House View

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May 2021

Commodities and equities enjoyed strong rallies in April. Despite a worsening in overall global Covid cases, vaccine rollouts and stronger economic activity in developed markets comforted investors. US corporate earnings have been very strong in the first quarter of 2021 and government bond yields have stablised from their sell off in January and February. Risk markets have now run hard in the first four months of the year and gains from here are expected to more moderate. Policy support is in the very early stages of winding but not a concern as yet.

Policy Watch: Following the lead of Norway last month, the central bank of Canada has now announced a modest winding back of its quantitative easing support. Investors continue to look for signs that the big three central banks are close to tapering, however the Fed, ECB and BOJ continue to stick to very expansionary polices. While fiscal support remains strong, the Biden administration in the US has now announced plans to introduce an increase to the personal tax rates of high-income earners to fund its spending programs and the Australian government has ceased the temporary Job Keeper Program. However, offsetting this somewhat is the push by the US to expand its infrastructure agenda and the expansionary budget expected in Australia on May 11 in a pre-election year.

Politics Update: The Tasmanian Liberal government is likely to continue the trend of incumbents being returned and has the prospects of leading a majority government again.

Vaccine Update: Issues around blood clots with a couple of the vaccines are causing concerns and have delayed rollouts in some jurisdictions. However, the overwhelming public benefit is seeing vaccinations continue more broadly and the experience in reducing transmission and the severity of symptoms is extremely encouraging. Investors are betting that programs will ultimately be successful, even against some of the newer strains which have emerged.

Inflation Watch: Investors are eyeing closely the rise in commodities. Copper has nearly doubled in the last year, iron ore and steel prices are very strong and soft commodities such as grains, pork and even coffee have been surging. There are some temporary supply problems exacerbating issues at present and retailers are absorbing higher costs for now. March quarter inflation in Australia was a little stronger but the annual rate of core inflation was a benign 1.4per cent, while the core annual rate of inflation in the US rose a little to 1.6 per cent. Most central banks continue to expect these price increases driven by energy and hard and soft commodities will be transitory.

Risk Budget: Volatility measures eased further in April. The major central banks continued to reassure markets that policy would remain supportive and have stabilised bond markets in the short term. We have maintained an active exposure to risk assets, with a preference to emerging markets and international equities.

Call to Action: While it is increasing uncomfortable to hold the line on risk assets as markets push through record highs, we continue to believe that investors should remain overweight equities but be alert to signals that could foreshadow a more pronounced sell off.

Portfolio

Investors' concerns about rising inflation, particularly driven by commodity prices, have eased somewhat with recent prints of relatively benign core inflation measures. Retailers continue to absorb higher price rises, particularly while labour markets remain weak and overall wages measures remain contained.

The reopening of economies, the rebound in economic activity and corporate earnings continues to be the driving force behind the more positive sentiment in markets. With bonds rangebound for now around current levels, equity valuations are being supported.

We have continued to hold our relatively high levels of risk assets through April and remain underweight more defensive asset classes such as fixed income. While the trend supports staying the risk on course, we remain alert to signs that we should de-risk. The indicators which would signal a more broad-based sell off remain absent for now. Policy remains supportive, core inflation remains benign, credit spreads remain tight and there remains significant liquidity in the system to support pull backs should they occur.

Stronger commodity prices over the month drove the $A dollar a little higher but we are comfortable retaining our international equities positions unhedged. The currency is struggling to gain traction to push through $US80 cents and historically this has proved a strong barrier to break.

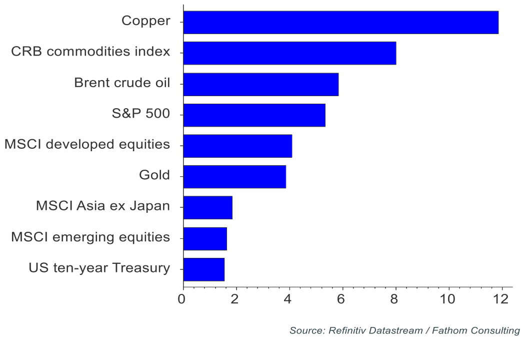
April Review

Positive risk sentiment overcame a disturbing rise in global covid cases over the month, particularly the harrowing episode unfolding in India. Developed market economies continued to generally show the positive effects of reopening, although Europe was soft in the first quarter as Covid lock downs were reintroduced.

Copper and the broader commodity suite rallied strongly in April while developed market equities outperformed emerging markets and Asian equities.

