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Q1 2020 REVIEW

While a pause in the rapid pace of the global recovery is one that should refresh and build a base for more sustained long term gains, Australian markets have already been consolidating for much of the past four months.

September swoon on global markets

Markets initially built on the strong June quarter, as good progress on COVID-19 vaccines and reopening optimism continued through to the August reporting season, which was resilient and better than many feared. The All Ordinaries Index registered its best month in August since 2009, rising 3%. However, some exuberance in the Technology sector, rising global COVID-19 cases, US election uncertainty and a pause in economic stimulus programs were all enough for a September swoon on global markets.

Australian shares shed nearly 4% in the month of September (down 2.1% on the final day), ending 5 months of gains since the onset of the COVID-19 crisis. So by the end of the quarter the All Ords eked out a modest 0.1% gain to record our worst September quarter in 5 years.

US markets suffered similar losses in September (as steam came out of the high flying Tech sector) yet they managed to post their best third quarter since 2010 to see the S&P500 rising 8.5%, while the technology focused Nasdaq jumped 11%.

While records were broken globally, the Australian June quarter decline was much softer than the COVID-induced destruction seen in other economies.

In Europe, shares were broadly weaker as COVID-19 case numbers forced renewed restrictions. In London, the FTSE fell 5% as Brexit concerns resurfaced, in Paris the CAC40 was 2.5% weaker, and the export-reliant German Dax Index bucked the trend to finish up 3.5% on firming industrial production data.

Major markets in Asia outperformed others in the region to see the Shanghai Index in China up 8% while Japan's Nikkei rose 4%.

Economy

Australia officially entered recession in September, snapping a record 29 consecutive-year run of economic growth, as COVID-19 wreaked havoc on the economy. While the economy declined by -0.3% in the March quarter, it was followed by a -7% decline in the June quarter, its largest quarterly decline on record, surpassing the -2% June record fall set in 1974. As records were broken globally, the June quarter decline was much softer than the COVID-19-induced destruction seen in other economies - the US contracted -9.1%, Europe -12.1% and the UK -20.3%. Australia's relatively mild contraction was softened by record government spending and stronger iron ore exports.

Record job focused stimulus programs centred on cushioning the household and consumer sectors are likely to see the budget deficit rise above $200bn or 11% of GDP this year. While the true number of unemployed may be masked by these measures, much better than expected employment

data has seen the unemployment rate fall to 6.8% and below the initial 10% peak forecast in June. This is a good outcome considering Victoria entered their second COVID-19 lockdown. While it remains an uncertain path ahead, Australia's unemployment rate is not expected to fall back to pre-COVID-19 levels of 5.5% for at least 3 years, meaning that interest rates are also unlikely to rise until 2023. This is a positive backdrop for risk asset and debt holders, but less so for savers and those seeking lower risk free returns.

A key focus for investors and government policy is the direction and health of the housing market. Despite Victorian second-wave lockdowns and defying doomsayer forecasts, housing prices have risen nearly 5% over the year and are, in fact, higher over the past 12 months. This has been supported by record low interest rates and deferral in mortgage repayments to avoid distressed sales.

While challenges lie ahead, including the removal of the marginal overseas home buyer given the expected lower population growth from COVID-19 restrictions, a pleasing turn of events occurred late in the quarter on lending standards. The government announced their intention to repeal responsible lending obligations (from March 2021) and replace the practice of lender beware to borrower responsibility principle. Treasurer Josh Frydenberg said, "The pendulum had swung too hard on blaming the banks if loans went bad." While many argue we don't have a credit supply issue, it remains a demand for credit problem. The stimulatory move by government is symbolic, creating a thawing of relationships and more cordial stance with banks which remain a linchpin to economic recovery. In principle, the restrictions reduce rules on certain lending criteria and create the potential for stronger loan growth. The banks responded favourably to the news, led by Westpac, which rose 7.4%, National 6.9%, ANZ 6.3% and Commonwealth 3%.

US markets leading the way

In a year of spectacular records, after falling 39% from their February peak and confirming a new bear market, the S&P500 index in the US took just a record 126 trading sessions to record the fastest ever bull market - measured as the time it takes to reclaim the previous bull market high. This surpassed the previous record of 310 days (Feb 1966 to May 1967) and was much shorter than the average 22 month duration. The major drivers for the breakneck speed of the recovery was the continuation of better than expected data on Manufacturing, Housing and Employment, while a comparatively better than expected US reporting season added support.

