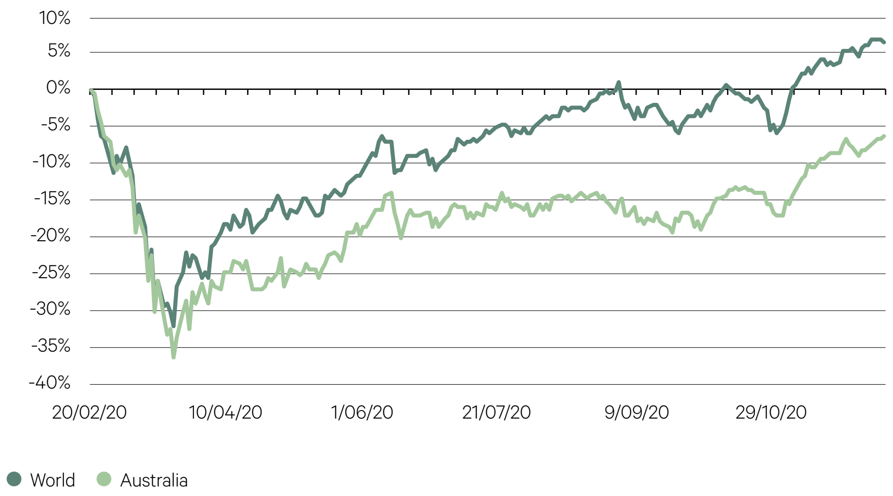
by demand growth not only from China, but also developed economies; while consumer-driven industrials are poised to benefit from pent up demand for services, a rebound in employment and the build-up in household savings over 2020.

Throughout 2020, investors in the Australian equity market were dealt the further blow of aggregate dividend payments declining by more than earnings. This can be attributed to several factors, including a cautious approach by companies in the face of a high level of uncertainty; regulator-enforced capital retention for the major banks; and prevailing high payout ratios leading into the crisis. While not returning to FY19 levels, we expect dividends to show a stronger recovery than earnings this year.

The rare combination of coordinated fiscal and monetary stimulus is the final piece of the puzzle. The Federal Government's response has limited job losses through the crisis period and has left household balance sheets in an improved shape, while the RBA has cut the cash rate to 0.1% and commenced a quantitative easing program. Critically, both the government and the central bank have telegraphed a clear message to the market that stimulus measures will remain in place for the foreseeable future.

Tempering our optimistic view is the starting point for valuations, with the forward PE ratio of the market at an elevated level. However, we don't believe that valuations look stretched considering both the earnings environment and the expectation that interest rates will remain contained through the year. We hence enter 2021 with a tactical overweight to the domestic market.

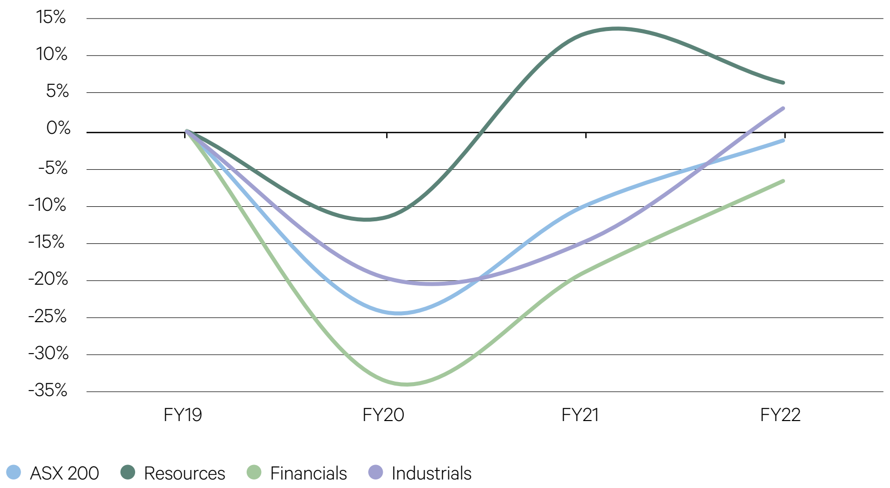
Equity Market Performance Since Peak



Source: Bloomberg

While Australia contained COVID-19 cases better than most countries, the domestic equity market still lagged global equites since the peak in markets in February.

