House View

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January 2021

The market continued its positive November rally into December to finish the year strongly. In an extraordinary achievement in a pandemic year with so much uncertainty and disruption, the US S&P500 index finished the year up over 16 per cent while the technology focussed NASDAQ was up 44 per cent on the year. Despite elevated valuations and frothy market signals, we remain constructive on the market into 2021 and continue to run relatively high levels of market risk in our portfolios.

Policy Watch: The US passed a further US$892billion Covid-19 stimulus package and lifted the government debt ceiling to avoid an imminent government shutdown. The European Central Bank also announced a further 500 billion Euro increase to its bond buying program and extended the program until March 2022 until the worst of the Covid-19 effects have passed.

Election Update: President Trump continues to cast widespread doubt on the US election result after most of the legal challenges have fallen away.

Vaccine Update: Fast track approvals and roll outs of the three main Covid-19 vaccines have started in response to the rapidly rising levels of Covid-19 infections and the escalating death tolls. The fight to balance keeping economies open to prevent further economic damage and hardship while protecting the spread of the virus and saving lives continues. Many jurisdictions have been forced back into lockdowns over the holiday period with markets continuing to be focussing on the forward-looking upside.

Inflation Watch: No real signs of any pickup in consumer or wage inflation although bond yields have risen slightly over the month.

Risk Budget: Volatility continues to ease back from the October spike which has allowed us to run higher levels of market risk in our multi asset strategies.

Portfolio

We have maintained our relatively high levels of risk assets in December with a view that our next portfolio move is more likely to take profits and de-risk portfolios somewhat.

It is important to remember that the economy is not the market. In a year when economic activity was devastated globally by lockdowns and a rapid increase in household savings, many global equity markets recovered quickly from the February/March sell offs to finish the year in modestly negative territory.

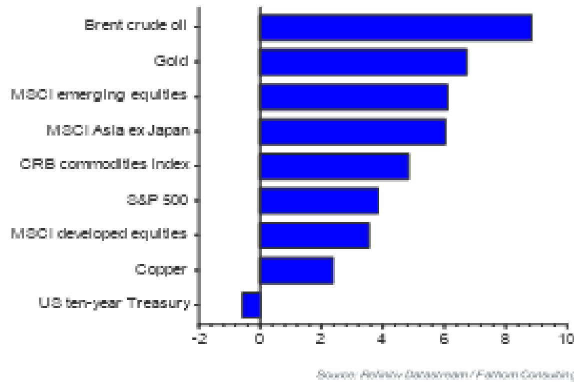
Over the next 18 months, corporate earnings are expected to return to pre pandemic levels – an assumption heavily dependent on a constructive rollout of the vaccines and an opening up of global trade and travel. A dramatic reduction in bond yields throughout the year has supported a significant increase in valuations and this is likely to unwind to some degree. Watching the speed at which bond yields readjust will be critical to the path of equity returns in 2021.

The $A dollar has performed strongly this year despite rising trade tensions with China. We expect that the momentum will continue although gains will be harder as the currency nears US$0.80 and the top of its traditional trading range. Credit spreads should continue to perform well as corporate earnings improve further and balance sheets are further repaired.

December Review

Global risk markets continued to perform strongly into year end with oil and gold generating very strong returns. Equity markets performed well while the

Chart 1: Asset Class Performance in October



The S&P500 index rose 3.7 per cent in the month to finish over 16 per cent higher on the year. The technology heavy Nasdaq index was up an astonishing 44 per cent in the year. The Australian ASX200 equity market rose 1 per cent in December but was still down 1.5% for the 2020.

Chart 2: US and Australian Equity

Clean energy, emerging markets, technology and financials all performed strongly in December. The value factor continued to recover some of the lost ground over recent years and gained against quality and momentum equity factors.

bond market continued to weaken resulting in US 10-year Treasuries having a negative return for the month.

Chart 3: Australian and US Government 10 Year Bond Yields

US Government ten-year bond yields have continued to drift higher in December, rising 8 basis points, and dragging the Australian 10 yield rate towards 1 per cent. Lower yields are an important foundation for the current valuations in equity markets and we are carefully monitoring the bond markets for a more concerning rise in yields. Our base case remains for an orderly rise based on recovering economies which is unlikely to derail equity market returns.