The US Federal Reserve added fuel to the rally by announcing a major policy shift. It indicated that monetary policy will remain lower for longer by moving to an average inflation target, allowing inflation to run hot and above the average 2% target, thereby lengthening the expansion recovery. Lower interest rates and bond yields have increased the present value of cash flows for risk assets such as shares, helping push up their value and above long term averages. The US's long duration growth sectors like Information Technology (IT) and Healthcare were the major beneficiaries of the move, prompting greater risk taking by investors.

Investors gravitated to those major technology companies that have benefited from the COVID-19 lockdown, as consumers and business went online. Most businesses have been forced, by COVID-19 induced demand and necessity, to compress their multi-year digital transformation plans into a few months since the pandemic outbreak. This trend was noted by US megatech company Microsoft which said it had seen two years of digital transformation in two months, as remote teamwork and learning, to sales and customer service, to critical cloud infrastructure and security, has driven demand for their services. Speed and agility are enabling business to innovate faster, and much of the transition will be the standard for digital engagement in the future, particularly in healthcare, given changing public health needs which are helping accelerate digital strategies by an average of six years.

These IT capital expenditure shifts by business are significant, so it was little surprise to see the best gains come from the major technology stocks again, but it was the concentration of those gains that creates some degree of caution on current valuations. The strong US gains were contained to just five big technology stocks, known by the famous acronym (FAANG), being Facebook, Apple, Amazon, Netflix and Google parent Alphabet, plus Microsoft, which now account for 25% of the S&P500 index and were, on average, up around 40% so far this year. This means the other remaining 495 stock, on average, fell 4% for the year, meaning increased concentration risk and volatility on the movement of a handful of stocks on their markets.

Such euphoria, and the rapid pace of the tech leaders, has been driven by low risk-free rates (interest rates), rumours of a large derivatives trade by Japan's Softbank across the major tech players, and momentum trading by the cohort of growing online Robin Hood retail traders, are reasons given for the rally. Quite simply, some of the moves have been amazing and a little confusing as the Apple share price surged by more than 10% after announcing a 4 for1 share split - a move that fundamentally didn't change the company, it just increased liquidity and accessibility for smaller investors. Apple shares have doubled from their March lows to now be the first US$2 trillion dollar company. Electric vehicle pioneer Tesla followed suit, similarly announcing a 5 for 1 split, soaring 13% on the news in August, and by the end of quarter its market capitalisation, nearly double to US$400bn. Amazingly, Tesla is now worth more than the combined value of car makers Toyota, VW, Daimler, BMW, GM and Ford. Some profit taking in the Technology sector was therefore, well overdue, and we saw a modest rotation to value from growth that helps remove some of the excess of the recent rally.

The US markets relatively lower exposure to cyclical sectors such as Resources, Manufacturing and Financials that have been hit harder by COVID-19 drove their out-performance. In contrast, Australia's largest 10 stocks on the market, accounting for over 40% of the index, being the Big 4 banks plus Macquarie, BHP, Fortescue, CSL, and retailers Woolworths and Wesfarmers. So given our greater exposure to housing (record low interest rates hurt bank margins), and a lesser exposure to Technology, meant our flat quarterly performance was respectable in this context. Those Top10 companies, in part, dragged down the overall performance on market that saw the ASX50 shares fall by nearly 2% for the quarter, as cheaper money promoted some greater risk taking by investors.

This higher risk taking was evident in the sectors that outperformed on our market, and this included Technology stocks as well as Small Cap and Emerging stocks. The Emerging companies index (average market cap of ~$250m) rose by 20% for the quarter (7% for the year to date), outpacing the Technology sector's 12% higher move and the Small Ord's (ASX100-300 stocks) 5% lift for the quarter. The ASX50 Mid Cap index (ASX 50-100 stocks) also rose by over 5% (including dividends) as investors chased higher growth among the blue chips. The trend of investors seeking exposure to Mid Cap stocks with a greater digital presence that will benefit from the COVID-19 disruption continued. While lower near-term earnings and dividend expectations are headwinds for Leisure and Hospitality sectors, encouraging vaccine developments and progressive reopening of state borders indicates the worst is probably behind the sector, and this optimism drove the performance of many smaller cap industrial and discretionary stocks.

US$ losing its Reserve status?