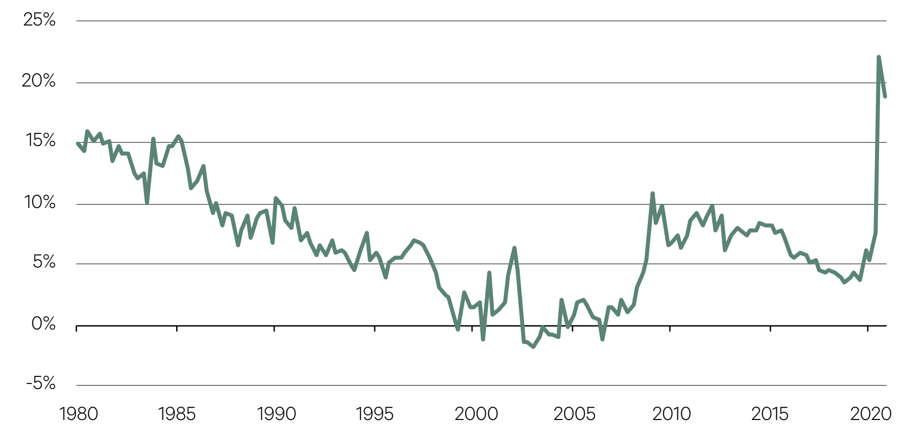
ASX 200: Cumulative EPS Growth



Source: UBS, FactSet

A strong rebound in earnings is anticipated across the next two financial years, with FY22 earnings expected to be at a similar level to FY19.

Australia Household Saving Ratio



Source: ABS, Bloomberg

Despite the recession experienced by Australia in the June half, household balance sheets are in good shape on the back of government support payments and a decline in services expenditure. The household saving ratio spiked from 5% to 22% in six months, the highest rate in more than 40 years.

International Equities

Tracey McNaughton
Chief Investment Officer

International equities are now a USD 100 trillion asset class! That is almost 300 times the market cap of bitcoin.

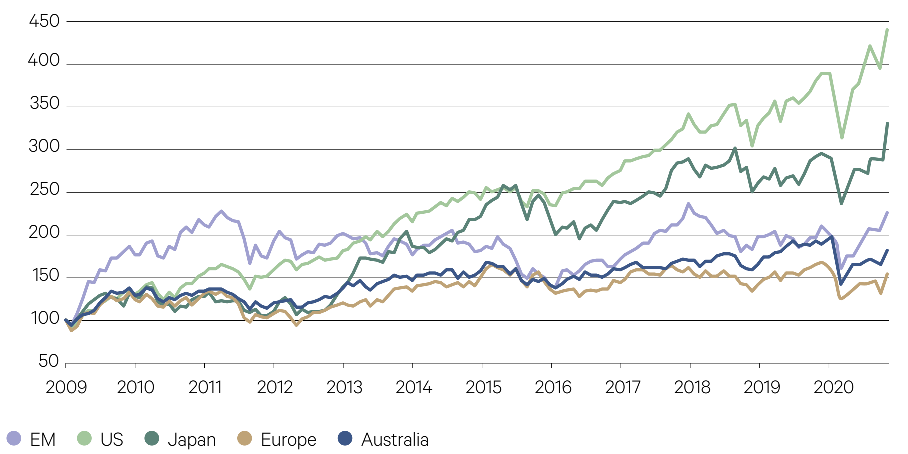
Our base case scenario remains very favourable toward global equities in 2021, particularly the cyclical sectors, small cap companies and emerging markets. The $20 trillion in global policy support will super-charge economic activity in 2021 which will lead to a rebound in corporate earnings growth.

