Economic & Investment Update - April 2021

Global GDP growth has continued to recover, with the IMF revising upwards their 2021 calendar year projections for the US to 6.4% and for China to 8.4%. Investor sentiment has been buoyed by the ongoing rollout of the Covid 19 vaccine, particularly in the US and UK.

In the US, the economy was further supported by the passing of US$1.9 trillion in additional fiscal stimulus by the Biden administration. Contrary to market predictions of a rise in unemployment, the rate in the US fell 0.2% to 6.0% in March 2021, aided by the easing of restrictions in the leisure and hospitality sectors. However, there is still a way to go for this to fall to its pre-pandemic rate of 3.5%.

The massive fiscal and monetary stimulus programs, coupled with the global economic recovery has increased fears of inflation. As such, there was an unprecedented rally in global bond markets over the March quarter.

The Chinese economy continues to be the preeminent winner with relatively robust growth figures. Notably, the first quarter of the year includes the Chinese New Year with the first two months of 2021 showing 33.8% growth in retail sales, reflecting the robust confidence of the Chinese consumer.

The laggard of the piece is Europe, where growth forecasts continued to remain negative given the ongoing struggle of handling the pandemic.

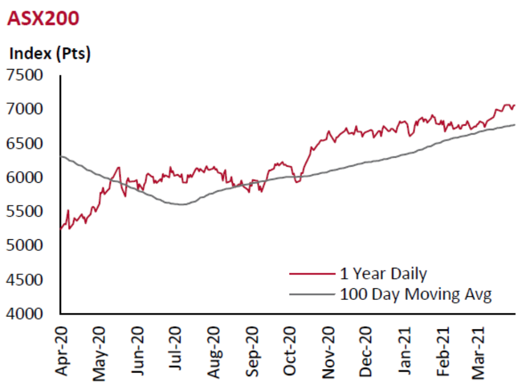
In Australia, the economic recovery continued with the end of JobKeeper coinciding with a decrease in the unemployment rate in March, from 5.8% to 5.6%. The RBA maintained the historically low interest rate of 0.10%, which together with a shortage of supply in the secondary property market for houses, has seen residential property prices escalate quickly.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished up 4.3% over the March quarter (and up 37.5% over the past 12 months).

The Telecommunication Services sector produced the largest quarterly sector gain of 13.9%, courtesy of mergers and acquisition activity and a proposed restructure by Telstra. The continued rebound in the price of the major four bank stocks saw the Financials sector post a gain of 12.1% for the quarter.

Some of the less economically sensitive sectors (i.e. Health Care and Utilities) continued on from the previous quarter to again post negative returns, this time -2.2% and -1.8% respectively.



Source: Bloomberg

Returns from the Small Ordinaries Index (top 100-300 companies) were more muted with a rise of 2.1% over the March quarter but a stunning 52.2% over 12 months - more than recovering from the drop of 21.0% for the 12 months to March 2020.

Global equity markets again produced strong gains over the quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 6.2% and +48.7% over the past 12 months, well in excess of the -21.8% Covid 19 induced fall in the March 2020 quarter.

In contrast to the rate of overall economic recovery, the strongest major global share market performer was the Deutsche Bourse DAX index (Germany) up 9.4% for the quarter and 51.0% for the year. In a similar contrarian vein, the Shanghai Shenzchen Index (China) actually fell 3.1% over the quarter albeit against a rise of 37.0% over the past 12 months. The relative strength of the German market was in part a reflection of how far it had fallen in the March 2020 quarter (-25.0%) as well as the record manufacturing numbers being recorded across Europe.

Returns for the quarter in Australian dollars (AUD unhedged) were 6.3% (against 6.2% for hedged), as the Australian dollar weakened against the US Dollar and British Pound, but strengthened against the Yen and the Euro.

Australian listed property securities lost ground with a fall of 0.5% over the quarter. Whilst the return to work in CBDs is progressive, there is a growing realisation that more flexibility to allow working from home arrangements is both possible and desired. Global property securities fared far better over the quarter with a positive return of 7.3%.

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by -3.2% over the March quarter as bond yields at the long end of the market rallied quickly and sharply on economic recovery and inflation expectations. The RBA however continued its commitment to monetary policy to maintain a target 3-year Government bond rate of 0.1%. A similar rally at the long end of the bond market occurred overseas.