The US Dollar (US$) weakened against most major currencies during the quarter as some doubts crept into its supremacy and ability to grow out of the crisis stronger than major peers. Record debt levels (100% of GDP – highest since WW-II) and de-globalisation of trade were seen as potential negatives. Strong capital inflows into the US economy have been a feature over the past decade, and while the trend against the US$ has some momentum, the question remains, is there a suitable rival to take the mantle? There remains room for the US$ to weaken further given its long-term out-performance, and this should support capital flows to emerging markets in Asia, and by association, Australia.

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In Australia, increased fiscal stimulus, interest rate cuts, and extra liquidity provided by the Reserve Bank of Australia (RBA) has seen continued downward pressure on bond yields and interest rates. Despite the weaker interest rate outlook, the A$ rallied to two year highs above US74c this quarter before settling up nearly 4% at US71.6c, as overseas investors were drawn to our relatively more attractive government bonds. Meanwhile, China, who were first in and first out the COVID-19 crisis, saw economic data strengthen (recording a seventh straight month of manufacturing expansion) driving iron ore exports and the $A with it.

China demand drives commodities windfall

Commodities were supported by US$ weakness (as it makes them cheaper for metals consumers to purchase), while COVID-19 related supply disruptions in South America (Brazil – Iron ore, Chile- Copper), and stronger Chinese manufacturing growth that recovered above pre-pandemic levels on robust infrastructure spending, underpinned metals consumption. Iron Ore hit six-year highs in August, on strong steel demand, to close up 18% for the quarter. Strong gains were also seen across the base metals complex as metals in demand for electronic vehicles supported the Nickel price which rose by 12% while copper prices rose by 8% to two-year highs.

Soft commodities also improved to see double digit gains in Wheat, Corn and Sugar, as good early rains in Australia should see growing conditions improve after a horrid year of abnormally dry weather that hurt global crop production.

As widely expected, oil cartel OPEC reiterated their commitment to curb oil supply, however, global growth concerns and weaker demand outlook saw Oil prices give up the bulk of the quarterly gains to close up around 3% on West Texas in New York.

Precious metals were in demand again, driving US$ weakness and its appeal as a volatility hedge to upcoming US elections and higher inflation expectations as governments enact record fiscal stimulus. Gold powered along, extending its winning streak to eight straight quarters to see the yellow metal hit a record high of US$2074oz before settling up 6% at US$1885oz, while Silver was the standout rallying by 26% to 8 year highs.

ESG is dynamite - watch boards explode

The rise and rise of Environmental Social Governance (ESG) came to the fore this quarter as shareholders and the public demand, and expect, more than pure monetary benefits from their executive leaders. Greater diverse representation on gender, race and equality of employment has broadened to increasing social and environmental governance and accountability for investment decisions and the actions of board members. This sweeping change has been evident across industry, and unfortunately, several high profile Large Cap stocks have been brought into the spotlight for shortcomings of senior management. Firstly, the decision and inadequate response by Iron Ore major Rio Tinto to the Yuukan Gorge explosion that destroyed an ancient Indigenous cave leading to a major shareholder revolt saw its Iron Ore Head and CEO, J-S Jacques, step down.

In the financial sector (this time not the banks) shareholder pressure saw insurer AMP retract internal promotions of executives due to harassment claims that resulted in prominent Chair, David Murray, resigning while similar investigations into harassment claims saw the resignation of QBE Insurance CEO, Pat Regan. Finally, an independent investigation by waste management firm Cleanaway into its CEO's overly assertive behaviour saw a warning and removal of executive bonuses.

Adding to increasing social and environmental pressures by shareholders, we saw major Resource and Energy firms commit to more renewable and cleaner forms of energy. Rio Tinto has pledged $1.5bn over five years to reduce carbon emissions by 15% over the next decade and be carbon neutral by 2050, having divested their coal assets. BHP has pledged to double that commitment by reducing carbon emissions by 30% over the next decade (while still investing in oil and gas) as they exit the thermal coal business and seek buyers for older oil and gas assets. BHP will increase investments in renewable and new technologies to lower emissions. These moves might come at the expense of short-term earnings and dividends, however, the public and shareholders demand accountability and the global ESG trend is growing rapidly.

Reporting season trends

August reporting was better than many feared. The aggregate number of companies reporting beat market expectations, however, broader earnings estimates were revised slightly lower, given asset write-downs as many Large Cap banks and miners marginally missed expectations. While forward guidance was sparse, the AGM season (October and November) may shed some light on current earnings trends, but the catch phrase of reporting season was one of 'resilience' given the challenges for businesses.