Unlike government balance sheets, corporate and household balance sheets were largely insulated implying little repair work that could possibly impede the recovery. Indeed, debt-servicing levels are at record lows for many households around the world thanks to the aggressive cuts in interest rates. Policy actions to sustain businesses through the pandemic means excess capacity remains high. This will help to keep inflation pressures in check over the coming year.

Market capitalisation of world equity markets (USD tn)

Source: Bloomberg

Global equity market performance since 2009



Source: Bloomberg

2020 was the 7th consecutive year with more than $3 trillion in global M&A. 2021 is set to be even bigger.

Within the US, the Federal Reserve will continue to pursue quantitative easing (bond buying) as the primary monetary policy management tool. The balance sheet of the Federal Reserve has exploded from around $2 trillion in size in 2009 to $7.2 trillion today. Central bank ownership of the bond market in the US has reached 20%. This compares with 40–50% in Japan and Europe and suggests capacity to continue buying more is ample.

Empirical research dating back to 1933 shows that US small cap stock indices tend to outperform large cap stock indices in the 12 months following the trough in the US economic cycle. The average 12 month return for small cap companies is 55% versus 26% for large. The outperformance is even larger and lasts longer following a major market meltdown. Over a one, three and five-year period, small cap indices outperformed large for both US and global indexes following the dot.com correction and the GFC.

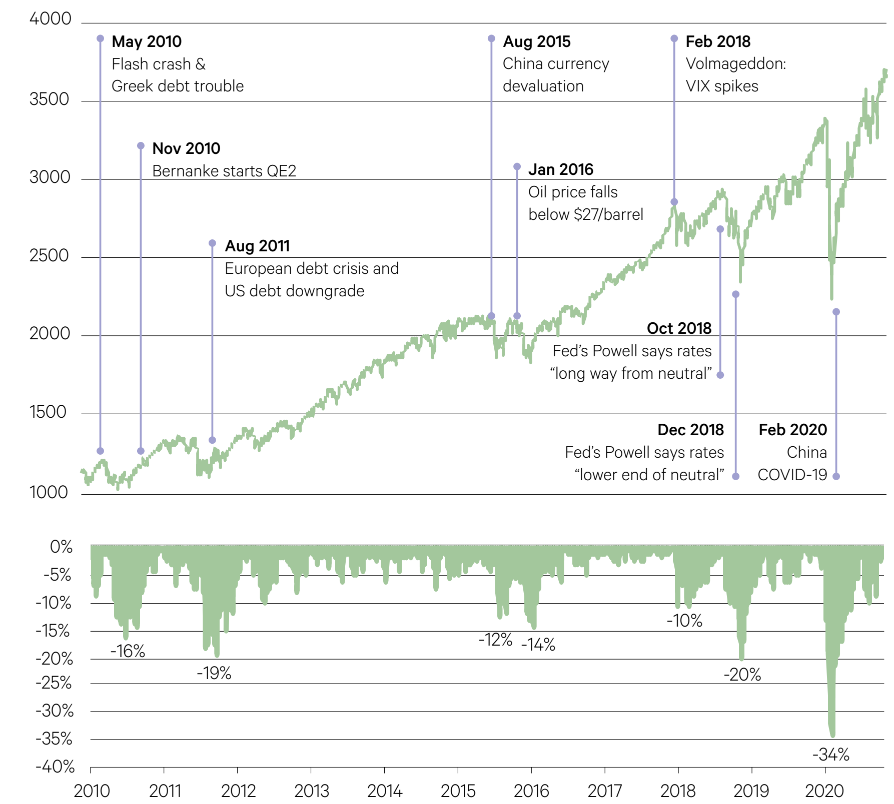
Within emerging markets, an expected easing of the US dollar will be favourable as will easier monetary policy by many emerging market central banks. We are looking for the TICK economies – Taiwan, India, China and Korea – to lead the emerging market recovery.