Chart 1: April Asset Class Performance

Percentage Change

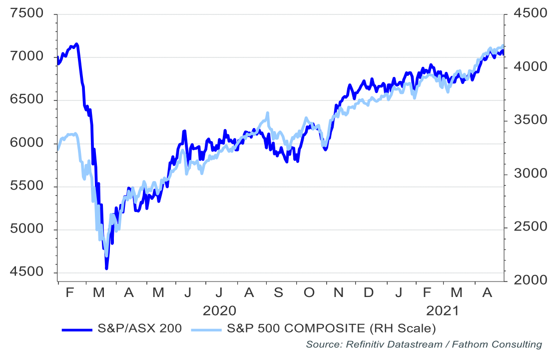


The S&P500 index rose 5.2 per cent in April to be up over 11 per cent for the calendar year. The NASDAQ composite also had a strong month, rising 5.4 per cent to be up a respectful 8.3 per cent for 2021. For another month, small companies took a bit of back seat to the larger companies, with the Russell 2000 adding a modest 2.1 per cent but remains a strong 15 per cent higher for the calendar year. European markets were mixed, the UK market falling 2 per cent, Germany increasing a modest 0.9 per cent and the French market rising 3.3 per cent.

In the Australian market, information technology was the standout sector, rising a strong 9.7 per cent for the month. Materials (+6.8%) and commercial services (+6.8%) were also very strong performers in April. Energy (-4.9%) and consumer staples (-2.6%) were the weakest sectors in the Australian market during April.

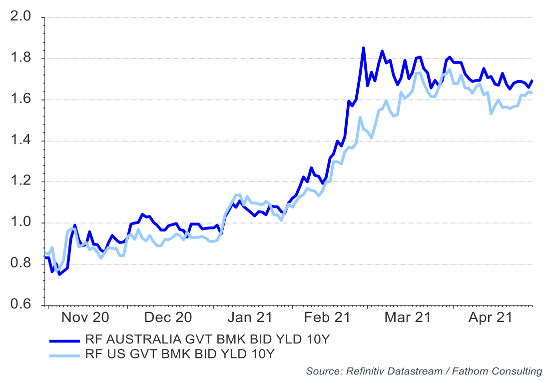
There was a return of momentum and growth factors driving the global equity markets in April while quality and value stocks lagged the rally.

Chart 2: US and Australian Equity Markets



US Government ten-year bond yields fell a touch over 11 basis points for the month and continue to trade in a relative benign manner following the savage sell of experienced in January and February. Benign inflation measures combined with continued support from major central banks have reassured bond investors. Some smaller central banks have already announced intentions to wind back their quantitative easing programs, including Norway in March and Canada more recently in April. There are some starting to advocate a reduction in the European bond buying program which is not scheduled to stop until March 2022. The Reserve Bank commentary continues to be on the dovish end with no taper and interest rate move expected for some time.

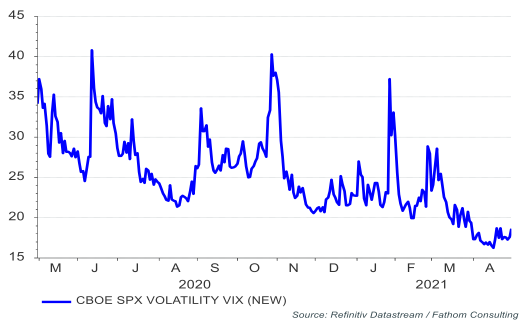
Chart 3: 10 Year Bond Yields (%)



Risk

The CBOE VIX index — a measure of investors' expectations for future volatility — eased again in April. The VIX traded down towards 16 in the early part of the month before closing a touch under 19.

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

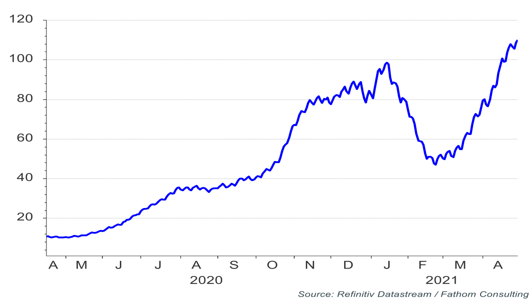


Investors appear to remain relatively relaxed on the outlook despite elevated equity multiples.

Outlook

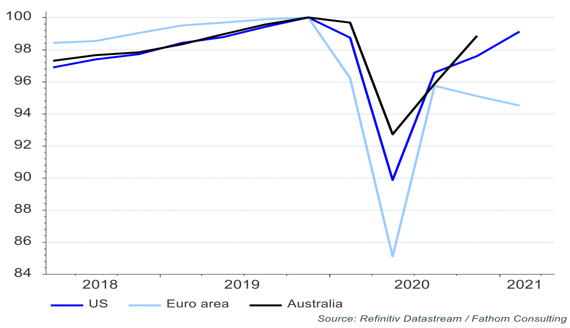
While vaccine rollouts are continuing to ramp up, and those countries further advanced with their programs are experiencing material falls in new cases, the number of global cases continues to rise. The worst performing countries during April where India and Brazil which experienced a dramatic increase in case numbers.

