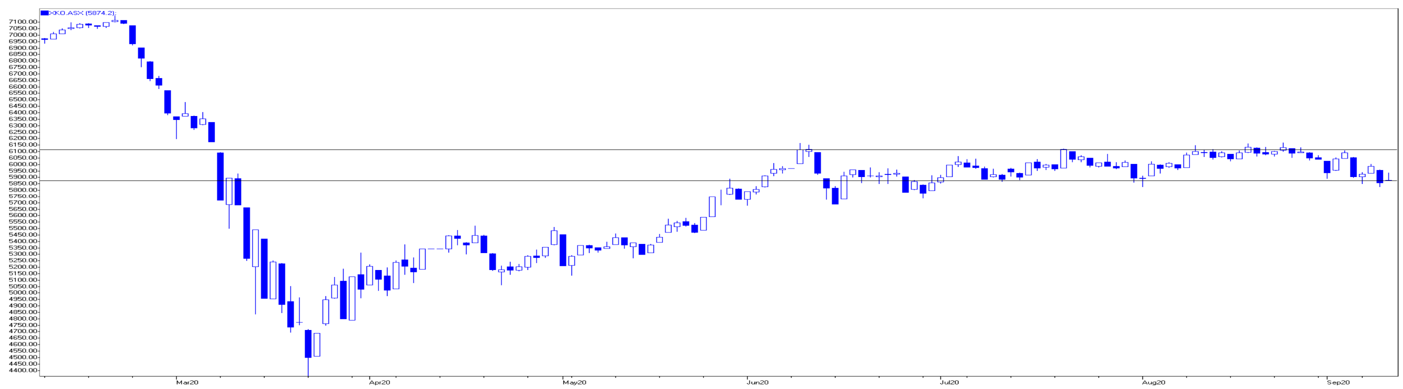
Market Wrap

Market Update – 18/09/2020

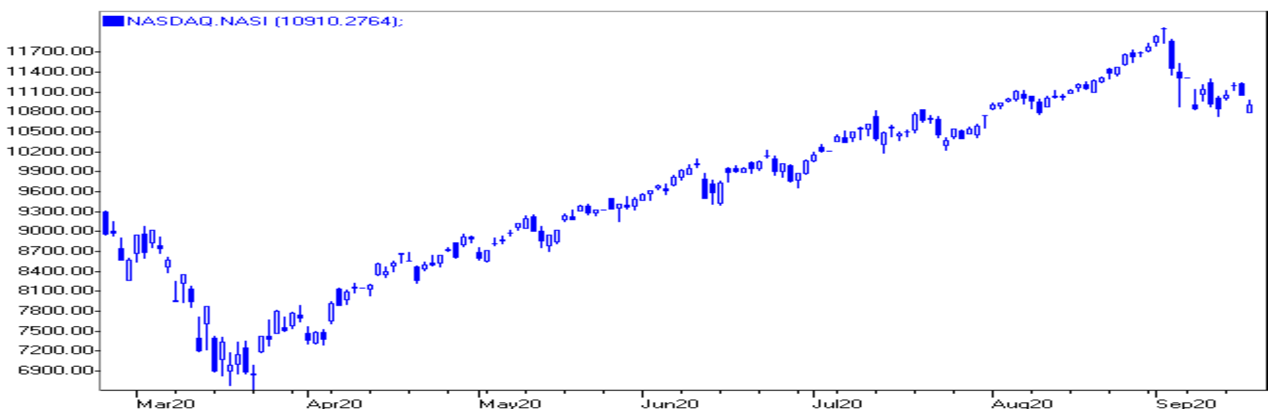
It has been a couple of months since our last Market Update, during that time nothing really changed. Our market continues and is still trading in a range between 6200 and 5800. Reporting season is over with results being slightly better than expectations and maintaining the market in the trading channel.