One of the biggest risks to our base case scenario is the potential for an earlier than expected retrenchment of policy support. Memories of 2018 are still fresh when cash was the best performing asset class over the year following the policy error of the Federal Reserve to raise interest rates too much.

One of the biggest uncertainties in 2021 is the outlook for the US dollar.

One of the biggest uncertainties in 2021 is the outlook for the US dollar. Aggressive quantitative easing by the Federal Reserve suggests the greenback should fall. But exchange rates are a relative game. A weaker US dollar implies a stronger euro. This is certainly possible given the close trade ties between Europe and China. But political risk will be heightened in 2021 in Europe with the bedding down of Brexit and the exit of long-term German Chancellor Angela Merkel in September.

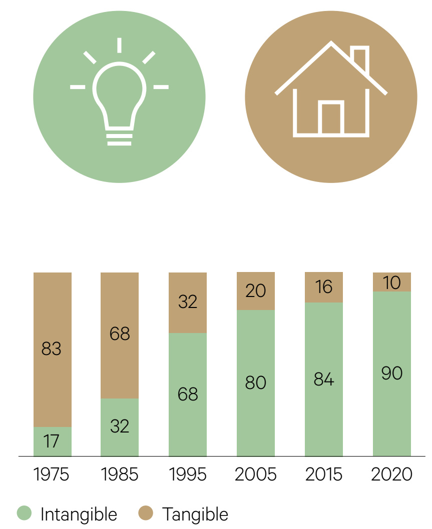
US S&P500 - Level and drawdown (1/1/2010)



The US S&P500 rose by 232% over the past decade but there were seven drawdowns of greater than 10%. The 34% drawdown in 2020 was the largest since the 57% drawdown following the GFC.

Source: Bloomberg

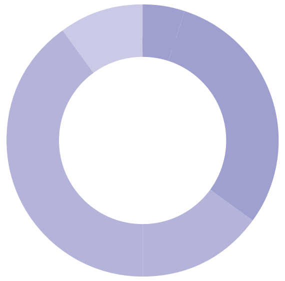
Tangible v intangible assets (%S&P500 total assets)



The proportion of "intangible assets" of S&P 500 companies, assets tied to reputation, brand and intellectual property rather than evaluable tangible assets, have reached record highs in the US. Worth over $21 trillion, they are often difficult to value using traditional accounting practices which is why integrating environmental, social and governance (ESG) practices into company analysis is becoming so important.

Source: Ocean Tomo Intangible Asset Market Value Study

Alternatives



Darragh Kennelly
Investment Analyst

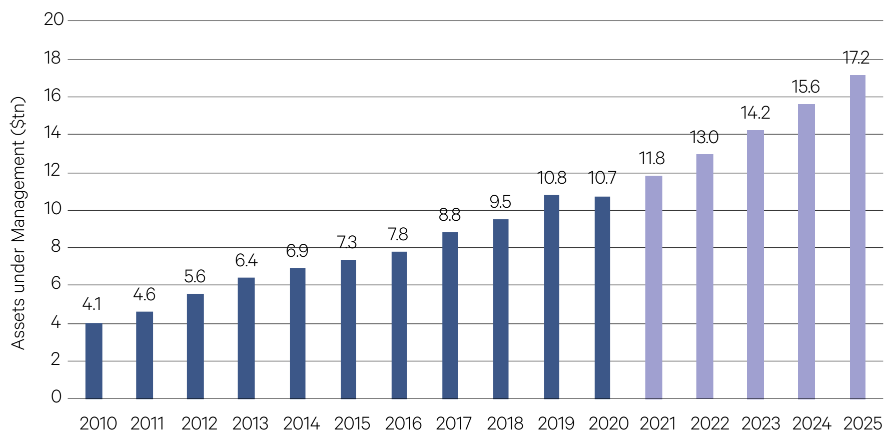
With central bankers increasingly crowding investors out of public markets, private markets will increasingly become an attractive option. Such an option brings with it some illiquidity risk but used in moderation at the total portfolio level we believe there are attractive risk adjusted returns to be had over the coming year. This will result in an extension of the trend that has been evident since 2020.

