House View

February 2021

Risk markets generally took a breather in January after an extraordinary recovery in 2020. Commodities continued to perform while developed equity markets generally lost some ground. The new US administration quickly announced a further stimulus package, and the vaccine rollouts across the globe are continuing to gather pace. Despite elevated valuations and an increase in volatility triggered by social media inspired short covering squeezes, we remain positive on the market this year and continue to run relatively high levels of market risk in our portfolios.

Policy Watch: The new US administration announced the "American Rescue Plan" – a $1.9 trillion package designed to support families and businesses along with a big commitment to the vaccine rollout.

Politics Update: The US Capital riot early in the month and the impeachment of former President Trump for his role in encouraging the action dominated politics in global markets. The widespread doubt over the validity of the US election result appears to be dissipating with legal challenges failing away and many Republican politicians starting to distance themselves from the former administration. This will give the new administration greater confidence to pursue its agenda and continue to support the economic recovery through 2021.

Vaccine Update: The roll out of the vaccine has been unable to stop many jurisdictions being forced back into lockdowns. The US administration has planned to commit a further $400 billion to vaccine rollout and testing.

Inflation Watch: Energy prices have risen sharply over the past two months and may feed into input higher input prices down the track. CPI releases during the month currently show no real signs of any pickup in consumer or wage inflation although bond yields have risen sharply over the month.

Risk Budget: Volatility did spike up in January due to the unexpected short squeezes inspired by social media. Despite this, we have actively maintained our elevated levels of market risk in our multi asset strategy portfolios.

Call to Action: We continue to favour our call from last month to invest in emerging markets while the $A is strong. Asian economies in particular are likely to benefit as economies reopen and trade and travel resume.

Portfolio

After a positive couple of weeks into 2021, global equity markets gave up ground in the later part of the month to close mostly in negative territory. Despite an uptick in volatility linked to the Reddit inspired short covering rally and broad market sell off, we have maintained our relatively high levels of risk assets in January believing the portfolio will continue to benefit from the rollout of the vaccine and the reopening of local economies and global trade, along with the significant fiscal and monetary policy support which will continue through 2021.

Our confidence that corporate earnings will continue to recovery towards pre pandemic levels has increased through the January US reporting season as corporates have consistently beaten elevated consensus expectations. The current lofty valuations in equity markets really require a supportive bond markets and a more dramatic sell off in yields certainly has the capacity to undermine equity markets. Our base case remains for an orderly rise based on only modest inflationary pressures which is unlikely to derail equity market returns.

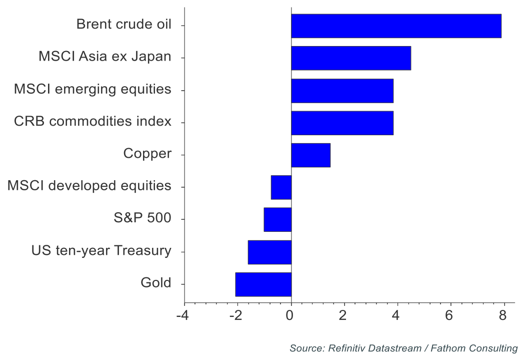
The $A dollar touched a high of US$0.78 during the month before falling back to the mid US$0.76 range. Iron ore prices have softened recently, and we expect further gains in the currency will be harder fought and continue to favour holding our international asset unhedged at this point. Credit spreads should continue to perform well as corporate earnings improve further and balance sheets are further repaired.

January Review

January was dominated by the riot at the US Congress building on January 6, the inauguration of Joe Biden as President of the United States on January 20 and wild short covering squeezes induced by the Reddit social medial platform in the later part of the month. This was all against a backdrop of the vaccine rollout and the hope that economies could re-open and lives return to a more normal footing through the year.

Commodities performed well in January, particularly oil which rose nearly 8 per cent. Emerging markets also added decent performance while developed markets, oil and gold all lost ground. The US dollar gained a little over the month after being under constant pressure since March.

Chart 1: Asset Class Performance in January

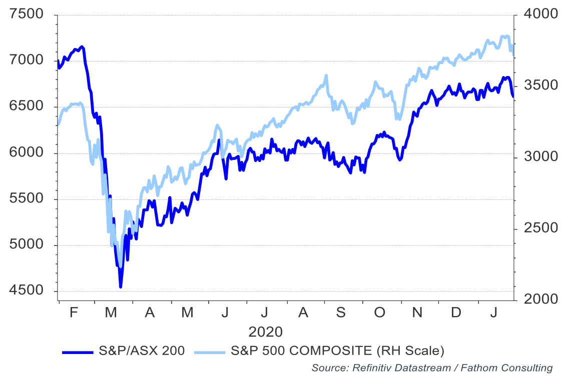


The S&P500 index fell 1.1 per cent while the NASDAQ composite finished up 1.4 per cent and the Russel 2000 gained a touch over 5 per cent. European stocks generally fell between 1 and 2 per cent.

Larger companies in the Australian equity market rose a modest 0.3 per cent while small capitalisation stocks underperformed with the Small Ordinaries index dropping 0.3 per cent. Consumer discretionary and staples stocks performed strongly in January as well as decent gains for financials and energy. The market was dragged down by heavy falls in real estate, industrials, and healthcare stocks.