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	4.3	37.5	10.3
	S&P/ASX Small Ordinaries TR (Accum) Index	2.1	52.2	10.7
International	MSCI World ex Aust NR Index (AUD)	6.3	23.6	13.7
	MSCI World ex Aust NR Index (AUD Hedged)	6.2	48.7	13.2
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	3.6	27.3	12.3
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-0.5	44.6	5.6
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	7.3	29.7	3.6
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	4.3	28.4	6.6
Currencies				
AUD v USD	Against US Dollar	-1.3	23.9	-0.2
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-3.2	-1.8	3.5
	Bloomberg Ausbond Credit All Maturities	0.1	2.6	2.6
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	-2.5	1.1	3.3
Commodities				
Gold	Gold – USD	-10.0	8.3	6.7
Oil	WTI Oil $/b – USD	21.9	188.9	9.1

Outlook

The rebound in equity markets over the past 12 months was initially fuelled by growth companies in technology and healthcare that performed well as the pandemic swept across the globe. As vaccines continue to roll out globally, the rebound now appears to have shifted to the cyclical areas of the market. However, the speed of rollout and the continuing mutation of the virus pose risks in respect of the full opening of economies and the speed of economic recovery.

Presently, equity markets are profoundly influenced by macro factors surrounding the management of Covid 19, with company specific fundamentals continuing to take a back seat. The unprecedented fiscal and monetary stimulus measures implemented around the world over the past 12 months should continue over the short to medium term, but gradually taper off as economies get back on track. As such, equity market sentiment may continue to be driven in the short term by macroeconomic factors especially the continuation of historically low interest rates.

Any upward movement in interest rates is likely to have a major detrimental influence over equity markets. However, despite the best efforts of central banks to reassure the market of their commitment to accommodative monetary policy, bond yields continue to rise off the back of increased rates of economic growth and inflation expectations. As such, inflation shocks may have a dramatic impact on the equity market, particularly growth stocks.

To complicate matters, rising rates of inflation may only be short term as commodity prices normalise and broader structural deflationary pressures, such as the impact of technology, continue to weigh on most developed economies. As such, central banks may retain cash rates at near zero levels for coming years on the grounds that underlying inflation rates remain below target levels. Indeed the Reserve Bank of Australia (RBA) has committed to pegging the short end of the bond market until 2024.

Given that the valuation of most asset classes e.g., equities, property, bonds are predicated on long term interest rates, holding such assets is to some degree a bet in the short term against inflation and rapidly rising interest rates in favour of increased economic recovery and increasing corporate profits within a low interest rate environment.

Our views on various asset classes are outlined below.

Australian Equities

We recommend investors hold a neutral position to Australian Equities in large cap stocks as well as smaller companies. Investors should take the opportunity to take some profits from the last 12 months returns if they are overweight to this sector, particularly with smaller companies.

Based on traditional measures, equity markets look expensive with the Price Earnings ratio of the Australian equities market at around 20 times against an historical average of 14.5 times. However, prices are being supported by both low interest rates and an expectation of increased profits as economic activity picks up.

Value (cyclical stocks) are likely to continue to benefit over growth type stocks as the economy moves towards a solid recovery phase.

International Equities

We recommend investors hold a neutral to underweight position to International Equities Developed economies whilst holding a neutral to overweight position to Emerging Market economies.

Recovery of European economies from the pandemic is proving a challenge both from the containment of the virus and the rollout of the vaccine. Although the US has performed better with its vaccine rollout and is set to benefit from the US$1.9 trillion in additional fiscal stimulus, concerns continue about the funding of any deficit and the impact on the US Dollar of having to retain low interest rates.

Conversely, Asian economies continue to perform both in respect of Covid management and from the recovery in GDP growth. Low US interest rates and a weaker US dollar are also supportive of money flows to such markets.

Investors should consider the benefits of hedged options (where available) on International Equity holdings.

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. A brighter spot is medical and life sciences office space where demand has been boosted by the pandemic.

A short term positive is low interest rates globally, which are having the impact of maintaining investor demand and underpinning tight market capitalisation rates. However, as interest rates rise and capitalisation rates widen, downward pressure will be placed on property prices.

Increased risk also exists in the office space, noting that CBD office vacancy levels have risen in Sydney and Melbourne from around 3 - 4% to 8 - 9% in the year to January 2021.

Fixed Interest

We recommend investors remain underweight to fixed interest securities.

The sharp jump in the 10-year bond rate by approximately 1% both in Australian and the US over the March quarter is a timely reminder of how quickly rates can change. Generally a 1% increase in rates will lead to a 2% to 3% capital loss in the fixed interest market. As such, we are still cautious of holding significant levels of Government bonds.

Despite a further tightening in credit spreads, credit securities (including hybrids) still appear more attractive.

Alternatives

Given recent gains, we now recommend a neutral holding in Infrastructure investments, preferring holdings 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 and some protection against rising inflation.

Sources: Lonsec