The total investment in alternatives is expected to grow at an annualized rate of 10% over the next 5 years. Private equity will gain the lion's share of this growth with investors expected to increase their allocation to the space by around 15%p.a. over the next five years.

Within private equity we like global managers that can achieve good diversification across deal type from direct equity, secondaries and co-investments, as well as investment style from early stage growth to more mature buyout style investments. Partners Group and Hamilton Lane are two such managers.

Investment in private debt is also expected to increase in the coming years according to a survey by Preqin. Dislocations caused by changes to bank lending practices has led to increased opportunities in the space. Within private debt we like managers focused on the top end of the capital structure with the ability to achieve diversification across industry, issuer and geographic locations such as Merricks Partners Fund.

Alternative Assets under management and forecast 2010–2025*

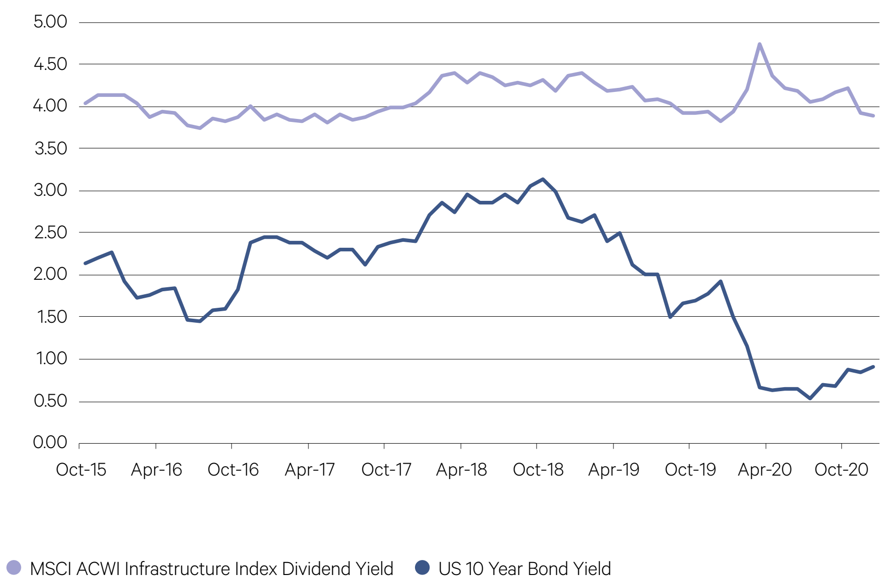


Alternatives total assets forecast to grow 60% by 2025.
*2020 figure is annualized based on data to October. 2021–2025 are Preqin's forecasted figures.

Source: Preqin

With bond yields sitting close to historic lows investors searching for yield are forced to look further out the risk spectrum to achieve the same level of return. Infrastructure is one such area.

Infrastructure dividend yield vs US 10-year bond yield (%)



Source: Bloomberg

While we expect the infrastructure sector to improve versus 2020, certain sub-sectors have a more uncertain outlook. For airports, 2021 should see a rebound but volumes are likely to be well below 2019 levels. Toll roads rebounded strongly when restrictions were eased and container volumes at US and European ports recovered quickly.

We are most positive on the outlook for digital and renewables infrastructure. The pre-crisis structural growth trends in digital infrastructure will accelerate significantly in coming years. The global cloud computing market size is expected to grow from USD 371.4 billion in 2020 to USD 832.1 billion by 2025. Demand to build hyperscale data centres required to facilitate this shift is growing at more than 20% annually.

Growth in renewable energy sources will continue in the coming years and improvements in energy grid stability and storage technology will be central to the continued growth of investment into wind and solar. It is estimated that USD 3.4 trillion will be invested globally in renewable energy by 2030. We see significantly investment opportunities in this area for our clients.

Real assets such as direct property can add defensive characteristics to portfolios whilst also providing a decent level of income. Should we experience any bouts of unexpected inflation in the near-term real assets can provide some protection with incomes typically linked to the consumer price index.

