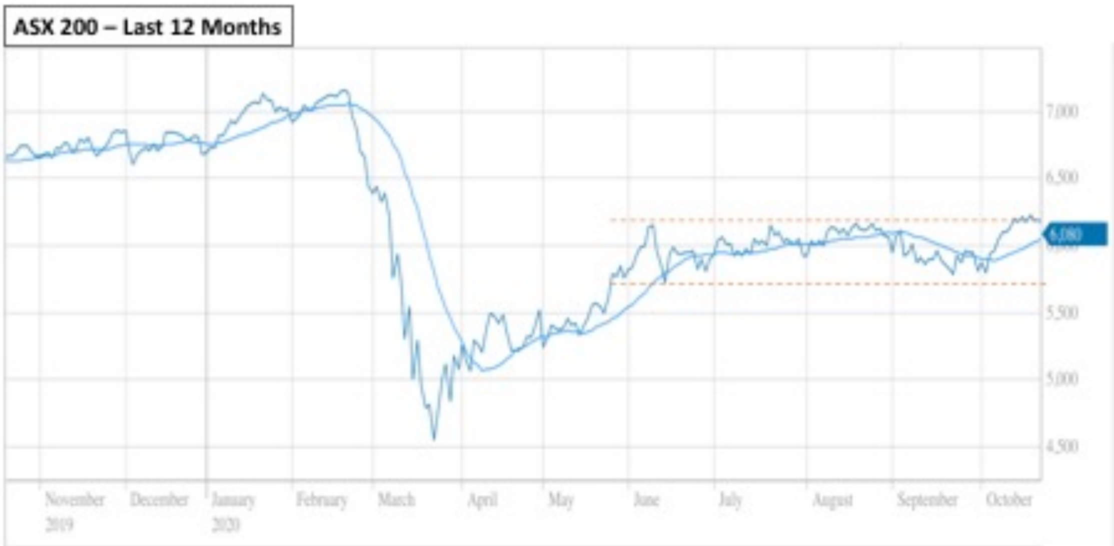
Dear Client,

MARKET REVIEW & OUTLOOK – SEPTEMBER 2020

The benchmark ASX 200 registered a COVID-induced drop in March of over **-37% pa** with the ASX 200 reaching a low of 4,546 on 23 March'20. This fall largely mirrored what occurred on the US market. Since that time, the ASX has now **recovered around 60% of its losses.**



The hardest hit stocks over this period have been the retail banks, experiencing some of the largest losses as concerns mount about the economic fallout from extended lock downs. In the absence of economic growth, a squeeze on interest margins, increasing remediation costs and mounting bad debts, markets are expecting a lean time for banks over the coming period. The major banks are still down (on average) by over 25% from their pre-pandemic levels. Energy companies have also suffered in the face of falling global demand (down closer to 40% presently). On the flip side technology stocks (of which there are very few on the ASX), healthcare (most notably CSL, Cochlear & Resmed) and gold have benefited. More recently, the Buy Now Pay Later sector has attracted disproportionate buying interest.

As the graph above demonstrates, after a (monetary & fiscal) policy induced bounce, the ASX has been trading in a reasonably narrow range over the last 4-5 months.

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The US market likewise fell significantly as a result of COVID-19, however over the last twelve months **the S&P 500 has pushed up over +15% pa, and is sitting higher than its pre-pandemic levels.** This result was driven overwhelming by the contribution of NASDAQ stocks, which posted a +40% pa return over the past year.

The performance of European and Asian share markets has been more in line with the Australian experience. The major outlier was probably the UK which is down -21% pa over the last year, with the COVID-19 impact being further exacerbated by uncertainty around BREXIT.

The metrics surrounding COVID-19 (eg infection rates, reproduction numbers, death rates, etc) are a focus of widespread media coverage around the globe. The COVID challenge for political leaders is to **manage the tug-o-war** between the epidemiology and the economic/social/emotional fallout caused by measures to restrict its spread. In Australia, we are pursuing an "aggressive suppression" strategy, which demands some social distancing, high levels of testing and robust contact tracing. Other nations are following less suppressive paths, which will likely put added strain on their health care systems as second and third waves develop. What has been uniform across all countries, however, has been the overwhelming levels of fiscal and monetary support thrown at economies to mitigate the impact of the virus. In this update, we'll look at how these strategies are playing out and also provide some commentary about the "ominous grey cloud" on the horizon (ie US presidential election).

Monetary Policy …….. Dead, but not Buried

The RBA began their current easing cycle in June'19 with a reduction in the target cash to 1.25% – this action was taken to support employment growth and to provide greater confidence that inflation would be consistent with its medium-term target. It chipped away a little further at the rate over 2019, before dropping rates on two occasions in 2020 in response to the COVID-19 pandemic. The cash rate now sits at 0.25% pa and, as we alluded to in our last update, the impact of conventional monetary policy is now all but at an end.

