Economic & Investment Update - July 2021

While the vaccine rollout accelerated during the June quarter, the global pandemic is still far from over as new virus variants surfaced and countries moved in and out of lockdown. However, key economic indicators around the globe are looking stronger as major economies continue their reopening.

The United States fell marginally short of their goal of providing at least one shot of vaccine to 70% of the adult population by 4th July holidays. The reopening of their economy saw annual GDP rise by 6.4% to March 2021 with personal consumption growing 11.3% over the same period, fuelled by stimulus payments to low income earners.

The vaccine rollout is even further advanced in the UK. 87% of the adult population had received at least one dose by early July with around 75% of those having received two jabs. Despite increasing numbers of Covid infections due to the Delta strain, this has allowed the UK to continue their easing of Covid restrictions with the consequential strong growth in retail sales. However, questions remain as to whether the UK is opening up too early.

The rollout of the vaccine in mainland Europe is not far behind that of the UK. The unemployment rate in the Eurozone fell marginally to 8.0% with inflation creeping up to 2.0%.

However, despite progress in the vaccine rollout and declining Covid-19 case numbers across much of the developed world, case numbers are spiking in Asia where vaccines have been slower to roll out. Alongside weaker economic data, concerns regarding re-opening have resurfaced with restrictions on mobility reintroduced.

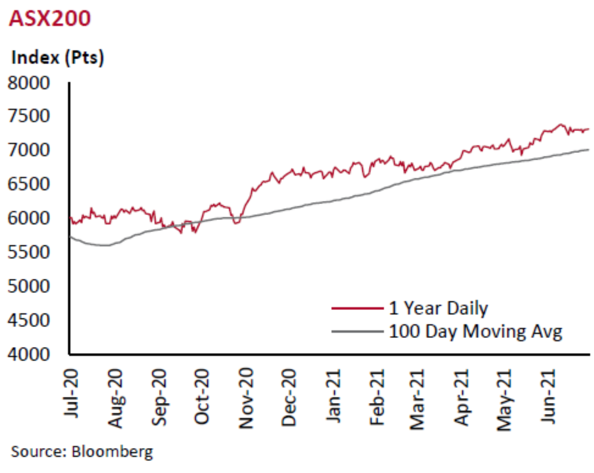
In Australia, the RBA left the cash rate unchanged at a record low of 0.1% during the quarter. Policymakers reaffirmed their commitment to maintain highly supportive monetary conditions until there is clear evidence that strength in the economy is translating into wage growth and a rise in inflation. This is expected to be in 2024 although some market commentators are predicting an earlier move. March quarter GDP came in at 1.8%, a third consecutive quarter of economic growth driven by continued rises in household consumption and private investment. The RBA board outlined it expects GDP to grow by 4.75% in 2021 and 3.50% in 2022, supported by fiscal measures and accommodative financial conditions. However, a prolonged lockdown in Sydney and other areas has raised the prospects of negative growth over the coming quarters.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished up 8.3% over the June quarter (and up 27.8% over the financial year).

The Information Technology sector produced the strongest returns rising 12.1% over the quarter with Afterpay up 16.4%. The Telecommunication Services sector also continued to produce gains, rising by 9.7%.

The Utilities sectors again posted negative returns and finished down 4.5% for the quarter and -18.6% over the financial year.



Returns from the Small Ordinaries Index (top 100-300 companies) were similar to those from the ASX 200, being up 8.5% for the quarter (and +33.2% over the financial year).

Global equity markets again produced strong gains with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 9.8% over the quarter and +30.8% over the financial year. The Australian Dollar weakened against the US Dollar (down 1.3% for the quarter, but up 8.6% for the financial year) assisting in unhedged quarterly returns of +9.3%. Reflecting the ramp up in the vaccine rollout and continuing government stimulus, the strongest global gains came from the US with the S&P 500 up 8.2% for the quarter and 38.6% for the financial year.

In Asia, returns for the quarter were flatter. The Shanghai Shenzchen Index (China) rose 3.5% over the quarter, with a rise of 25.5% over the financial year. However, Japan's struggle to control new Covid outbreaks was reflected by a fall in the Nikkei 225 PR Index of -1.3% for the quarter, albeit up 29.2% over the financial year.

Property markets fared much better over the quarter, with Australian listed property securities gaining 10.5% over the quarter and 33.2% over the financial year. Furthermore, Australian residential housing market prices continued to increase, supported by the Australian government providing $200 billion, over three years, to banks at an interest rate of 0.1% under a Term Funding Facility. With interest rates at historically low levels, housing credit growth had also strengthened, with strong demand from owner-occupiers, especially first-home buyers. Global property securities also performed well over the quarter with a positive return of 9.8% (and up by 30.8% over the financial year).

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, rose by 1.5% reversing some of the -3.2% fall over the March quarter. The RBA however continued its commitment to monetary policy to maintain a target 3-year Government bond rate of 0.1%. A similar but smaller reversal happened with overseas bond markets.