Chart 5: Global COVID-19 New Cases (Number of cases per million, one week moving average)



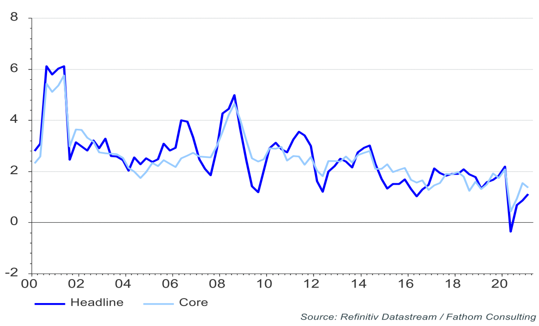
Despite the increase in global cases, economies continue to reopen and experience better than expected growth. In the US, the economy grew an annualised 6.4 per cent in the first quarter growth while Australia is forecast to have increased by around 1.6 per cent in the March quarter, lifting overall activity to a level higher than the pre pandemic peak. The unemployment rate has fallen to 5.6 per cent and is expected to show a modest increase in April as the effects of end of the Job Keeper Program works through the economy. European growth actually fell 0.6 per cent in the March quarter as the reintroduction of lock downs caused economic growth to side backwards.

Chart 6: GDP Levels (Index:2019 Q4=100)



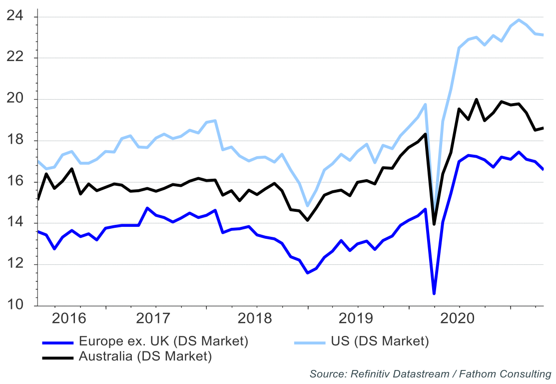
Despite the surge in some hard and soft commodities over April, the overall price level remains well contained. Central banks are convinced that the increase in prices transitory and their confidence is supporting markets for now.

Chart 7: Australian Inflation Rate (4 quarter percentage change)



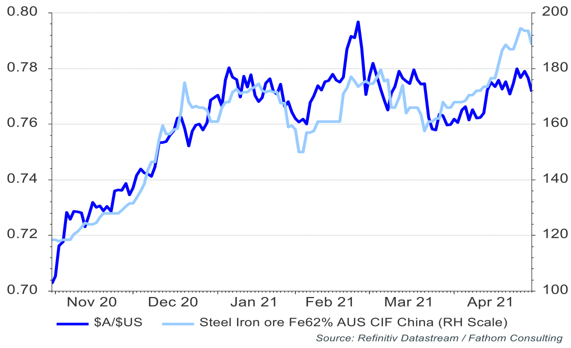
The softer tone in bond markets, supported by the extremely strong rebound in corporate earnings is holding equity valuations at higher levels.

Chart 8: Twelve-month forward PE Ratios



Iron ore prices rose strongly in April as continued supply problems in Brazil and strong steel prices in China encouraged higher sea-borne prices. While the $A was a little stronger on the back of the strength in overall commodity price, the $A surprisingly struggled to push materially higher.

Chart 9: Australian Exchange Rate and Iron Ore Prices ($US)



The strength in commodity prices has been driven by speculators and producers who have bought stockpiles of commodities ahead of economies reopening and announced government infrastructure programs. However, these infrastructure programs are likely to years to roll out and the higher commodity prices will eventually lead to a supply response from commodity producers. We continue to believe commodity-based currencies will not push significantly higher from here and still favour holding our international assets unhedged.

Interestingly, there was a noticeable return to momentum and growth factors driving equity markets in April. This could signal that investors are now looking to rotate back into names that will likely lead the market after the initial rebound in economies gives rise to the lower growth trend we were experiencing before the pandemic commenced.

Liquidity in the system for now remains high and is still finding its way into real assets and equity markets. Natural profit taking pull backs are expected to be well supported in the current environment. While the gains in risk assets are expected to be harder fought from these levels, we remain significantly overweight risk assets but are closely watching a range of risk indicators for signs we should de-risk more pre-emptively.

James Wright, Chief Investment Officer