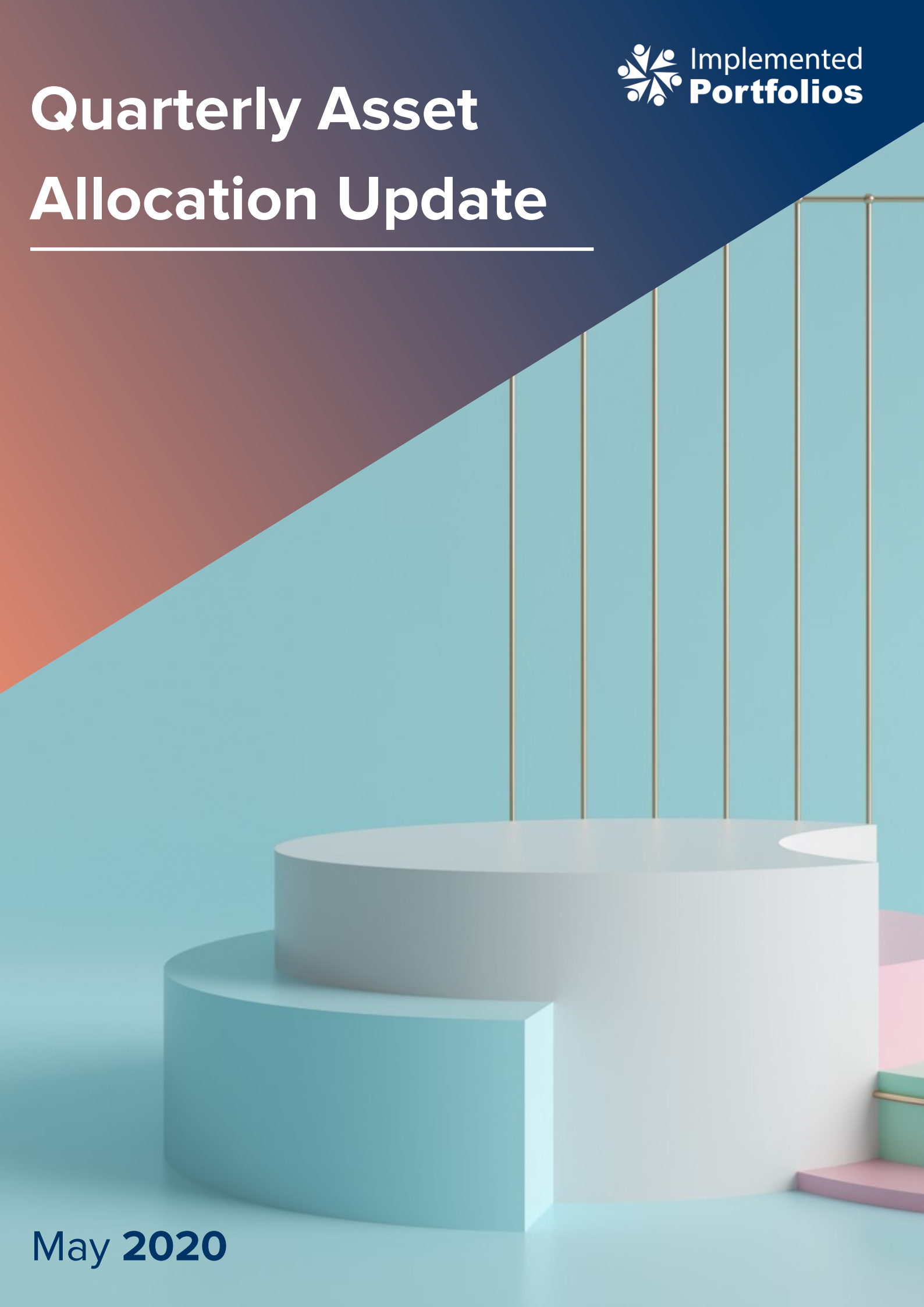
Implemented Portfolios

Quarterly Asset Allocation Update



May **2020**

ALLIEDWEALTH

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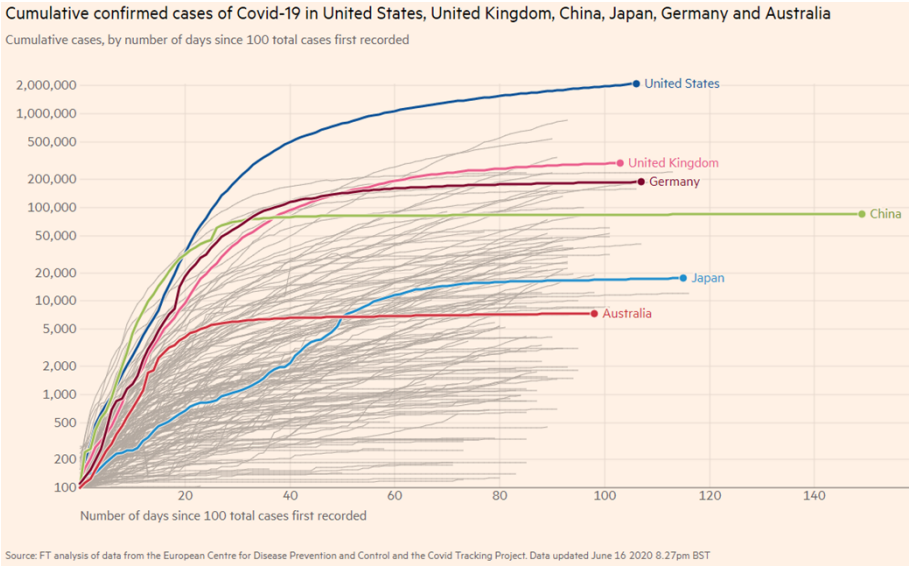
So, are we out of the woods? Is it onwards and upwards from here?

The simple answer is no. However, as is often the case, the simple answer is inadequate, and we need to be more nuanced, firstly in interpreting the question and then in developing our answers.

As a start, there is no single 'we' in any useful question or answer. The initial spread and subsequent efforts at containment of the coronavirus has certainly not been a uniform phenomenon amongst regions, countries, or even within countries. Similarly, the success of containment measures and the different policy measures deployed to support the nascent economic recovery are likely to mean we will see significant divergences in the respective recoveries. We should also not lose sight of the fact that we are all still grappling with the question of whether there will be a second wave of infections, and all the attendant risks to any recovery that that would obviously entail.

Not surprisingly given that context, whilst financial markets have retreated from the extreme volatility and disruption that we saw in March, both are still at elevated levels. One simple illustration of that is provided by the Dow Jones Industrial Average index in the United States which began in 1896. In just the first half of 2020 it has recorded six of its biggest 50 down days from that entire history. It is also worth noting that the most recent of those six days was a decline of 6.9% that was recorded on June 11th.



We include here a chart[1] that shows a global view of the current virus cases, with several key countries highlighted. These are cumulative case counts and reflect quite successful policies in most cases as evidenced by the flattened lines.

