Economic & Investment Update - October 2021

While the Delta variant of Covid-19 continued to spread and concerns about the pace of the global recovery and inflationary pressures increased, markets remained mostly positive during the September quarter.

In the US, economic data cooled as the Delta variant led to a reduction in consumer spending while supply chain bottlenecks hit businesses. Annualised inflation rose to 5.4% in September, a 13 year high, however, the US Federal Reserve maintained its view that this spike is transitory. Federal Reserve Chairman Jerome Powell also advised that it was 'on track' to shortly begin tapering asset purchases (quantitative easing) with the timing expected to be announced in early November.

In Europe, despite the Delta variant leading to an increase in infections, higher vaccination rates in the larger eurozone countries allowed restrictions on travel and other activities to be lifted. As the quarter progressed, inflation became a concern with annual inflation estimated at 3.4% in September. The European Central Bank announced a reduction in the pace of asset purchasing, noting it would tolerate a moderate and transitory overshoot of the 2.0% inflation target. The end of the quarter saw a surge in power prices due to low gas supply and weather-related issues over the summer. Germany held a general election, with the Social Democrats receiving the largest share of the votes. Coalition talks are underway to form a new government.

In Japan, politics dominated as Prime Minister Suga stepped down as leader of the Liberal Democratic Party (LDP) with Fumio Kishida taking over. While Suga faced widespread criticism over his handling of the pandemic and his popularity was fading, the announcement was still a shock given he'd only spent 12 months in the role. PM Kishida flagged additional fiscal stimulus to support the economy through the pandemic as industrial production and household spending fell.

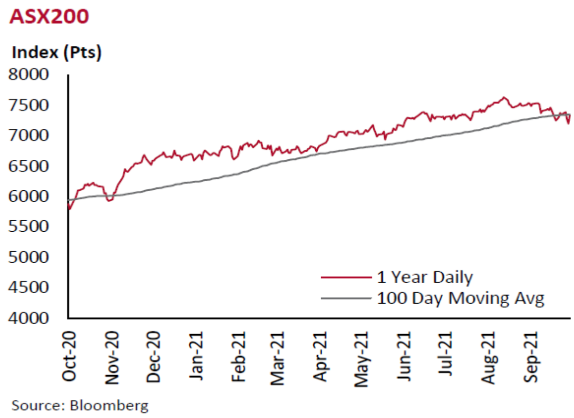
China's woes began to unnerve investors in the quarter as the government looked to assert more control in several sectors. In the technology sector, China dished out large fines for monopolistic practices with Alibaba hit with a record $3.8 billion (AUD) fine. In the property sector, authorities looked to rein in debt and bring prices under control, with Evergrande Group, struggling to clear $300 billion of debt, potentially a casualty. Evergrande sparked global investor concern as a default by the company would not only be disastrous for China's real estate sector (28% of GDP) but could have a domino effect throughout the economy, and potentially globally. China trimmed economic growth forecasts as a power shortage impacted factories and homes.

In Australia, data released in September showed the economy grew 0.7% for Q2 (year-on-year growth of 9.6%) but with growth slowing from Q1. Inflation increased to 3.8% in Q2 2021 with the largest increases coming in fuel, pricing for furniture due to timber prices and supply shortages as well as childcare, as free childcare ended. In its September minutes, the RBA again said it "will not increase the cash rate until actual inflation is sustainably within the 2 to 3 percent target range".

MARKETS

In Australia, on the back of a strong reporting season with record resources profits and dividends, the S&P/ASX 200 Accumulation Index finished up 1.7% over the September quarter.

The Energy sector produced the strongest return for the quarter, up 8.0% as oil markets tightened and energy demand strengthened. The Telecommunication Services sector also continued to perform well, rising by a further 7.6% for the quarter.



The Materials sector generated the lowest return, down 9.6% as economic issues in China and a collapse in the iron ore price put downward share price pressure on BHP Group, Rio Tinto and Fortescue.

Smaller ASX-listed companies (top 100-300) returned 3.4% for the quarter, with energy companies rallying hard on spiking prices for thermal coal, gas and oil.

Global equity markets produced modest gains during the September quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 0.6%. However, with the Australian Dollar depreciating against most major currencies, the September quarterly unhedged return was +4.0%.

In the US, shares notched low positive returns with the S&P 500 up 0.6%. While strong earnings had lifted US shares, growth and inflation concerns saw US shares pull back in September. Eurozone shares were mostly flat for the September quarter.

In Asia, Japan generated the best quarterly return (up 2.3% as measured by the Nikkei 225 PR Index) as investors were reassured by news that the Liberal Democratic Party was likely to remain in power and provide continued fiscal stimulus and monetary easing. Chinese markets finished the quarter considerably lower as investor sentiment soured. Falling sentiment was headlined by systemic risk from China's Evergrande crisis and its potential negative impact on the broader real estate market and the Chinese government's imposition of broad regulatory reforms.

Property markets were mixed over the September quarter, with Australian listed property securities gaining 4.2% but global property securities finished down 0.2%. The release of strong 2021 full-year financial results in August helped push the domestic property market higher.

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, rose by 0.3% over the September quarter. A similar but smaller gain occurred in overseas bond markets. While the trend of decreasing yields (rising bond prices) continued early in the quarter, growing fears that the current high levels of inflation may not be transitory drove yields upwards (bond prices lower) in September.