Risk

The CBOE VIX index — a measure of investors' expectations for future volatility—continued to ease back in December after a small spike in the lead up to the US election.

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

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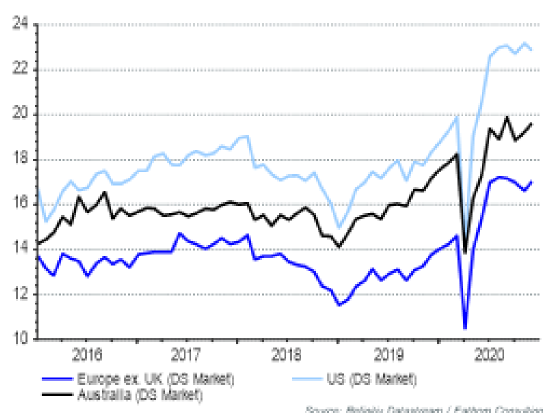
Outlook

In January we will see the transition to the new US administration and the UK finally leave the European Union. We are expecting both these significant events to go relatively smoothly, but will be watching closely where changes would derail the constructive outlook we have for risk markets in 2021.

Governments will need to remain committed to supporting economic recoveries in 2021. While markets have rebounded sharply, the economic damage from the global shut down has created significant hardship for many economies through loss of output and unemployment. We expect corporate earnings will be recovering and many developing economies are likely to benefit more significantly as global trade and travel recover to pre-pandemic levels.

The key risk to this view is valuations are stretched and equity prices might struggle to perform despite an improving backdrop of corporate earnings.

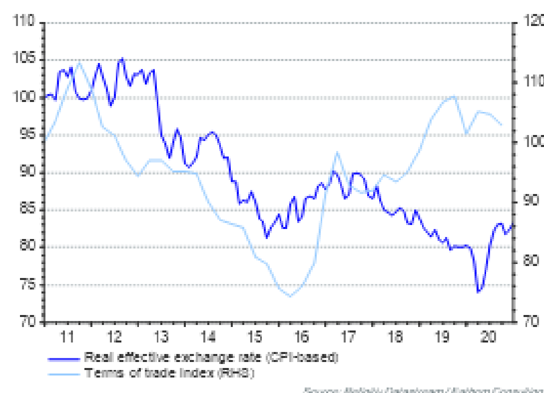
Chart 5: Twelve-month forward PE Ratios



To this end, bond yields will be critical in determining the path of returns in 2021. If central banks are successful in maintaining stimulus without inflation, the bond yield sell off should remain benign and support the elevated multiples in equity markets. Should a more aggressive sell off occur along the lines of 1994, valuation support would be undermined and likely see both major asset classes underperform. While not our central case – it is a risk we are monitoring closely.

The $A is now playing catchup to the strength we have seen in Australia's terms of trade strength over recent years.

Chart 6: Australian Terms of Trade and Real Exchange Rate (Index, December 2001 =100)



The $A dollar rose over 3.5 cents against the $US in December to close the year at $US0.7694. We have been expecting the $A to perform well against other major trading countries, particularly given the scope of commodity price catch up and the extended money printing programs offshore.

Iron ore prices should remain elevated into 2021 as Brazilian production is slow to return. We fully expect the $A to stretch a little higher towards US$0.80 but gains will be harder beyond this key psychological level. The currency has only pushed above these levels on a couple of occasions – most recently during the GFC where the rest of the globe was in a deep recession and China hyper stimulated its economy, setting a rocket under commodity prices. The circumstances in 2021 are very different and the ongoing trade tensions with China should keep a lid on more pronounced rallies in $A.

There are so many uncertainties facing us in 2021. However, if the price earnings multiples can remain around current levels and corporate earnings can return to pre-pandemic levels, the US equity market alone would likely rise over 14 per cent in 2021. Definitely a solid reason to remain with a bias to risk assets.

James Wright, Chief Investment Officer

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