Economic & Investment Update - January 2021

Notwithstanding, rising Covid-19 infection numbers across most of the world, global markets performed strongly over the December quarter as positive economic data releases and vaccine breakthroughs fostered hopes of a return to economic normality.

In the US, businesses appeared to be recovering despite softening payrolls. News of vaccine developments arguably eclipsed Joe Biden's win in the US presidential election in November, as well as a US$900 billion stimulus package announced in late December. The US Federal Reserve nonetheless reinforced its supportive messaging, stating it will continue with current levels of quantitative easing.

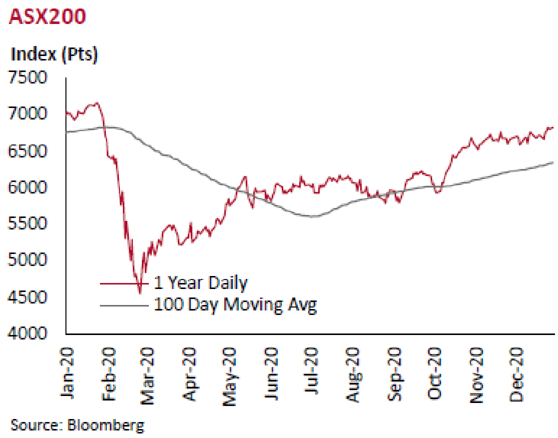
However, in Europe, the stringency of lockdowns across the euro zone to contain Covid-19 threatened to deepen what already looks likely to be a double-dip recession. Political unease over the future leadership of Germany and a crisis in Italy are compounding the gloom.

The Chinese economy continued to power along. Boosted by fiscal stimulus measures, recent data showed that China was likely to be the only major economy to have grown in 2020. Other Asian economies were also impacted to a lesser extent by Covid-19 with Japan benefiting from further stimulus and a rebound in exports.

In Australia, the economic recovery continued and was underpinned by low Covid-19 case numbers nationwide and optimism surrounding news of successful vaccine trials. Jobs data continued to improve, housing approvals were up more than 30% since June 2020 and exports rose, dominated by iron ore. The RBA lowered interest rates to an all-time low of 0.10% in November and committed to the purchase of $100 million worth of 5-year and 10-year government bonds over the next six months.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished up 13.7% over the quarter (and up 1.4% over the 2020 calendar year).



The energy sector produced the largest quarterly sector gain of 26% supported by a stronger oil price (up 20.6% for the quarter) and the depreciating US dollar, while being highly leveraged to the re-opening of the economy. The four major banks recovered from their lows earlier in the year, with ANZ gaining 32%, CBA jumping 29%, NAB up 27% and Westpac rising 15%. A jump in the iron ore price led to a re-rating of the three largest local miners, with Fortescue surging 44% higher, Rio Tinto climbing 21% and BHP rising 19%.

Some of the less economically sensitive sectors (i.e., Health Care and Utilities) delivered negative returns for the quarter. CSL led the healthcare sector down, with the company announcing the cessation of its Covid-19 vaccine, which triggered false positives for HIV.

The Small Ordinaries Index (top 100-300 companies) also performed well and returned +13.8% for the December quarter and +9.2% for the 2020 calendar year.

Global equity markets again produced solid gains over the quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 11.7% (up 10.6% over the past 12 months).

Across global markets, the strongest performer was the Nikkei 225 Index (Japan), up 18.4% for the quarter and 23.1% over the 2020 calendar year while European markets marginally lagged other global markets as rising Covid-19 infections led to the reintroduction of local restrictions. In the US, equity markets continued to rally with the S&P 500 up 11.7% for the December quarter and 16.3% for the calendar year.

However, returns in Australian dollars (AUD unhedged) were lower as the Australian dollar continued to strengthen against most major currencies, most notably against the US Dollar. The MSCI World (ex-Australia) Net Return Index (unhedged) rose by 5.7% for both the December quarter and the 2020 calendar year.

Australian listed property securities continued to recover during the December quarter with a gain of 13.3%. However, the return for the 2020 calendar year was -4.6%. Global property securities also rebounded, up 10.6% for the December quarter but still down 13.7% over the past twelve months. Globally, discretionary retail continued to struggle compared to sectors such as industrial, logistics and non-discretionary retail.

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by -0.1% over the December quarter as bond yields finished marginally higher. Notably, domestic credit markets were the key performer (+1.4% for the December quarter) as spreads compressed on the back of further RBA easing and tighter trading conditions. Global bonds, as measured by the Bloomberg Barclays Global Aggregate TR Index (AUD Hedged), returned 0.8% for the quarter and 5.1% over the twelve months.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	13.7	1.4	8.7
	S&P/ASX Small Ordinaries TR (Accum) Index	13.8	9.2	10.5
International	MSCI World ex Aust NR Index (AUD)	5.7	5.7	10.9
	MSCI World ex Aust NR Index (AUD Hedged)	11.7	10.6	11.4
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	11.2	7.8	11.5
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	13.3	-4.6	7.0
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	10.6	-13.7	2.9
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	11.5	-11.3	7.0
Currencies				
AUD v USD	Against US Dollar	7.4	9.6	1.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-0.1	4.5	4.6
	Bloomberg Ausbond Credit All Maturities	1.4	5.3	5.0
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	0.8	5.1	4.6
Commodities				
Gold	Gold – USD	0.7	25.1	12.3
Oil	WTI Oil $/b – USD	20.6	-20.5	5.6

Outlook

After suffering a sharp decline in Gross Domestic Product (GDP) in 2020, the global economy is likely to continue to recover in 2021, supported by ongoing accommodative monetary and fiscal policies and the rollout of Covid-19 vaccines.