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	1.7	30.6	10.4
	S&P/ASX Small Ordinaries TR (Accum) Index	3.4	30.4	10.2
International	MSCI World ex Aust NR Index (AUD)	4.0	27.8	15.2
	MSCI World ex Aust NR Index (AUD Hedged)	0.6	28.3	13.4
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-4.5	17.3	10.5
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	4.2	30.0	7.1
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-0.2	29.1	4.4
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	2.9	22.0	5.8
Currencies				
AUD v USD	Against US Dollar	-3.6	0.9	-1.2
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.3	-1.5	3.1
	Bloomberg Ausbond Credit All Maturities	0.3	1.3	3.9
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	0.1	-0.8	2.7
Commodities				
Gold	Gold – USD	-0.7	-6.8	6.0
Oil	WTI Oil $/b – USD	2.1	86.6	9.2

Outlook

With Covid-19 Delta variant induced lockdowns, global supply-chain disruptions, and soaring prices likely to continue to impact the global economy, the pace of global growth is expected to moderate over coming months. The International Monetary Fund (IMF) recently lowered its global growth forecast for this calendar year to 5.9% (down from 6.0%). However, it has maintained its view that global growth would moderate to 4.9% in 2022.

While the IMF expects that inflation will return to pre-pandemic levels by mid-2022, it warned that the negative impacts of inflation could grow further, if the pandemic-related supply-chain disruptions turn out to be more damaging and long-lasting. A sustained period of inflation could result in an earlier tightening of monetary policy by central banks, holding back the global recovery.

Regionally, while there may be a short-term slowdown, the U.S. economy is likely to sustain above-trend growth into 2022. Early evidence that the Delta variant wave may be fading and the potential for greater vaccine access for children are positives for a more complete recovery in the quarters ahead. The US Federal Reserve looks poised to start tapering its asset purchases toward the end of 2021 however, this will be dependent on economic data released in coming months. The timing of the first-rate hike will then hinge on what happens to inflation next year. Fiscal stimulus, tax provisions and debt ceiling negotiations are also likely to continue to grab headlines and impact investor sentiment in the months ahead.

The Eurozone looks on track for a return to above-trend growth over the fourth quarter of 2021 and into 2022. Vaccination rates are high, and the euro area has more catch-up potential than other major economies, particularly the United States. The euro area is also set to receive more fiscal support than other regions, with the European Union's pandemic recovery fund only just starting to disburse stimulus.

In Asia, the Japanese economy is expected to get a shot in the arm as rising vaccination rates improve mobility and reduce the risk of further lockdowns. However, the Bank of Japan is likely to significantly lag other central banks in normalising policy. Meanwhile, Chinese economic growth is likely to be robust over the next 12 months, supported by a post-lockdown jump in consumer spending and incremental fiscal and monetary easing. The major risk in China is the potential for financial contagion to sweep through the property sector as its investment and construction driven model of growth begins to creak under the strain of mind-boggling debts. Should this occur, this may have global economic ramifications.

The Australian economy is set to return to life, with lockdowns easing in Victoria and NSW. Consumer and business balance sheets continue to look healthy, which should facilitate a strong recovery. The re-opening of the international border is likely to provide a further boost. Fiscal policy has supported the economy through the downturn, and there is potential for further stimulus in the lead-up to the federal election, which is due before the end of 2022. The Reserve Bank of Australia has begun the process of tapering its bond-purchase program, but we expect that a rise in the cash rate is unlikely until 2023.

Our view on various asset classes is outlined below.

Australian Equities

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

Based on traditional measures, Australian equities appear expensive with the Price Earnings ratio at around 21 times earnings against an historical average of 14.5 times. Cyclical indicators have also weakened in recent months with the deterioration largely driven by recent Covid-19 shutdowns in NSW and Victoria.

With the Delta variant expected to subside over the coming months as states reach their vaccination targets and the weather warms up, we expect to see another economic rebound in activity upon re-opening. However, with company valuations high, there appears less reward on offer for taking that additional risk than in prior re-openings.

We also note the risks associated with a slowdown in Chinese residential construction which could lead to further weakness in the iron ore price and lower earnings for miners and the overall Australian share market.

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 continuing accommodative fiscal and monetary policy, S&P500 and NASDAQ valuations appear stretched. We now see more value in Europe, UK and Japan.

Emerging markets equity returns continue to lag developed markets meaning relative valuations are now looking more attractive. We favour emerging markets over developed markets but recognise some of the risks to growth, especially in China.

Property (REITs)

We recommend investors retain a neutral position to Australian and International property. With Victoria and NSW reopening, recent pressure on the retail and office sectors is expected to ease. However, should online shopping or working from home become permanent sector shifts, this could place longer term pressure on these sectors.

Property valuations continue to be underpinned by low bond yields and a rise in bond yields may place downward pressure on property prices. However, it is worth noting that the domestic listed property sector has historically performed well (on a relative basis) during periods of above average inflation expectations (one reason for rising bond yields). Real estate stocks are an "inflation protection sector," as unlike bonds, income streams can grow. Many lease structures also have built in inflation linked annual increases.

Fixed Interest

We recommend investors remain underweight to fixed interest securities.

Bonds are currently looking more attractive than they have for some time from relative valuation and cyclical perspectives with weaker growth supporting bond prices and keeping rates low. However, shorter term risks remain if inflation concerns linger.

Investor demand for credit is likely to remain strong in an environment where official cash rates are at or close to zero and investors globally continue their reach for yield. The accumulated and still growing stock of bonds on global central banks' balance sheets will also underpin demand for high quality credit and is likely to help keep a ceiling on any spread widening episodes. Based on this backdrop, we expect the corporate credit market to continue to perform reasonably well.

Alternatives

We retain a neutral setting for Infrastructure investments which remain cheap versus global equities. However, with many infrastructure businesses highly leveraged, we highlight the risk in this area from 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 correction. 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. In the current economic climate, an allocation to other commodities should also be considered.

Sources: Lonsec. Vanguard