Importantly, there have been a number of other (non-conventional) actions that the RBA has implemented. It has undertaken yield targeting on 3 year bonds (its version of Quantitative easing), it established a $90bn term funding facility to enable banks to continue to provide loans to small & medium business, and it has dropped the rate on bank exchange settlement accounts to 0.1% pa (this determines the rate charged/paid to banks for overnight balances in daily settlement accounts).

These actions have collectively ensured the maintenance of liquidity and the proper functioning of credit markets (problems with the latter drove the economic & financial turmoil associated with the GFC). We don't believe that there is much to be gained by the RBA further lowering the official cash rate (there is speculation that they will drop the rate by 0.15% to 0.1% at their November meeting). This will do little to stimulate credit growth and runs the risk of putting structural pressure on bank balance sheets and earnings (ie creates financial instability).

Preferably, the RBA will continue progressing non-conventional measures, pursuing the opportunity to further reduce its 3 year bond target and exchange settlement rates. There would also be considerable merit in the RBA expanding its "QE" programme to target additional maturities – shifting up the yield curve to push down 5 year and 10 year bond rates (similar to action taken by other Central Banks).

The other important factor on the monetary policy front was the largely over-looked announcement by the RBA at its 15 October meeting to change its inflation targeting approach. The RBA will now place "greater weight on actual, not forecast, inflation" – which means it is more likely to tolerate movements above its upper inflationary band.

These measures will collectively ensure a "lower for longer" paradigm for interest rates here in Australia and this will mean **significant and prolonged liquidity support for asset markets (ie share prices).**

At last, a "Breath Taking" Level of Fiscal Support

As many pundits have been demanding for some time (including the RBA Governor) the pandemic has finally brought the Federal Government out of its Fiscal shell after it abandoned any thoughts of a budget surplus and set about crafting one of the biggest Federal Government response to a crisis the nation has ever seen. The recession of the early nineties saw the Government of the day implement discretionary fiscal measures that accounted for just over 3% of GDP. At the time of the GFC, Wayne Swan rolled out programmes that saw spending rise to over 6% of GDP. With its **initial pandemic salvo** (involving support for job retention, small business cashflow, additional welfare payments and the like) Josh Frydenberg released an "eye watering" suit of measures that represented over 10% of GDP – eclipsing not just every historic spend by an Australian Government since WW2, but also surpassing the pandemic response of almost every developed nation around the globe.

The Federal Budget in early October then built on many of the support payments and concessions initially announced in response to COVID, and overlaid a cross-section of tax cuts (including business investment measures) and job creation initiatives. Brokers and economists enthused over the magnitude and nature of Government spending, and the Australian share market responded by rising almost 5% in the days following the budget (which is quite a rare feat).

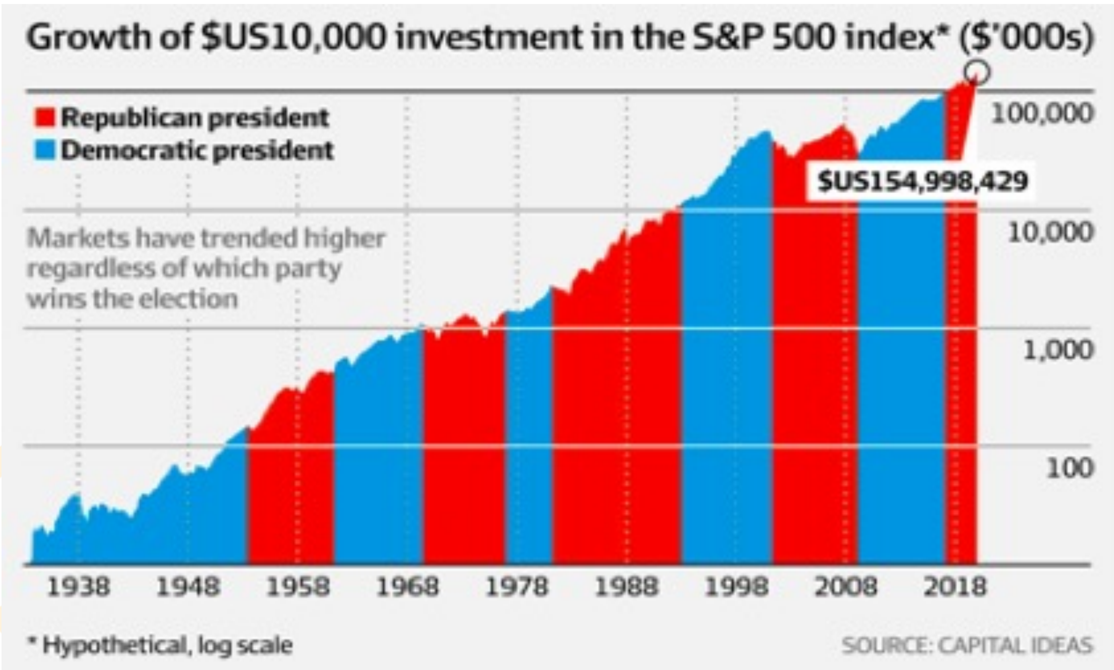
The potential impact of the Federal budget was probably best summed-up by Paul Taylor, Head of Equities at Fidelity International, who said "I actually think it's a game changer – its really important. The amount of money really is unprecedented and its very stimulatory. Its going to add up to a huge tailwind for equity markets" (AFR 8 October 2020).

