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Q4 2019/20 REVIEW

Reopening optimism

The pace of the recovery has been as breathtaking as was the precipitous fall just 3 months prior. A strong rebound in consumer spending, improved global industrial production and less dire predictions about housing and unemployment have policy makers (at least in Australia) working out how to rein in stimulus spending (JobKeeper) now that worst of the crisis has been averted.

While we did not dismiss the chance of a 'W' Shaped recovery just 3 months ago (and second wave risks remain), the last quarter has all but dispelled that theory for now, as unprecedented central bank stimulus underwrites risk and as economies gradually reopen, a wave of optimism continues to support equity markets.

Looking back

The first half of the financial year is somewhat of a distant memory, paling into insignificance compared to what's unfolded in the past 6 months.

Markets were constrained for much of 2019 by US-China trade frictions, however, things appeared to turn for the better late in the year on trade, while the Brexit saga in the UK was also finally put to bed. As geopolitical uncertainty faded, optimism grew that a rebound in global trade and business investment would see stronger corporate profits.

The early signs were encouraging, despite Australia suffering a series of devastating bushfires and drought that curbed economic growth forecasts. In February, we had a better than feared earnings season that drove the ASX/S&P200 to fresh 11 year highs, around 7200 index points (on February 20th), before the world health pandemic, Covid-19, took centre stage. Markets plunged an astonishing 2800 points or 39% in just one month to eight year lows of ~4400 index points on March 23rd. So, following the markets largest quarterly losses since the 2008 GFC, we saw a blistering rally and a 'V Shaped' recovery driven by coordinated central bank stimulus.

Pledges by the world's largest central bank the US Federal Reserve and Chair Jerome Powell that surprised markets stating 'that now is not a time to worry about debt' and took a 'whatever it takes' attitude by upsizing his stimulus commitments and buying corporate debt - even high yield junk bonds. This helped stabilise credit markets that otherwise would've seen record loan defaults and sent markets into a tailspin.

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So it was record stimulus that's helped deliver some of the best quarterly performance gains markets have seen in recent times.

Q4 in Australia

In Australia, the ASX/S&P200 index rallied 34% off our March lows, rising 16% for the quarter (best quarterly performance since September 2009) to finish the Financial Year down around 11% - our first negative year in 4 years.

The standout sectors for the year were Healthcare, Technology and Consumer Staples, whilst Energy, Financials (Banks) and Real Estate lagged. The biggest change for the year was global blood plasma group CSL Limited becoming the largest company on our market, displacing Commonwealth Bank. The 'buy now, pay later' theme grew legs as Asian tech giant Tencent acquired a 5% stake in Afterpay, catapulting the company to become our biggest tech stock and 23rd largest on the market despite them having yet to make a profit.

The sectoral composition of our market has been progressively transitioning towards global healthcare and technology stocks, seeing our major Big 4 banks de-weight from around one third of the market's capitalisation (just 5 years ago) to just 17% today, while the Healthcare and Technology index combined has grown from around 7% combined to 16%. This highlights, that while yield remains

an attractive feature for many investors, record low interest rates and cheaper funding continues to support the structural shift in technology adoption, rewarding those companies that reinvest in their business rather than pay away future growth via dividends.

Q4 globally

Overseas markets also rebounded strongly as the Dow Jones Industrial Average in the U.S. rose 17% for the quarter but fell 3% for the year. This was the Dow's best quarterly rise since 1987. The S&P 500 Index was 20% stronger for quarter, finishing the year 5% higher.

Meanwhile, the technology-heavy Nasdaq Composite led the way surging 30% for the quarterly (best quarter since 1999) to finish the year up a staggering 26% to close near record highs. Since bottoming at 5 year lows on March 23, the Dow Jones and S&P 500 have gained 42% while Nasdaq has outperformed rising by 52%. The much loved FAANG Stocks (Facebook, Apple, Amazon, Netflix and Google) led the way that on average rose by 40% for the year.

Furthermore, the secular trend that has insulated many technology businesses from covid related shutdowns, by driving greater business and consumer engagement, now has the five largest stocks in the S&P 500, being those FANG stocks plus Microsoft (which recently became the fourth trillion dollar US company). These now represent over 22% cent of the index.