So what has changed. The quick answer is America; the S&P 500 hit record highs which the NASDAQ (Tech Stock) made massive gains. These gains were on the back of speculation that the tech sector was to be the big winner out of the COVID 19 crisis coupled with the Feds flooding the economy with money. We saw record new trading accounts opened and first time investors entering the market with a buy now, profit later approach to investing.

Tesla dropped 33% since the start of the month, while Facebook, Amazon.com, Apple, Tesla, Microsoft, Alphabet and Netflix had collectively lost more than US$1 trillion in market capitalization since 2 September. Energy shares slumped 3.71 per cent as oil prices fell below $40 a barrel.

Around two weeks ago we started to see the NASDAQ start to pull back as fund managers started to take profits on overvalued companies. In lock step with the US markets our market has been trading at the low end of the trading channel, around 5800 points, while volatility moved up around 35% in the last couple of weeks.



Australia

Back in Australia, government inflation linked bonds with a maturity of 2035 suggested inflation would be practically non-existent over the next decade. We are currently in a recession and expect inflation to remain quite low for the next two to three years. Government and central bank bailouts that save businesses from bankruptcy act to increase the probability and likely severity of system collapse in the future.

Market volatility is expected to further increase in the run-up to the US presidential election, with September and October also historically turbulent months of the year.

The second half of 2020 saw earnings per share growth fall 38% for the ASX200, which for context, was larger than what we experienced during the weakest point of the GFC (-20%). Despite the local economy having re-opened faster than expected and most companies benefiting from fiscal stimulus one way or another, 40% of firms missed estimates, which is above the typical 30%. However, investors seem very prepared to look through both this and next year's earnings in an unusual display of patience.

Some key takes away for the second half 2020 reporting season:

Capex: we saw caution around companies making longer term capital investment decisions, with many companies also taking a 1 year break from maintenance/refreshment expenditure.

Labour force: most companies are downsizing headcount, many taking pay cuts (at an executive and Board level) and pausing near-term recruitment plans, together with active management of all discretionary expenditure.

Lack of guidance: the vast majority of companies have refrained from giving guidance for FY21, but we have seen some willingness to give guidance for 1H21 (i.e. the 6-month period ending 31 December 2020). This has been a useful way to deal with stale and/or a large dispersion in current consensus estimates. Where guidance has been provided, it is subject to further government-imposed lockdowns and any material delays in supply chains affecting delivery of goods**.**

General result update by sectors:

Materials: Strong results given resilient commodity prices, but broadly in-line with expectations. The bulks BHP, Rio Tinto and Fortescue all benefited from elevated iron ore prices. This is a sector of the market which is delivering attractive returns; dividend yields are well above market average and the expectations that elevated returns will remain in the near term given the high iron ore price.

Healthcare: Broadly exceeded expectations and is well positioned for future growth. There are some clear winners over the last few months, in particular those leveraged to respiratory masks and humidification products such as Fisher and Paykel and Resmed, however there have also been others that were negatively impacted by wide-spread shut downs, impacting surgical procedures as well as supply chains (e.g. Cochlear, CSL). From a reporting perspective, most of our Healthcare companies saw material share price gains on the days they reported.

Industrials: COVID-19 significantly impacted earnings. Industrial stocks recorded generally weaker results with an already softening economic backdrop further exacerbated by a COVID-19 induced recession. The transportation sector (Airports, Ports and Airlines) posted the sharpest decline in earnings particularly in the June quarter, off the back of rolling lock downs and travel restrictions. Mining service companies saw their margins severely impacted, although the broad expectation is for these to recover from here.

Consumer: Broadly exceeded expectations given stimulus support and migration to on-line. The consumer sector was a bright spot of the FY20 results season, with a number of companies delivering strong results notwithstanding the tough macroeconomic backdrop. Several key themes were evident across much of the sector. Firstly, COVID-19 driven lockdowns have underpinned acceleration in the channel shift to online, a move we believe will be structural. Secondly, retailers generally saw consumer demand rebound sharply, supported by fiscal stimulus and a lack of other avenues for

spending such as travel or out of home dining. As a result of these factors many retailers have reported strong sales growth in the early months of FY21. We view this as largely cyclical and are closely monitoring for any signs of stress as support measures such as JobKeeper and temporary mortgage deferrals are tapered.