The major highlight was better than expected cash flows as companies cut costs, deferred capital expenditure and benefited from rent deferrals and government job stimulus programs. While this should help improve balance sheets and, in time, fund higher dividend payments, the hit to

capital expenditure does leave a gaping hole in future earnings growth. More modest earnings growth expectations need to be factored into stocks in the absence of major reform or stimulus programs to support the economy.

Stimulus coming... Budget in focus

Further support is likely to come in two forms over October (Federal Budget) and November (RBA), and a twin barrel of stimulus should provide support for the economy over the next year.

The government will move from persistent surpluses to record deficits in the next year to tackle the biggest recession since WW-II. The budget due on 6 October will see larger fiscal stimulus programs centred on tax cuts and incentives for job creation. While debt levels will rise substantially, Australia has entered this crisis in a relatively stronger position than global peers. Confidence can be gained from our ability to handle the COVID-19 crisis and our record of fiscal management which can now support growth initiatives.

The RBA may elect to await the details and ramifications of the budget before committing one of its many stimulus tools, having recently expanded its term funding facility to $200bn (until June 21) which allows low cost funding for banks to lend to business and consumers. The RBA has been well telegraphed that the next move will be to lower interest rates from a record of 0.25% (presumably to 0.10%) when they meet on 3 November - the same day as the US election.

US stimulus and election uncertainty

Despite the embarrassing and shambolic display of the first presidential debate in late September, high hopes remain for a resolution to the next major US stimulus package that has stalled since the previous programme expired at the end of July. Should a deal not be struck between the respective Republican (Trump) and Democrats (Biden) parties, a deal may not materialise until after the US election. This could potentially be as late as January when the President and new Senate are sworn in. Such a lengthy delay could stall the strong economic recovery to date, so it remains a risk for investors.

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Commentators have been discussing which party the markets prefer to win the election, and history has shown it is not necessarily the political party who wins the election that delivers the best results for investors, it's the economy the party inherits that ultimately determines investor fate.

Furthermore, any uncertainty, such as tightly run race or a contested result, will be negative for markets, as would be the composition of government should one party hold the Senate and the other the House or Presidency, creating a gridlock and inability to get things done. As it stands, the polls, which, mind you, have been notoriously wrong of late - i.e. Brexit (2015), Trump election (2016), Morrison election (2019), and were all non consensus results - has the Democrats widening their lead. Should a Biden victory eventuate, a bigger spending government might help Main Street, while a bigger taxing government that's keen on more regulatory oversight might hurt Wall Street. However, an offset might be a more harmonious trade relationship that could be a benefit to non-US shares. Should the Republicans retain power, higher taxes might be averted. However, deteriorating trade relations may continue over the responsibility of COVID-19 and US concerns on cyber-security and human rights in Hong Kong.

Outlook

While a pause in the rapid pace of the global recovery is one that should refresh and build a base for more sustained long term gains, Australian markets have already been consolidating for much of the past four months (around 6000 index points, putting shares some 17% below our yearly highs and down 12% for the year). In contrast, overseas markets (led by the US) have significantly out-performed to see the S&P500 Index reclaim their yearly highs to be up 4% for the year while the Nasdaq is now 24% higher on the year.

Arguably, Australian investors could feel a little hard done by, given our fewer COVID-19 cases, better than expected falls in unemployment, rising commodity prices that saw Iron Ore hit six-year highs (driven by China's first in - first out of the crisis recovery) and smaller contraction in growth than overseas peers. We therefore see scope for Australian shares to reverse part of this trend and outperform over the coming quarters, and view the recent pull back as a great opportunity to add positions for the next market upswing.

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Further fiscal and monetary stimulus is likely to come in the next few months via the Budget (October) and RBA (November) which will support markets. This will keep interest rates at depressed levels meaning alternative risk-free assets like cash and term deposits remain less attractive. Such a dynamic will continue to see money move into shares and explains the higher than average market multiples investors are paying. As it stands, the broader market is offering a forecast dividend yield of 3.5%, a significant premium to 10-year government bonds at 0.80%, so investors (willing to take on additional market risk) will continue to seek higher alternate sources of income lending support for Australian equities. We would therefore use any market volatility around the US election outcome to add to positions, as we expect dips to be shallow given the outlook for improving earnings, and the attractive equity yields on offer.