The US does look to be a clear exception though, with rising cases in many states even as there is a growing momentum behind reopening their economy.

United States

The recovery in the US market has also been quite concentrated in the five largest companies; Microsoft, Apple, Amazon, Facebook and Google (Alphabet). The S&P500 is the benchmark index and a broader measure than the Dow Jones referenced above, however these companies now account for a larger share of the total index than any five have in close to half a century. These are dominant businesses, but an important rule for investors to follow is not just to buy good companies but to make sure you are buying them for a good price. High valuations compared to historical norms have been sustained for some time, and may well continue to be as we are likely to remain in a low interest rate, low inflation environment. However, the combination of risk and reward on offer in the US doesn't look attractive at these levels.

The forecasting and valuation metrics are a quantitative process, however it is impossible and imprudent not to also consider a qualitative or more subjective assessment. The United States is clearly a deeply divided country and one deep in the mire of hyper-partisanship. In the medium to longer term they are on an unsustainable fiscal trajectory, and seemingly have little prospect of cohesive policy co-ordination. The US did not take the restrictive measures to combat coronavirus as seriously as other nations did, and as a result is not on the same recovery path as those who did, but is re-opening their economy anyway. Whether we call it a continuation of the first wave or a second wave, political leaders will not be able to simply mandate an increase in confidence or spending and investment in the household or business sector.