We are most positive on the outlook for digital and renewables infrastructure.

The commitment to environmental, social and governance (ESG) principals is growing within the alternatives asset class. Over the past decade USD 3 trillion has been raised across more than 5,400 funds managed by firms subscribing to ESG principles. The world's largest fund managers are leading the way on this front; of the funds raising USD 1 billion or more in the market 70% had ESG commitments attached to them.

Asset Class Quilt of Market Returns

High ↑ / Low ↓

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2013
AE 10.1%	Gold 24.8%	EM Eq 51.6%	AE 27.6%	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%	Gold 29.6%	US Eq 29.6%
IFI 8.3%	IG 14.8%	HY 32.4%	EM Eq 22.4%	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%	EM Eq 16.4%	IE 24.1%
AFI 5.4%	IFI 11.6%	IE 30.8%	HY 13.2%	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%	HY 14.8%	AE 19.7%
Cash 5.2%	AFI 8.8%	US Eq 26.4%	IE 12.8%	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%	US Eq 12.8%	HY 7.3%
IG 4.4%	Cash 4.8%	Gold 19.4%	IG 9.5%	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%	IE 9.6%	Cash 2.9%
Gold 2.5%	HY 4.1%	AE 15.9%	US Eq 9.0%	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5	IFI 9.3%	IFI 2.3%
HY 2.3%	EM Eq -8.0%	IG 14.3%	IFI 8.9%	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%	AFI 6.0%	AFI 2.0%
EM Eq -4.9%	AE -8.1%	IFI 6.6%	AFI 7.0%	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%	IG 5.8%	IG 0.3%
US Eq -13.0%	IE -21.2%	Cash 4.9%	Cash 5.6%	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%	Cash 4.7%	EM Eq -5.0%
IE -17.8%	US Eq -23.4%	AFI 3.0%	Gold 5.5%	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%	AE 3.3%	Gold -28.3%

2014	2015	2016	2017	2018	2019	2020
US Eq 11.4%	AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%	Gold 25.1%
IFI 10.4%	IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%	US Eq 16.3%
AFI 9.8%	AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%	EM Eq 15.8%
AE 5.0%	Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%	IE 14.1%
IG 3.1%	US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%	IG 10.4%
IE 2.9%	IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%	HY 7.0%
Cash 2.7%	HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%	IFI 5.1%
HY 0.0%	IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%	AFI 4.5%
Gold -1.4%	Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%	AE 3.6%
EM Eq -4.6%	EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%	Cash 0.4%

AE: Australian Equities
HY: High Yield Credit
Gold
IFI: International Fixed Income
EM Eq: Emerging Market Equities
Cash
AFI: Australian Fixed Income
US Eq: US Equities
IG: Investment Grade Credit
IE: International Equities

Source: Bloomberg

2020 will be a year many would prefer to forget but few will. Equity markets swung wildly plunging in March during the early stages of the pandemic, before rebounding quickly in response to massive fiscal and monetary stimulus.

In the space of just six months, $US30 trillion dollars was lost and regained in world equity markets.

Belying this volatility, annual returns in 2020 were well within standard ranges.

We saw solid returns in global shares with Asian and US equity markets (boosted by high exposures to IT and health care) outperforming. The more cyclical Japanese and European markets underperformed.

Australian shares also underperformed due to the greater cyclical exposure of the Australian share market.

Investment grade credit was well supported by the actions of the US Federal Reserve, which also helped to underpin high yield bonds.

Government bonds had reasonable returns as yields fell in response to central bank rate cuts and bond buying along with safe-haven demand – which drove capital growth.

Australian cash generated the lowest annual return ever (0.4%) in the 33-year history of the data, a fact that has not escaped the attention of income-based investors.

An important lesson from the asset class quilt is the importance of diversification. As can be seen, every asset class, at some point, has been among the best performers in that year, even cash.

ESCALA
PARTNERS

Chief Investment Office