Real Estate: The divergence in performance across sub-sectors were more pronounced than ever, as COVID-19 had varying effects across retail, office and industrial. Retail undoubtedly was the hardest hit, with rent collection <50% for discretionary malls. The pandemic accelerated the pace of e-commerce penetration. The impact of this is rising rent incentives and falling asset values as brick and mortar retailers give back excess space. On the commercial properties front, office and industrial names saw limited impact at the income line as corporate tenants continued to service rent. For office, the unabated construction of pre-committed supply in the face of flexible working has the market questioning future rental growth. Industrial demonstrated resilience as it was the clear beneficiary from COVID-19, with strong demand in prime warehouse assets. In an environment where interest rates continue to be lower for longer, property players that have well-structured long term leases will continue to be well supported.

Financials: Mixed, dependent on the underlying segments. Commercial banks continued to report a challenging outlook. The absolute loss rates through time are yet to be determined as a result of COVID-19. What we do know though is that we continue to see loan deferrals in the economy, with loan losses so far supported by government support to consumers as well as business. There has also been regulatory relief provided to the banks on how deferred loans are treated.

Technology: A stand-out in the market for top line growth. Australia's comparatively small IT sector (relative to the US) has gained an astonishing 142% since market lows on the 23 of March 2020. As such, there were high expectations going into the reporting season for many of these stocks and some disappointed the lofty market expectations, while others continued on their stellar run. Valuations in this part of the market are looking increasingly stretched, and as such we take a discerning view on which companies we own. We back those we expect to be long term winners in their respective markets, and can get there, generally, on an organic basis.

Communication Services: A challenging period. It was a difficult reporting season for Telcos as COVID-19 caused high margin mobile roaming revenues to evaporate, while enterprise contracts were delayed. This has caused an impact to free cash flows which has placed pressure on forward-looking dividend expectations. The launch of Apple's 5G mobile devices later in 2020 are expected to be a positive catalyst for the industry, while weaker economic conditions may cause competitive conditions to be unfavourable.

Utilities: Whilst proved its resilience to COVID-19 was not entirely immune and this in general was a slight disappointment to investors.

Energy: Results were impacted by the spectacular collapse in oil and gas prices, weighing heavily on revenue and driving asset impairments as management re-set long term oil price assumptions. We expect that the next half will remain challenging for profitability given the oil and gas prices have remained low and there is a lag in terms of prices realisation. But the set up in the medium term is more constructive due to the significant cuts in near term capex (slower supply growth) and expected return of demand lifting prices.

The money supply in Australia has increased nearly 40% in the last 12 months; while this is buffering the financial impact of COVID-19, it has created two upside-down circumstances in investing today.

The first is the **stimulus distortion** whereby the $750 weekly JobKeeper benefit has intersected with an economy where sectors such as tourism and leisure are shuttered. As a result, consumer spending has been forced into retail and caused share prices in that sector to re-rate in the short-term.

The second is the **interest rate distortion** whereby low and negative rates globally have triggered a further extension of growth names over value, causing retail investors to aggressively chase momentum stocks, particularly in small and micro caps, and hyped up interest in gold as an inflation hedge.

Stimulus and Interest rate distortion results in companies trading well over their fair value, long term investing under conditions historically reduces poor returns. We recommend investors continue to buy value companies based on past performance as opposed to buy off expected performance.

Summary

The risk for the market is to the downside. We are comfortable being overweight cash and parking funds in fixed interest. We are focused on looking for good quality value stocks which are trading below fair value and providing solid yield and long term growth.