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Asset allocation

As noted earlier, international oil prices declined 30% during October and November. Part of the decline was due to OPEC's decision to maintain current production levels and create oil price instability, which appears to be a long-term strategy to undermine the economics of higher cost oil production, including the US's unconventional shale oil producers. Globally, lower oil prices should also be a positive tailwind for improved consumer confidence as it transfers wealth from oil producing countries to developed market consumers. We should see downward pressure on global inflation given that lower oil prices also have second round impacts on the prices of other commodities such as chemicals and goods with a large transport cost component. With lower fuel and commodity costs, households and many companies will have higher disposable income, or net earnings, which is positive for overall growth and for many listed equity sectors. Lower inflation will also hold down interest rates lower for longer which will benefit economic growth, and the prices of growth assets. Low inflation will also stop bond yields from rising too quickly.

Overall, global equity markets are in a sweet spot. China, Japan and Eurozone Central Banks are either cutting interests or employing massive quantitative easing to maintain economic growth. This has been reflected in the Shanghai-Shenzen Composite Equity Index which rose 10.9% last month and Japanese and German indices also rose strongly. The US has completed its quantitative easing and is looking at the appropriate time to raise official interest rates. In Australia, interest rate rises are a long way off and there are calls to actually cut rates further in 2015. This in turn augurs well for growth assets where valuations do not appear stretched and a low interest environment is supportive for equity prices.

By Nick Ryder, NAB Private Wealth Investment Strategist

Asset allocation summary

Asset Class	View	Comments
Cash	+	• Hold a slight overweight position in cash until better opportunities emerge • We suggest term deposits out to two years are preferred over at-call cash
Fixed Income	+	• We suggest an overweight position in fixed income • Developed world government bonds are expensive and offer poor absolute value, so prefer products with limited interest rate risk • We suggest an equal split between Australian and (hedged) international bonds • Tactical and absolute return fixed income strategies, floating-rate corporate securities and short duration fixed income are all preferred over benchmark-aware bond strategies
Australian Equities	–	• Remain underweight • Valuations have pulled back but growth outlook remains lower than other markets • Favour selective industrials (i.e. offshore earners), building materials, infrastructure • Hold positions in quality smaller companies but do not add
International Equities	N	• Given higher valuations in developed market shares, hold a neutral weighting • Maintain unhedged currency exposure • Favour US, then Japan over Europe • Emerging markets are relatively cheap so maintain exposure either directly, or indirectly through the emerging markets earnings of global companies
Alternatives	N	• Maintain a neutral allocation until opportunities emerge • We believe that alternative sources of risk and skilled active management represent important diversifiers for the future • Alternatives as part of an overall strategy of building allocations to assets with low/moderate correlation to equities.
Property	N	• Hold a neutral allocation to commercial property. Demand for core property is robust and rental growth fundamentals should gradually improve • At current pricing, Australian and international property appears fair value

About our recommendations

The asset allocation recommendations reflect NAB Private Wealth's views on the relative attractiveness of the asset class over a 1–3 year holding period. A neutral allocation (orange) means hold a neutral strategic allocation to the asset class, single minus underweight (orange) or single plus overweight (light green) recommendations are meant to rebalance the asset class progressively towards the bottom or top of your strategic asset allocation range using cashflows inflows or outflows to the portfolio. A double plus overweight (dark green) or double minus underweight (red) recommendation is intended to be rebalanced to the top end or bottom end of your strategic asset allocation range immediately by selling some assets and buying others.

Asset allocation

Australian Equities

The S&P/ASX 200 Accumulation Index fell 3.3% in November. Healthcare and telecommunications stocks rose about 1.2% while all other sectors posted negative returns. Energy shares fell 13% due to the fall in the oil price, materials stocks fell 5.6% due to the fall in the iron ore price and consumer staples shares were down 8.3% due to the 13% fall in Woolworth's shares.

After the recent price falls, the S&P/ASX 200 index is currently trading at 15 times forecast earnings and a cash dividend yield of 4.8% - around fair value. We still favour selective industrials, infrastructure, building materials, healthcare, consumer discretionary and diversified financials and are underweight the banking sector.

We suggest:
Remain underweight.
Valuations are at about fair value, but attractive growth or value opportunities are harder to find.

International Equities

In November global equities rose by 2.9%, in local currency terms, with Germany and Japan the stand out developed markets with gains of 7% and 6.4% respectively. In emerging markets, Chinese stocks continued to perform very strongly with the Shanghai index about 11% higher over the month.

Despite higher prices in the US, lower oil prices and low interest rates are supportive for equities and earnings growth remains attractive. Our preferred exposure is to US equities, in particular healthcare, technology and telecommunications stocks. Japan also has a preferred bias, a lower Yen leading to increased corporate earnings. Europe remains at a neutral weighting.

We suggest:
Maintain a neutral exposure to international shares.
Favour US over Europe.
Maintain exposure to emerging markets shares.

Fixed Income

Australian bonds returned 1.3% in November, as bond yields fell for the second month in a row. Three-year government bond yields fell 22 basis points to 2.43% per annum (below the 2.50% overnight cash rate), while 10-year yields fell from 3.36% to 3.06% per annum, in line with global bond yields.

Internationally, the widespread decline in longer term bond yields saw the Citi World Broad Investment Grade bond index return 1.0% for the month.

We suggest:
Overweight overall exposure to fixed income with an equal split between Australian and international bonds
Stay underweight longer term government and corporate bonds.
Prefer tactical income and absolute return fixed income strategies.

Cash

Australian bank bills returned 0.21% in November as three month bank bill yields ticked up from 2.72% to 2.74% per annum. At its December Board meeting, the RBA kept official cash rates unchanged at 2.50% per annum, for the 16th consecutive month, and it appears comfortable keeping interest rates stable for an extended period.

With the recent third quarter GDP figures showing that economic growth was slower than economists and the RBA had been expecting, money markets have now priced in one to two 25 basis point rate cuts within the next 12 months. NAB economists are also now expecting two 25 basis point rate cuts in 2015, in March and August, to take the official RBA cash rate to 2%.

We suggest:
Retain an overweight position.
Bank term deposits preferred relative to government bonds and at-call cash.

Alternatives

Hedge funds returned +0.3% in October with varied returns across the different sub-strategies. The best performing strategy group was funds which invest based on macro-economics and trend-following. These funds returned 1.7%, the best monthly return in five years. The worst performing funds were relative value funds which were down 0.9%.

The pick-up in volatility and trending markets should assist certain hedge fund strategies (such as macro and trend following strategies) in coming months, however, bottom-up individual manager selection is more likely to provide better returns than top-down strategy selection.

We suggest:
Maintain a neutral position.
Manager selection remains more important than strategy selection.
Liquid alternative investments including hedge funds remain favoured over equities for incremental risk exposures.

Property

Returns from unlisted Australian core property funds were 8.8% in the year to the end of October 2014. Average distribution yields are 5.8% but range from 5.2% for retail property, 6.1% for offices and 7.8% for industrial property. Listed property continues to perform well, with 2014 global property securities prices rising by 15.4% in US Dollar terms.

Sentiment and capital flows are still favourable for certain commercial property segments, with the lower interest rate environment helping support investor demand which is pushing yields lower. Property fundamentals in Australia still favour tenants over landlords and rental growth is harder to generate.

We suggest:
Remain neutral with no preference for Australian over global property.