Five months out from a Presidential election the environment is only going to become more combative, and the prospect of a Biden administration and a Democrat controlled Senate was given as one of the reasons for the most recent sharp decline in equity markets mentioned above. Finally, it should be acknowledged that there is a not insignificant chance that the United States does not have an orderly transition of power when the results from November's election are tallied. One can only presume that it is an understatement to say that will be unsettling to investors and financial markets.

Japan, Europe and Asia-Pacific

We will group the remaining International Equities exposures under one heading. In Japan, the government is doubling down to deliver what has been described at the world's biggest stimulus package as Prime Minister Abe delivers on his promise to keep businesses and households afloat. The latest measures amount to an extra ¥117 trillion (A$1.6 trillion), including *"financing help for struggling companies, subsidies to help firms pay rent and several trillion yen for healthcare assistance and support for local economies*."[2] All up, the total policy response will be equivalent to about 40% of Japan's GDP. Like other countries their economic data has been terrible, but with this level of policy support and an effective effort at combatting coronavirus, markets and investors can look ahead to a continuing recovery.

Chancellor Merkel has continued to release the German economy from the fiscal straitjacket that was enshrined in their constitution. Also, against a current dire backdrop, the moves to support the German economy are substantial with the latest package worth €130 billion (A$213 billion) to be rolled out in July. Tax cuts, direct transfer payments, bridging finance for small and medium businesses are included with accelerated investments in digital, security and defence projects. Importantly, the German response has not been one delivered in isolation, with both individual countries and the European Central Bank also adopting bold policy responses. At the most recent meeting of the ECB, its president Christine Lagarde underscored the bank's commitment to supporting the European economy, and the European Commission is supporting a €750 billion Recovery Fund. As one analyst summed up: "*The ECB is acting much more aggressively than it has ever done before, and so is the German government. The policy response has been much more rapid and coordinated and focussed compared to the global financial crisis.*"[3]

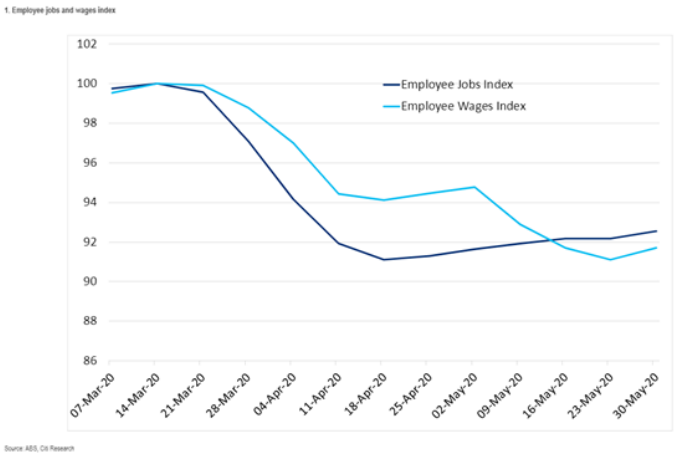
In China, the story remains consistent with the First In, First Out narrative that has characterised the virus outbreak and control, and the economic path of contraction and recovery. The National People's Congress was held a couple of months later than originally scheduled, and one important development was the abandonment of formal GDP targets. Arguments have been made that in the past meeting that specified growth, target took precedence over balanced policies and lead to inefficient investment and allocation decisions in the Chinese economy. Looking through their crisis response measures, and based on budget deficit projections, analysts have concluded that the Chinese economy is likely to grow at a rate of between 3% and 3.5% in 2020.

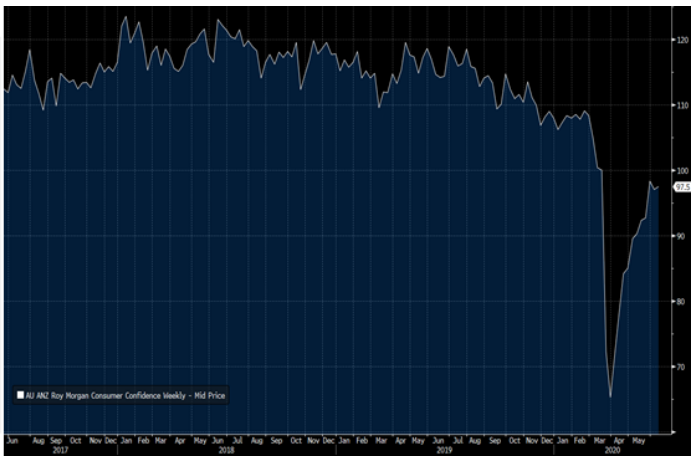
From an Australian perspective, it is pleasing to see that there will be an important focus on infrastructure spending in the stimulus, and this coupled with more supply disruptions from South American mines has seen the price of iron ore trade well above US$100/t in recent times. There will be a broader focus to the stimulus though, and priorities include *"new infrastructure such as data centres, industrial facilities powered by artificial intelligence and cold-chain logistics for products such as frozen goods, all of which could unleash China's potential as an economic powerhouse over the next decade."*[4]