In Europe, the Stoxx 600 Index delivered its best quarter in five years, jumping 12.6% (down 13.6% for the year), as Germany's DAX30 led the way, rising 24% in the quarter (down just 1% for the year) despite the collapse of online payments and tech darling Wirecard (a DAX30 constituent) on fraud allegations. Meanwhile, respectable quarterly gains of around 13% were recorded in both Italy and France while in London, the FTSE100 rose by 9% (down 17% for the year) hurt by dividend deferrals, a weaker British Pound and a failure to contain the covid crisis early by delaying shutting its borders to Europe.

Closer to home, the Nikkei 225 in Japan rose 18% for the quarter, China's Shanghai Composite Index rose around 8% while Hong Kong's Hang Seng Index lagged to rise a modest 3% finishing 15% lower for the year as Beijing's imposed national security laws created further social unrest and global backlash that may lead to US sanctions on the region.

Commodities

Despite the global turmoil, the iron ore price was resilient, up 20% for the quarter (down just 13% for year) supported by supply disruptions in Brazil (on rising covid cases) and improving Chinese demand. However, oil reversed much of the previous quarter's plunge, rallying 60% yet still finished 35% weaker on the year as OPEC supply cuts could not outweigh the temporary pull-back in travel related energy demand. Base metals lifted on rising industrial production numbers and reopening optimism that saw strong quarterly gains as industrial metals used in the electric vehicle markets, such as copper and nickel, outperformed to finish in positive territory for the year. On that front, US based electric vehicle pioneer Tesla surged 380% last year to become the world's most valuable auto company at $200bn.

Significant moves came from Gold as investors sought safe haven assets as a hedge to the economic uncertainty ahead and the long term inflationary impacts of record central bank stimulus. Gold hit fresh 8 year highs, closing up 17% for the quarter (26% for the year) to US$1780oz - its seventh straight quarterly gain.

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Currency and money markets

The Australian Dollar (A$), a cyclical commodity currency, traded in the widest trading range in five years, hitting 17 year lows of US$0.55 in March before rebounding strongly on risk on trade to close down just 2% at US$0.69 by the end of the year.

The lower risk US 10 year treasuries stabilised, but closed down 67% for the year at 0.65% while in Australia, the 10 year government bonds improved to close the quarter at 0.87% (down 34% for the year). The sharp drop in bond yields was driven by central banks slashing interest rates to record lows, enacting colossal stimulus while pledging to keep interest rates low until employment and inflation return to pre covid levels (meaning that rates are forecast to remain at current depressed levels through to 2022).

For markets, looser monetary policy and extra liquidity by central banks will continue to put downward pressure on bond yields, thereby making equities a more attractive

relative yield investment (albeit with greater risk), even as the forecast yield for the market has fallen to 3.4% after the impact of dividend deferrals.

Cheaper money has promoted some greater risk taking, and this was evident across the sectors that outperformed and included many technology, small cap and emerging stocks.

Sector movers and shakers

The Technology sector's 48% surge for the quarter (18% for the year) outpaced the Emerging companies index (average market cap of ~$200m) that rose by 44% for the quarter (-3% for the year), while the Small Ord's (ASX100-300 stocks) rose 23% for the quarter.

Emerging biotech, Paradigm, capped off another stellar year continuing their meteoric rise rallying 125% for the year, and in the process, graduating from the Emerging market index to the ASX300 index.

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The ASX50 Midcap index (ASX 50-100 stocks) also outperformed rising by over 30% for the quarter (-2% for the year) as investors chased higher growth among the blue chips. By the end of the quarter markets had recovered strongly and a rotation from defensives to high growth (technology) was evident in sectoral performance.

Where to now?

US fourth quarter earnings (July) and Australian full year earnings seasons (August) are ahead of us, and, while we know what the P is (in regards to Price), we will get more colour on the E (Earnings) to better gauge company valuations. Sporadic company updates and regulatory relief on continuous disclosure obligations since the pandemic took hold make it hard to measure where businesses are tracking. Company updates (particularly retail) have generally focused on sales (not margins), and as economic data continues to be better than feared, equity markets are rising ahead of future earnings forecasts. Over bearish analysts have been upgrading forecasts but time will tell if the contraction in corporate profits was less dire than predicted.