Additional stimulus packages continue to be announced while in the US, President Biden described the $900 billion stimulus passed in December as a "down payment", advising that he would call on Congress to pass additional measures, including more direct payments and aid to cities and states.

Following multiple vaccine approvals, vaccination programmes are also ramping up – at differing rates – across many countries. This is giving hope of rolled back restrictions and further recovery in demand growth. However, this remains a key risk to watch as any disappointment here, including the vaccines effectiveness against new virus strains, could hit markets and erase recent gains.

As a result of expectations of a vaccine-powered strengthening of activity later in the year and additional policy support in a few large economies, the International Monetary Fund recently revised upwards its 2021 forecast and now projects growth of 5.5% in 2021 and 4.2% in 2022. Regionally, the US and Japan are projected to regain their pre-Covid activity levels in the second half of 2021, while in the euro area and the United Kingdom, activity is expected to remain below pre-Covid levels into 2022. China's effective containment measures, a forceful public investment response and central bank liquidity support, has already facilitated a strong recovery.

Despite the massive amount of economic stimulus that has been injected into markets during 2020, underlying inflation is expected to remain subdued during 2021-22 and below central bank targets.

In Australia, while the economic outlook for 2021 looks positive, there are risks that could see recent momentum reverse including the winding back of the Federal Government's JobKeeper wage subsidy and JobSeeker payments at the end of March, the fraught diplomatic relationship between Australia and China and its impact on trade, and the rising Australian dollar.

Our views on various asset classes are outlined below.

Australian Equities

We recommend investors hold a neutral position to Australian Equities both in large cap stocks as well as smaller companies.

Presently, the Australian equity market is largely influenced by macro factors surrounding the management of Covid-19, with company specific fundamentals taking a back seat. The unprecedented fiscal and monetary stimulus measures implemented should continue over the medium term but gradually taper off on the basis that Covid-19 is contained and the economic reopening become sustainable.

From a valuation perspective, the Australian equity market is trading on a one-year P/E ratio of nearly 20 times, which is circa 30% above the long-term average of 14.5 times and prima facie looks stretched relative to history. However, based on the current environment, with policy and liquidity support underwriting economic activity for the foreseeable future, the market only appears to be moderately expensive.

International Equities

Within International Equities, despite recent gains, we recommend investors retain a neutral position to developed markets. Again, this is based on the level of fiscal and monetary policy around the globe and the potential for a further support package in the United States.

However, it is important to note that there are some near-term risks to our positive expectations. There is the possibility that investor sentiment has become overly optimistic following the vaccine announcements, making markets vulnerable to negative news. This could include extended lockdowns in Europe and North America as virus cases escalate, logistical difficulties in distributing the vaccine, earnings disappointments, and negative economic growth in early 2021 if government support measures are unwound too quickly.

We continue to recommend a neutral to overweight exposure to emerging markets, noting that low US interest rates and a weaker US dollar are supportive of money flows to such markets.

Investors should consider the benefits of hedged options (where available) on International Equity holdings. Despite recent falls, the US Dollar may weaken further over the medium term, given the likelihood of further stimulus packages and increasing levels of Government debt.

Property

We recommend investors retain a neutral position to Australian and International property with a bias away from discretionary retail and the commercial (office) sector.

The domestic listed property sector (A-REIT) is priced on a 2022 dividend yield of 4.2%, a 320 basis-point spread over 10-year bonds. We expect sector earnings to slowly recover and all distributions to resume in 2021 as State borders reopen, businesses recover and activity broadly picks up. However, valuations are expected to soften in the short term with discretionary retail and the commercial (office) sector likely to come under pressure due to lower occupancy rates.

Gearing across the sector is relatively low at 26%, and we expect the continuation of low interest rates to provide support for asset values.

Fixed Interest

We recommend investors remain underweight to fixed interest securities.

While Central bank intervention in the developed world bond primary and secondary markets has significantly reduced market volatility and potential returns for shorter term bonds, a steepening in long term bond yields (higher than pre COVID levels in Australia) provides some investment opportunities.

Despite a further tightening in credit spreads, credit securities (including hybrids) appear more attractive. The excess liquidity in the Australian system and attractive credit spreads against very low cash and bond rates will continue to attract buyers to the sector, supporting credit markets.

Alternatives

Despite recent gains, we remain positive about the longer-term prospects for Infrastructure investments on a hedged (currency) basis.

Private Equity investments are expected to continue to be well supported underpinned by the risk-on mood, strong returns, excess liquidity and the chase for yield.

In the current economic climate, despite recent falls, we continue to suggest consideration be given to an allocation to the gold sector within portfolios. Exposure to gold, either through gold producers or via an investment in physical gold, provides additional diversification within portfolios.

Sources: Lonsec