AUSTRALIA

We have been saying for some time that we are progressively becoming a little less cautious and a little more confident about both the economic and equity market recovery in Australia. To be clear, and to return to our opening question, we are still in the woods, but we do seem to be on a well-defined path which will in time lead us into a clearing. As an economy, we were in reasonable shape at the start of the year, a conclusion supported by the fact that our contraction in Q1-20 was a quite modest -0.3%. It will be early September by the time the GDP data for the current quarter is published, and the consensus expectation is currently that we will emphatically confirm the current recession with a -8.5% result for this quarter. More timely data does however provide support for what we are all observing in our daily lives, that we are slowly getting back to normal and that the recovery is undoubtedly still in its early stages but has at the very least begun.

Here we share two charts to describe the state of the household sector, a view on the labour market on the left and the rebound in consumer sentiment on the right. The jobs and wages data are based on a new weekly series from the Bureau of Statistics and indicate that most recently we have actually seen job gains, and that corresponded with what looks like a bottoming out and an initial recovery in wages. The chart on the right is ANZ's household survey on consumer confidence, and whilst it is clearly not yet back to the old normal, there has been a strong recovery since the late March bottom.





Next, we look to the business sector, and specifically to the National Australia Bank's monthly Business Indicators. The top panel shows Business Confidence and the bottom panel - Business Conditions. We think of the top as being more forward looking, and whilst it is still a red bar, the improvement is very substantial.

Current conditions have improved, though this seems to reflect a realistic assessment that there remains a long way to go with the recovery.

Australia is among the group of nations that can feel some pride about the generally very effective way in which we acknowledged the virus and responded to it. That includes the household, business and government sectors, and as such we should all share an increasing confidence that we are on a sustainable path to recovery. We know that there is additional stimulus coming to support that recovery, and especially to ensure that people return to either their old jobs or newly created ones. We expect that there will be more bumps in the equity markets, but at this stage remain of the view that an overweight stance to Australian Equities will serve your portfolio well over coming months and years.

Kind regards,

Asset Allocation and Investment Committee

Ten Year Forecast Returns

	Australian Equities	Inter Eq - Dev Mkts	Inter Eq – Emerg Mkts	Listed Property	HY Income Securities	Income Securities
Current Yield	5.6%	2.3%	2.5%	5.2%	7.8%	2.8%
+ Currency Impact		0.6%	-2.8%			
+ EPS Growth (10 Yrs)	2.9%	3.6%	6.7%	2.2%*		
+ Valuation Effect	0.4%	-0.2%	0.4%	1.1%	-4.0%	
Index Return (Pre-Tax)	8.8%	6.3%	6.9%	8.5%	3.8%	2.8%

* Forecast Distribution Growth

Please note that the active asset allocation targets mentioned below apply to both the Exchange Traded Fund portfolios managed by Implemented Portfolios and the portfolios that own direct shares which are managed by Joseph Palmer & Sons. However, commentary below about individual investments is in relation to the ETF portfolios only.

Australian Equities

Australian Equities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	10.0%	15.0%	20.0%	27.0%	40.0%
Target*	13.0%	19.5%	26.0%	35.1%	51.4%

After lagging quite substantially in the early stages of the recovery, the Financials sector has managed to participate more fully in recent times. An important aspect of this is a somewhat more benign outlook for both the labour and housing markets. Treasury officials have announced they expect a peak in the unemployment rate at 8.5% rather than in the low double digits, and house prices have remained quite robust. Anecdotal indications from banks are that some people are already voluntarily electing to cease their deferrals and re-commence mortgage payments. We should expect to see a pick-up in defaults coming, especially when the JobKeeper program winds up in a couple of months' time. However, at this stage the banks look to have been quite conservative in their provisioning earlier this year, and we do expect to see a resumption in dividends in 2H-20.

