House View

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December 2020

Risk markets rallied strongly through November as positive phase three trials on a several COVID-19 vaccines were released. Regulators are looking to fast track approvals and pharmaceutical companies are well placed for mass distribution to developed markets through 2021. Investors looked through more shut-downs to buy risk assets.

Policy Watch: Fiscal and monetary support still supporting the impacts of COVID 19. This month the Victorian and NSW Budgets gave the local economy a major stimulus through infrastructure spending and incentives to business. The RBA cut rates to 0.1 per cent in November and re-affirmed to bond purchases of $100 billion.

Election Update: While initially looking to challenge the election result, we are now starting to see a more orderly transition to a Biden Presidency. The Republican retained control of the Senate which was well received by markets – reducing concerns that some of the more extreme left-wing policies of the Democratic Party would be approved if they controlled both houses of the Congress.

Vaccine Update: While COVID-19 infection rates continued to surge through the start of the Northern Hemisphere winter and several countries moved to reintroduce lockdowns to stem the spread, markets were buoyed by results from several major vaccine trials which released phase three trial outcomes with over 90 per cent efficacy. These drugs have been in production while the clinical trials were being conducted – effectively building a stockpile that can be deployed before the end of the year. Efforts will now turn to how to keep a record of which person actually takes which vaccine and keeping an effective health passport for further analysis and to allow free movement of people across domestic and international borders.

Inflation Watch: With aggregate demand still trying to recover, there is very little sign of goods and services inflationary pressures in the economy. Real assets on the other hand continue to set record highs acerbating inequality concerns in the economy.

Risk Budget: Volatility indictors fell sharply in the month and long bonds sold off early before rallying back through the month. This effectively expanded our risk budget and we took the opportunity to add to equities.

Portfolio

The signposts we were looking for to add risk were delivered – a clear cut election result with a split of power in the Congress and the release of positive phase three trials for the Covid-19 vaccine. Volatility measures quickly subsided, and we were able to add risks through our dynamic asset allocation. We now have a more pronounced overweight to risk assets – particularly global and emerging equities.

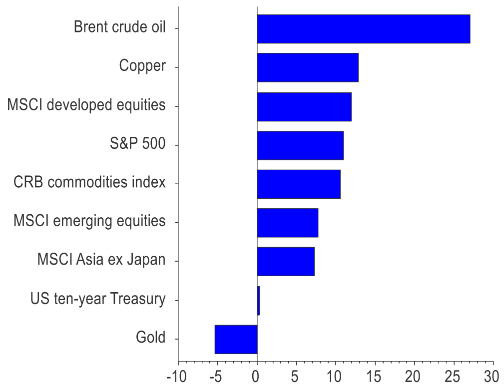
While $A dollar has rallied strongly versus the $US, we continue to believe that there is further upside based on prevailing commodity prices and the strong fiscal stimulus the economy has received. The only worry has been the dialling up of tensions with China which has now threatened the wine industry after impacting on barley and coal. China is our largest trading partner and a further escalation in tensions could undermine the $A strength.

With central banks around the world recommitting to maintaining supportive monetary policy and buying long end bonds – it is difficult to see any major sell off in yields derailing risk assets (valuations). We believe risk assets will continue to grind higher in 2021 despite some withdrawal of policy support.

November Review

Global risk markets rallied strongly in November, triggered by the US election result and positive results from several phase three vaccine trials. Most markets put on big gains, with gold being the major exception, falling more than 5 per cent in the month. Commodities were the best performing assets along with strong gains for developed (particularly Europe) and emerging equity markets.

Chart 1: Asset Class Performance in November



Source: Refinitiv Datastream / Fathom Consulting

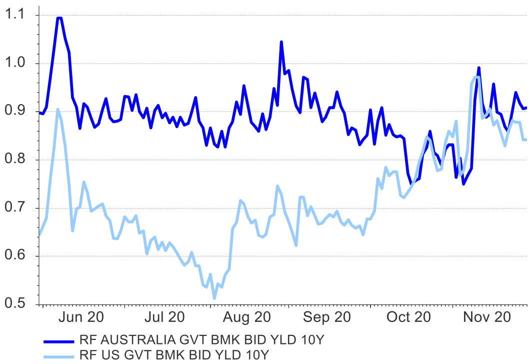
The S&P500 index rose [2.8] per cent in the month while the Australian ASX200 equity market put on [1.9] per cent. This has increased the year to date returns in US equities to [1.2] per cent by the end of November while the Australian market is now [down only 11 per cent since the start of the year].