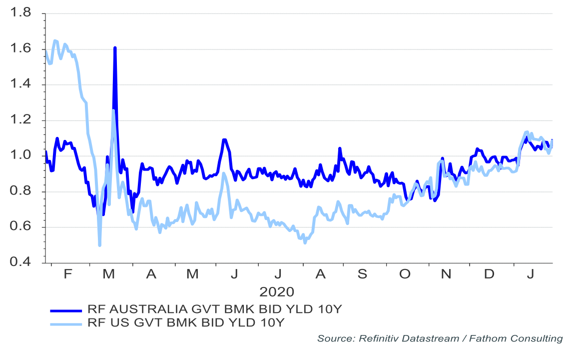
The value factor continued to outperform growth in January, both domestically and globally. The momentum factor was broadly neutral over the month and the quality factor significantly underperformed during the month, particularly in North America.

Chart 2: US and Australian Equity



US Government ten-year bond yield sold off 23 basis points in the early part of January to reach a high of 1.14 per cent. It closed the month at 1.09 per cent.

Chart 3: 10 Year Bond Yields



The Federal Reserve held a 2-day meeting in January and reinforced their willingness to support the recovery and not unwind its support too early. In August 2020, the Federal Reserve explicitly changed its charter to focus on a 2 per cent inflation target through the cycle and have explicitly said they will let the economy bound back further than they would normally allow before tightening policy. Markets continue to worry about an acceleration in inflation. US CPI rose 0.4 per cent in December to an annual rate of 1.4 per cent. The Australian CPI rose 0.9 per cent in the December quarter which was above consensus but remains at an anaemic annual rate of 0.9 per cent. The rise of energy prices over the past few months is attracting attention and could flow through to higher prices later in the year.

Risk

The CBOE VIX index — a measure of investors' expectations for future volatility— spiked higher to 37 in January on the Reddit inspired short squeezes. This resulted in forced selling of longs by several hedge funds and a reassessment of valuations in the broader market. The social media retail demand pushed several stocks to unsustainable valuations and the US regulators are monitoring the developments. As more normal valuations reassert themselves in these underperforming stocks, it will be interesting to see if there are further social media targets and whether they have the same enthusiasm.

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

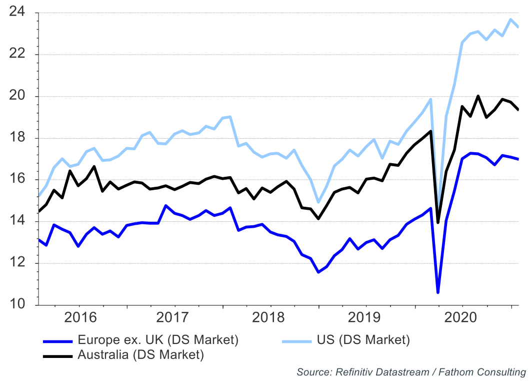
Outlook

The vaccine rollout continues to be the number one focus on a return to a stronger level of economic activity in 2021. Currently infection and death rates are continuing to climb in most countries and the rollout of the different forms of vaccines have been disorganised and slow.

While higher energy costs and excessive stimulus could lead to an overheating economy and a rebound in inflationary expectations, we continue to discount this as a relatively small risk in 2021. There remains significant slack in global labour markets and the productivity trends being unleased by technology continue to put downward pressure on margins in many industries.

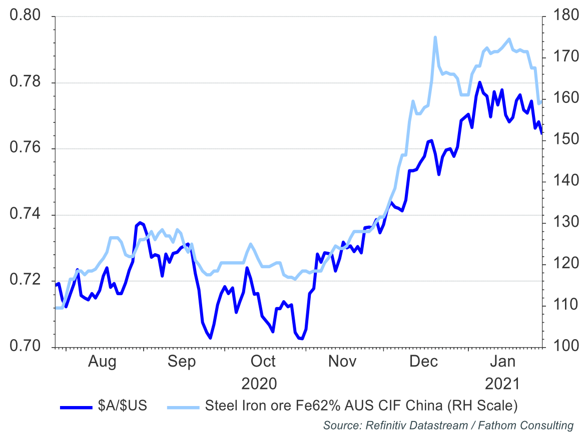
While equity valuations did moderate somewhat in January, they remain at elevated levels. Central banks have recently reinforced their commitment to maintain supportive policy via quantitative easing which should keep bond yields in check and provide a foundation for these elevated multiples until the full recovery in corporate earnings comes through over the next 18 months.

Chart 5: Twelve-month forward PE Ratios



The $A has been strong since the market lows in March 2020, largely tracking the improving iron ore prices through the year. In January, the currency dropped back on weaker iron ore prices. While Brazilian production is still expected to be slow to return following supply disruptions, Chinese demand is expected to soften as the current price renders many Chinese steel mills unprofitable. The Australian Government expects iron ore prices to remain elevated in the short run before easing to just over $75/t by the end of 2022. We continue to favour holding our international assets unhedged as we expect the $A to moderate in response.

Chart 6: $A/$US Rate and Iron Ore Prices



On the Australian policy front, the RBA is not expected to make any changes to the cash rate in early February. However, the RBA Governor will be giving a speech to the National Press Club on 3 February which is likely to give the banks detailed view of the economy and provide the platform for signalling any changes to policy tools and settings.

James Wright, Chief Investment Officer