All sectors of this asset class remain in negative territory on a calendar year-to-date basis but are substantially above the March lows. Rolling back just a year earlier though to the start of 2019, we have annualised returns of; ASX50 (SFY) +8.8%, Financials (OZF) -3.5%, MidCap (MVE) +10.9% and Small Companies (MVS) +4.4%. We acknowledge again that is a helpful starting point that coincides with the recovery from the Q4-18 sell off, but still provides important context. At our most recent meeting we elected to persist with the prevailing underlying holdings.

International Equities

International Equities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	5.0%	10.0%	15.0%	23.0%	35.0%
Target*	5.0%	10.0%	15.0%	23.0%	34.6%

Movements in the respective currencies have been top of mind, as we have seen the Australian dollar continue to move in a manner consistent with the underlying economics and market momentum. As the crisis intensified, we saw the A$ drop to a multi-year low, but with the recovery so too we have seen the local currency rally strongly. That has curtailed somewhat the recovery in your investments in Japan, Europe and the Asia Pacific, and that is the price that is payable for the cushioning that a depreciating currency provides when we see the markets fall. We remain comfortable with an overall neutral allocation to this asset class, and in our most recent meeting did discuss our potential response if we see the exchange rates for the A$ with the Yen and Euro approach the recent lows. We will of course, keep you informed if any changes are agreed to in future meetings.

Listed Property

Listed Property	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	5.0%	5.0%	10.0%	10.0%	10.0%
Target*	5.0%	5.0%	10.0%	10.0%	10.0%

This was among the most beaten down asset classes in the recent sell off, and it is fair to say that there remains some uncertainty as to the outlook, particularly about the office and retail sectors. The bounce from the March low to the recent peak was better than 50%, providing some indication of the extent to which it was oversold. We have observed that Listed Property continues to be sensitive to changes in bond rates, and as we expect these to remain relatively low that will continue to be supportive. Our neutral stance here was confirmed in our most recent meeting.

High Yield Income Securities

HY Income Secs	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	10.0%	15.0%	15.0%	15.0%	10.0%
Target*	0.0%	0.0%	0.0%	0.0%	0.0%

We remain 100% underweight here as the forecast return is insufficient to compensate for the risks.

INCOME SECURITIES & CASH

Income Securities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	40.0%	40.0%	30.0%	20.0%	0.0%
Target*	52.9%	51.4%	38.6%	26.3%	0.0%

Cash	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	30.0%	15.0%	10.0%	5.0%	5.0%
Target*	24.1%	14.1%	10.4%	5.6%	4.0%

These defensive investments have returned to normal, following the disruptions to trading activity that were seen both here and in major international markets. In the depths of the crisis, the Exchange Traded Funds continued to provide liquidity and an important price discovery mechanism, which was important in ETFs passing another import test of their efficacy as a toll for building efficient portfolios. Similarly, the major bank listed preference shares traded at discounts during March and April but have now returned to be broadly in line with our assessment of fair value of these investments. The comments in Australian Equities about a more benign outcome for the banks are also relevant to these investments.

** The Target weights outlined above reflect both the active asset allocation stance as determined by the committee and also the impact of market price changes as portfolios use a floating weight regime for securities within an asset class, and asset classes within each of the respective Investment Programs.*

Asset Class Tipping Points

The table below is provided with a mid-June update, to reflect both the moves in investment markets since the end of May but also further adjustments that the Asset Allocation and Investment Committee has made to the long-term forecasts. About two months ago we adopted a base case and a more pessimistic case for how earnings and dividends were likely to be impacted from the coronavirus. Pleasingly, not only have we not had to consider the pessimistic scenario, we have been able to incorporate some optimistic assumptions than were included in the base case. This is reflected in the higher long-term forecasts shown below, and the investment committee will continue to monitor and make adjustments as deemed appropriate while we navigate the path to recovery.