Chart 2: US and Australian Equity

Source: Refinitiv Datastream / Fathom Consulting

Value stocks had a particularly strong month as the optimism about a vaccine and corresponding rebound in global growth encouraged a heavy rotation into many of the names that have been languishing during the pandemic. We also saw some of the 'stay at home' stocks come under pressure as earnings expectations were scaled back.

Chart 3: Australian and US Government 10 Year Bond Yields



Source: Refinitiv Datastream / Fathom Consulting

US Government ten-year bond yields rose early in the month to reach 96 basis points before rallying to close at 84 basis points. Australian yields tracked closely. As expected, the RBA cut the cash rate to 10 basis points on Melbourne Cup day and recommitted to keeping rates on hold for an extended period and implementing its $100 billion bond buying program.

Risk

The CBOE VIX index —a measure of investors' expectations for future volatility— almost halved in November, falling from 38 to finish the month at 20. The VIX peaked in March at around 83 and has been trending down on policy support and positive vaccine news.

Chart 4: S&P 500 Volatility Index (VIX)

Outlook

The comparison between this current cycle and the GFC is stark. The GFC evolved over nearly 18 months with policy makers being quite slow to react to the unfolding liquidity crises. The bottom of the market has not reached until the Federal Reserve announced they would print money in March 2009. In comparison, the policy response this time around has been early and enormous. The low was set on 23 March when the Federal Reserve announced a package of measures and surprised the market by the sheer quantum of their support.

Chart 5: S&P 500 – Comparison from Peak

(index; peak in S&P500+100)

Markets are not the economy and we now face a situation where risk assets have rallied very hard already and the global economies are only now just starting to recover – albeit patchy in parts. The ingredients are all there to support further gains in risk assets although we would expect that a lot of the outsized gains have already been made. While value performed strongly in November, we continue to believe that quality and momentum factors will drive better returns next year – particularly given the patchy nature of the recovery we expect globally.

Chart 6: US Equity Market Factor Returns

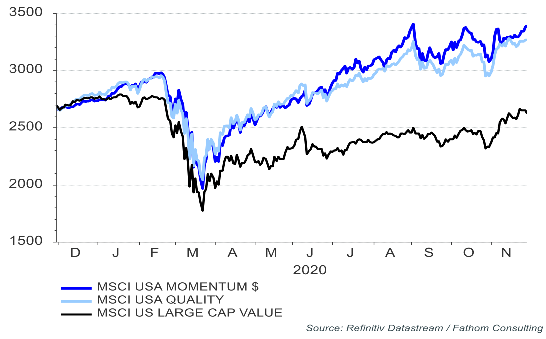
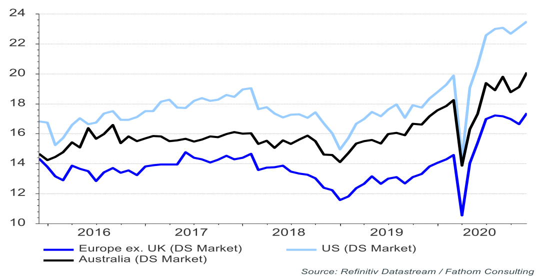


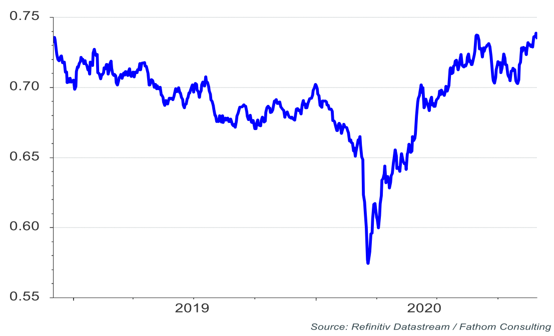
Chart 7: Twelve-month forward PE Ratios



While corporate earnings will continue to improve, investors will be assessing what is the right valuation to put on those future earnings. We expect the price earnings multiple of the stock market to come back a little as earnings recover.

The Australian dollar rose over 3 cents versus the $US in November, finishing at 73.45 US cents.

Chart 8: Australian Dollar (versus $US)



We expect that the Australian dollar can continue to rally while the Australian economy is expected to outperform global peers. However, as the rollout of the COVID-19 vaccine occurs, the rebound in global growth should see some moderation in the $A strength.

The increasing political and trade tensions with China are a real concern and we will be watching closely to see how this evolves. To date the currency and equity market have looked through the escalation, but if not resolved quickly, has the potential to undermine confidence in both our currency and our stock market. We will be staying alert should we need to de-risk quickly.

Written by:

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