Retail sales have been a bright spot of the recovery, given the surge of stay-at-home spending, underpinned by JobKeeper and the early access to up $10,000 of superannuation this year (estimated at $17bn) and ability to access another $10,000 next year may see an artificial bump to consumption. It is the $100bn fiscal cliff that comes at the end of September when JobKeeper ends as well as the moratorium on household debt deferrals from banks that is due to end. This pull forward of demand has boosted consumption and upgraded GDP forecasts for the next quarter but it won't be enough to stop the Australian economy entering a technical recession (2 consecutive quarter of negative growth) for the first time in 28 years.

A key downside risk remains to employment growth, and companies are already starting, in part, to transition away from JobKeeper, as evidenced by major airline Qantas, that announced a 20% reduction in its workforce given the uncertain road ahead. JobKeeper currently masks the true unemployment rate which currently sits at 7.1% (highest since 2001). Once JobKeeper ends, risks to consumption remain. Governments will be all too aware of this and alternative targeted stimulus measures are likely to come, such as the recently announced infrastructure spending and housing support to cushion the economic blow. Despite, initially announcing a record post war $130bn JobKeeper stimulus package (that took three rescue packages to $214bn, 11% of GDP) a somewhat concerning but pleasing overestimation by Treasury means that $60bn of the JobKeeper won't be required as a shallower economic trough is now forecast. This means that committed stimulus spending sits ~$150bn (7% of GDP), a much lower future government debt obligation, providing additional stimulus should it be required as we move out of the crisis.

For the market, and as it stands today, Australian company profits are expected to decline by 15% this year and 3% next year, meaning the market is undeniably expensive, trading at 19 times forward earnings and well above long term averages. However, pledges to keep interest rates at record lows and the inflationary impact that will come from record stimulus measures means stocks remain an attractive (inflation linked) asset class, relative to bonds, helping support above average valuations in the short term.

Any dips have become very short so far, and investors are waiting for any chance to build up their equity weightings.

Many analysts are now wondering if markets will start moving sideways as concerns about the pace of the recovery and signs of a COVID-19 second wave emerge. COVID-19 case numbers in the US continue to rise (as expected as economies reopen) and closer to home Victoria is now seeing case numbers trend higher as restrictions in that state ease. Optimism and confidence of a vaccine cure remains high and a return to social normality should continue to see economic growth and company profits rebound from low levels aiding support for markets.

A contrarian indicator that markets may have some further upside ahead is that many investors are still holding high cash positions looking to buy the dip that has not been forthcoming in the past few months. A recent survey by US major multi-asset manager Fidelity found that one third of American investors aged over 65 years of age sold their entire portfolio moving to cash over the March to May period. A separate report from Bank of America indicates that many institutions around the world took cash levels above the 10 year average to 5.7% in May. However, any dips have become very short so far and investors are waiting for any chance to build up their equity weightings so in June, they then saw the biggest dash away from cash since 2009 as more fund made their way back into the market. Despite recent moves US Money market cash levels sit at double the level they were at 5 years so there remains plenty of idle cash on the sidelines.

The risks moving forward

We remain optimistic for the year ahead, supported by stimulus initiatives, while corporate activity is set to recover given the swath of cash on the sidelines which, all in all, should be supportive for markets. However, risks to the recovery remain, and a sustained pick up in global demand is still critical for stimulus initiatives to be scaled back. The risk of a sustained second wave of COVID-19 exists, US-China tensions continue and the pivotal US Presidential Election in November, which currently has President Trump well behind on the polls, could be another drawback for markets.

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The glass is still 'half full'

A true reflection of corporate earnings will be revealed in the upcoming reporting seasons that should help dictate the short term market direction. After such a strong quarterly performance, more moderate market returns would not be unexpected, with defensive and/or higher quality stocks being favoured after investors chased risk assets that offered greater turnaround potential.

The expectation of further positive global growth surprises (with global restocking a key theme) should support commodity and industrial stocks.

The banks have lagged and, despite near-term headwinds, look attractive over the longer term given their strong capital levels, and dividends should progressively lift after this year's pause.

Equities are in a sweet spot, government spending has much more to go, and interest rates remain at a near record low, which all suggests that risk assets could do better with Australia offering cyclical leveraged exposure to the global recovery.

We remain optimistic that markets can maintain their recovery path and we would use any meaningful dips to put spare cash to work as the 3.4% forecast yield remains attractive relative to bonds.