Asset Class Tipping Points - June 2020

Underlying assumptions have been re-adjusted to reflect current estimate of recovery from coronaviorus impact on global economy and financial markets. (Jun-20)

Australian Equities				International Equities - Developed				International Equities - Emerging				Listed Property			
All Ords	10 Year Forecast	Valuation	12-Jun	World ExAust	10 Year Forecast	Valuation	12-Jun	Emerging Markets	10 Year Forecast	Valuation	12-Jun	ASX200 Property	10 Year Forecast	Valuation	12-Jun
9,900	1.7%	Overpriced		3,300	1.3%	Overpriced		1,550	1.5%	Overpriced		2,400	1.2%	Overpriced	
9,600	2.1%	Fully Priced		3,200	1.7%	Overpriced		1,500	1.9%	Overpriced		2,325	1.6%	Overpriced	
9,300	2.5%	Fully Priced		3,100	2.0%	Fully Priced		1,450	2.3%	Fully Priced		2,250	2.0%	Fully Priced	
9,000	2.9%	Fully Priced		3,000	2.4%	Fully Priced		1,400	2.7%	Fully Priced	USA 2.4%	2,175	2.4%	Fully Priced	
8,700	3.4%	Fully Priced		2,900	2.8%	Fully Priced		1,350	3.1%	Fully Priced		2,100	2.9%	Fully Priced	
8,400	3.8%	Fully Priced		2,800	3.2%	Fully Priced		1,300	3.5%	Fully Priced		2,025	3.4%	Fully Priced	
8,100	4.3%	Fully Priced		2,700	3.6%	Fully Priced		1,250	4.0%	Fully Priced		1,950	3.8%	Fully Priced	
7,800	4.9%	Fair Value		2,600	4.1%	Fully Priced		1,200	4.5%	Fully Priced		1,875	4.4%	Fully Priced	
7,500	5.4%	Fair Value		2,500	4.5%	Fair Value		1,150	5.0%	Fair Value		1,800	4.9%	Fair Value	
7,200	6.0%	Fair Value		2,400	5.0%	Fair Value		1,100	5.5%	Fair Value		1,725	5.5%	Fair Value	
6,900	6.6%	Fair Value		2,300	5.5%	Fair Value		1,050	6.1%	Fair Value		1,650	6.1%	Fair Value	
6,600	7.3%	Cheap		2,200	6.1%	Fair Value		1,000	6.7%	Fair Value	EM 6.9%	1,575	6.8%	Fair Value	
6,300	8.0%	Cheap		2,100	6.6%	Fair Value	Dev 6.3%	950	7.3%	Cheap	Asia 7.3%	1,500	7.5%	Cheap	
6,000	8.7%	Cheap	Aust 8.8%	2,000	7.2%	Cheap		900	8.0%	Cheap		1,425	8.2%	Cheap	A-REITs 8.5%
5,700	9.5%	Cheap		1,900	7.9%	Cheap		850	8.8%	Cheap	Euro 8.1% Japan 8.2%	1,350	9.0%	Cheap	
5,400	10.4%	Cheap	Fin'l 10.7%	1,800	8.6%	Cheap		800	9.6%	Cheap		1,275	9.9%	Cheap	
5,100	11.4%	Cheap		1,700	9.3%	Cheap		750	10.4%	Cheap		1,200	10.8%	Cheap	

Income	5.6%	p.a.	Income*	2.9%	p.a.	Income*	-0.3%	p.a.	Income	5.2%	p.a.
Earnings	2.9%	p.a.	Earnings	3.6%	p.a.	Earnings	6.7%	p.a.	Dist Grwth	2.2%	p.a.
Valuation	0.4%	p.a.	Valuation	-0.2%	p.a.	Valuation	0.4%	p.a.	Valuation	1.1%	p.a.
Forecast	**8.8%**	**p.a.**	**Forecast**	**6.3%**	**p.a.**	**Forecast**	**6.9%**	**p.a.**	**Forecast**	**8.5%**	**p.a.**

** Income for International Equities includes dividends and forecast currency impact.*

Source:

1. Coronavirus tracked: has the epidemic peaked near you? Financial Times. 16-Jun-20.
2. Y Takeo, et al, "Japan Doubles Down on Stimulus with Extra $1 Trillion in Aid" – Bloomberg.com. 27-May-20.
3. C Stirling, et al, "Lagarde-Merkel Double Act Unites Europe in Stimulus Zeal" – Bloomberg. 5-Jun-20.
4. J Shen, "China's stimulus sceptics need not fear side-effects this time" – Financial Times. 31-May-20.

NOTE: It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio please contact your Adviser.