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	8.3	27.8	11.2
	S&P/ASX Small Ordinaries TR (Accum) Index	8.5	33.2	11.2
International	MSCI World ex Aust NR Index (AUD)	9.3	27.5	14.7
	MSCI World ex Aust NR Index (AUD Hedged)	7.6	35.8	14.4
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	6.6	29.2	12.8
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	10.5	33.2	5.8
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	9.8	30.8	4.2
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	2.0	18.1	5.7
Currencies				
AUD v USD	Against US Dollar	-1.3	8.6	0.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	1.5	-0.8	3.2
	Bloomberg Ausbond Credit All Maturities	1.1	2.5	4.2
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	0.9	-0.2	2.9
Commodities				
Gold	Gold – USD	3.6	-0.6	6.0
Oil	WTI Oil $/b – USD	24.2	87.1	8.7

Outlook

Economic indicators such as employment numbers, the PMI (Purchasing Managers Index) and consumer confidence all suggest that the economic recovery is well on track, with some indicators exceeding pre-Covid levels. Studies predict that around 75% of the world's population will have received at least one vaccine dose by the end of 2021, noting that some of the vaccines appear to be more effective than others.

Equity markets continue to rally, supported by historically low interest rates and unprecedented levels of Government stimulus. Equity valuations appear expensive on an absolute basis with markets trading on high Price Earnings multiples, although at the same time appearing to provide good value compared to bonds and cash, although with higher risk.

However, there is growing concern regarding inflation around the world. For example, US CPI (All Urban Consumers Index) rose 0.9% in June and 5.4% over the past 12 months. Whilst acknowledging the rise in inflation, key central banks have taken the view that much of the rise is attributed to imbalances between supply and demand caused by Covid and is hence transitory in nature. The US Federal Reserve have now adopted average inflation targeting, making 2% a long term goal rather than an upper limit.

If the rise in inflation instead turns out to be structural in nature, central banks can be expected to tighten monetary policy sooner. Any potential change in policy rhetoric by central banks would see bond yields rise, potentially delivering negative returns for fixed interest securities. The higher bond yields would likely see increased pressure being placed on equity markets.

The consensus view is that current inflation is transitory, this being further supported by stubbornly low wage growth. Other market risks are also on the rise including the risk of policy error, geopolitical tensions and the unpredictability of Covid as new variants arise.

Our view on various asset classes is outlined below. Although these positions have not changed significantly over the past quarter, we recommend that investors consider 'taking profits' from overweight equity holdings.

Australian Equities

We recommend investors hold a neutral position to Australian Equities in large cap stocks as well as smaller companies. Given the large rise in equity markets over the past 12 months, investors should take the opportunity to take some profits if they are overweight to this sector.

Based on traditional measures, Australian equities look expensive with the Price Earnings ratio at around 21 times against an historical average of 14.5 times. However, cyclical indicators look particularly strong and point to further gains driven by a recovery in earnings (subject to the impact of Covid). Valuations also look attractive when compared to bonds and cash.

Investors must weigh up the significant risk of a market correction when bond yields start to rise, albeit potentially not for another couple of years. They must also be prepared for further twists in the Covid saga (e.g. a variant immune to current vaccines) which could see markets correct. Hence our recommendation that investors consider taking profits from overweight positions.

The rotation from growth stocks to value / cyclical stocks appears to have played out.

International Equities

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

US markets look the least attractive of the developed markets from a valuation perspective. Despite the recent recovery in earnings and accommodative fiscal and monetary policy, S&P500 and NASDAQ valuations are looking stretched. We now see more value in Europe, UK and Japan.

Emerging markets equity returns have lagged developed markets over the short term, meaning relative valuations are now looking more attractive. We favour emerging markets over developed markets despite China softening slightly and India lagging the global recovery.

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. Covid continues to put pressure on profits from traditional shopping malls whereas the office sector carries the additional risk of employees seeking to work from home in the long term. We currently see more value in sectors such as industrial property and healthcare.

Valuations in the sector are underpinned by historically low bond yields. As noted in previous quarters as bond yields rise and capitalisation rates widen, downward pressure will be placed on property prices. As such investors need to be cognisant of the risk of asset price falls when bond yields rise.

Fixed Interest

We recommend investors remain underweight to fixed interest securities with a bias towards hybrid securities and away from Australian and International Government bonds.

Although on a relative valuation perspective, bonds look slightly more attractive to equities than they did a quarter ago, the tightening of yields across the sector means that from an absolute valuation perspective, there is little value except in providing diversification and downside risk in case of an equity market correction. Short term risks remain if inflation continues to linger.

Alternatives

We retain a neutral setting for Infrastructure investments, preferring holdings on a hedged (currency) basis. Again, we highlight the risk in this area of future interest rate increases.

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 this climate of increased risk, long short funds and market neutral funds can offer some protection against a market corrections. Furthermore, we continue to suggest consideration be given to an allocation to the gold or silver sectors 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. Vanguard
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