The US Presidential Election

Presently, one of the largest grey clouds on the horizon is the US election. The election will be critical not just for the presidency (which some are already prepared to hand to Biden), but (particularly) the composition of the House of Representatives and Senate. Trump fashioned a narrow path to victory in 2016 and whilst the odds appear stacked against him in 2020, his campaigning will target the swing states in the lead-up to the election and his focus will be on another "silent majority" – namely, older voters. His task is not only to encourage more republicans to turn-out to vote for him on 3 November, but also to discourage a turn-out from those contemplating a vote for Biden.

Given his position in the poles, Biden has (understandably) been running a "small target" campaign. His challenge, however, is similar to that which confronted Bill Shorten at the last Australian Federal election – and we all know how that played out. Biden is relying on voters being motivated against Trump rather than being in support of him. The Democrats believe this will be enough to get him across the line (and the poles appear to support this position), however, Trumps campaigning (likely to be more vigorous and potentially desperate over the final days) will determine the election result.

There is an often cited myth in the US that stocks do better under Republican presidents. Somewhat surprisingly, equity markets move higher **equally well under Democratic and Republican stewardship** (see graph below).



What will potentially have a greater impact on markets is the nature of any election victory. There are a number of permutations as to how the presidency, House of Reps and Senate results might play out.

The biggest concern for markets, however, would be a **disputed or contested election result –** which, if it were to occur, would most likely involve Trump loosing narrowly to Biden (particularly were it to be on the strength of late-counted postal votes). Trump has already claimed that unprecedented numbers of mail-in ballots will lead to widespread fraud. He has also repeatedly refused to commit to a peaceful transition of power if the vote count indicates he has lost to Biden.

That could set-off one of many legal and/or political dramas in which the presidency could be decided by some combination of the courts, state politicians and Congress. This would likely see confusion rein politically, economically and socially in the short term and it would no doubt put equity markets into a tailspin for a period of time.

However, even with the involvement of the courts, the Constitution mandates that the new Congress is seated by 3 January and that on 6 January both houses meet to endorse the vote count. It also stipulates that the term of the current president ends on **20 January'20** at which point the new president must be inaugurated.

So, what does all this mean for equities? Well, markets detest uncertainty and a period of extended confusion (in the event of a contested result) would see markets move lower in the short term. Similarly, there is little doubt that the initial direction of markets in the event of a Democrat victory will be down. However, this could well be short-lived. Yes, Biden is advocating increased taxes (both corporate & personal) and increased regulation. But, on the flip side, he is also looking at higher levels of infrastructure investment, higher public spending (welfare & health), more stable foreign policy (less US centric) and more cohesive social policies.

In fact a recent Oxford Economics study (reported in the AFR 28 October'20) indicated that the fiscal uplift from Biden's policies would result in GDP growth of 4.9% in 2021 versus 3.7% under Trump. The reality is also likely to be that with the current impact of COVID, Biden's **proposed increases in taxes and business regulation will be postponed or materially watered-down**.

OUTLOOK

With the reporting season about to kick-off both here and in the US, we will get a better sense of the impact COVID is having on company earnings. In short, we remain constructive on equities, however, the key risks to this view include:

- COVID infection rates are increasing in the US & Europe (which is particularly concerning as we move into the Northern Hemisphere winter).
- The upcoming US election, together with the lack of agreement around further COVID stimulus in the US.
- The continued deterioration in the trade relationship between Australia and China.

On the flipside, as far as COVID is concerned, there are currently 10 candidate vaccines in Phase 3 trials and there is the prospect of an approved Vaccine by early next year (the share market is positioned on the assumption of a vaccine in mid'2021). Even in the absence of a vaccine, there has been positive progress on anti-virals. Additionally, lock down arrangements appear to have had a significant impact on the spread of the virus and social distancing, together with other COVID-safe practices plus tracing/isolation strategies, are helping us live with the virus.

On the economic front, the latest OECD Leading Indicator data shows the US progressed to the "expansion phase" in September. The Euro area has also progressed to expansion, following the lead from China where growth momentum continues to build.

And of course, the elephant in the room continues to be the unprecedented levels of monetary and fiscal policy support around the globe, which underwrites the value of world share prices. Whilst ever this remains the case, markets will pretty much be comfortable with whatever is thrown at them and this gives us confidence that, in the medium term (once we move beyond the US election), equity markets should move higher.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** We are now more comfortable to maintain a neutral position to Australian equities. Opportunities exist in medium and small cap companies at this point in the cycle.
- **Global Equities (Slightly Underweight):** The US market is looking a little stretched. Asian and European markets appear to have more headroom for growth.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro tailwinds have now abated.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little more in fixed interest instruments relative to cash.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, our net cash position is slightly overweight.

Regards

Andrew & Stephen
28 October 2020