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Changing our regional equity market preferences

Today we are making some changes to our **regional equity market preferences**. While we maintain our modest overweight to equities within our tactical asset allocation (and underweight sovereign bonds), we are moving underweight US equities and adding to our European and emerging market positions. We are closing our small overweight to the UK and remain tactically most disposed to domestic equities.

We expect the coming weeks to be characterised by periods of heightened market volatility, particularly due to uncertainty in and around November's US presidential election and renewed outbreaks of the COVID-19 virus in Europe and the UK. Looking beyond the near term, our revised regional tilts position portfolios for the moderate U-shaped recovery we expect to unfold through 2021. If sustained volatility leads to a further drawdown in equities, we will look to add to our current modest overweight, in light of still attractive free cash flow and dividend yield spreads to sovereign and corporate bonds, as well as our expectation that central banks will remain very accommodative for the next several years.

Avoid taking large tactical bets

After a severe pandemic-led global recession in H1 2020, the global economy is currently rebounding strongly in Q3, as evidenced by the strength of consumer spending, housing activity and leading surveys of business conditions. However, the true shape of the economic recovery in the months and quarters ahead remains uncertain, and some loss of growth momentum into year-end is likely. It remains unclear the pace at which consumers and businesses will be able to return to somewhat normal activity, amid the social impacts of the crisis and ongoing requirements for physical distancing and restricted business practices. Moreover, uncertainty around the outcome of the US election and potential for a contested result, periodic outbreaks of the virus that reverse re-opening for a time and the prospects for a vaccine, flag the potential for a period of elevated volatility. We continue to view this as an environment to avoid large tactical bets and one where portfolio diversification remains key.

Our central case is for a stop/start global and domestic recovery in 2021

While the near term may be a challenging environment for risk markets to move higher, we continue to favour equity over fixed income returns in our tactical asset allocation. We also continue to favour credit and strategic allocations to alternative assets. Our central case, as it has been since the onset of the pandemic in early 2020, remains focused on a U-shaped, rather stop/start, global and domestic economic recovery in 2021. A synchronised global recovery through 2021 embodies expectations for a modest rise in bond yields, as well as a weaker trend for the US dollar. While equity market valuations appear on some metrics to have already factored in a number of years of growth, ongoing highly accommodative monetary and fiscal support suggest even below average equity market returns ahead will likely outpace skinny sovereign bond returns on a six to 12-month view.

Looking beyond the near term, we are making some changes to our regional equity preferences, given our central case outlook, current market valuations and evolving risks:

US equities—we are moving 2% underweight (from neutral), reflecting election risk and arguably more extended valuations than other regions (and concentration risk). Diminishing odds of additional fiscal support is also likely to weigh on the US outlook as do risks of renewed virus outbreaks as cooler conditions approach. This does not reflect a view that US equities will fall per se, but captures the potential for this market to lag gains elsewhere should a 2021 macro recovery portend stronger gains in cyclical sectors.

European equities—we are closing our 2% underweight and moving neutral. Monetary and fiscal stimulus has been faster, somewhat stronger, and more co-ordinated than expected. Europe's equity markets also share (with emerging markets) one of the higher return betas to the expected recovery in industrial and international trade expected through 2021.

UK equities—we are closing our modest 1% overweight to UK equities and moving neutral. While the UK remains one of the cheaper regional markets, both relatively and compared to history, hopes of a sustained improvement in the UK's virus experience and progress around Brexit have not been forthcoming. The recent renewed lockdowns, which have the potential to become more severe, add risk to the near term.

Emerging market equities—we are moving modestly overweight by 1% (from neutral). Like Europe, emerging equity markets are among the more leveraged to a pick-up in global activity, expected in 2021. China continues to recover strongly, and an expected weaker US dollar trend should benefit emerging market returns. Renewed geo-political tension presents a risk to this region.

Domestic equities—we are maintaining our overweight at 2%. Domestic equities have lagged over the past month (after a period of outperformance), and the market is now at a significant discount to the US. Looking ahead, recent positive virus trends (and imminent warmer weather) suggest an accelerated re-opening of Melbourne and state borders, while prospects for additional monetary easing and fiscal stimulus in the early October budget are potential catalysts for the market near term. Australia's strong linkages to Asia, where growth is recovering more quickly and virus trends are superior, are also a positive for Australia's growth and market outlook.