Client Newsletter

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Summary of Key Views

Markets are up but vulnerable to negative news

Markets didn't blink in May continuing their upward trajectory buoyed by accommodative policy settings for risk assets. Many investors have been left scratching their heads given the poor economic outlook and increased geopolitical tensions, coupled with civil unrest in the US. However, what it does tell us is that markets like liquidity. This is not a new play book, as markets have been supported by accommodative central bank policy since the global financial crisis in 2008 – we are simply seeing it applied much faster and on a more unprecedented scale than before. Looking at fundamentals remains important in analyzing markets, however understanding money supply is also essential.

In our most recent asset allocation committee meeting we did not make any changes to the existing asset allocation settings. The previous move to neutralize our slightly underweight exposure to equities has benefited the portfolios as equity markets have continued to rise on the view that COVID-19 cases have peaked across many key economic regions, and that economies will begin reopening for business. At the same, time further fiscal stimulus packages have been announced within Europe as well as China, which the market has reacted to favourably.

In March and April, we saw our valuation signals go 'green' for most risk assets as asset prices fell. Since then we have seen valuation opportunities within equities as share markets reduce, most notably in the US, where shares have recovered since their trough in March. Our valuation model indicates that most asset classes are trading at fair value, with the exception of government bonds, which continue to look expensive, and A-REITs, which look attractive on a relative basis.

Liquidity and policy remain favourable as central banks and governments continue to prop up economies via monetary and fiscal policy measures. Cyclical indicators remain weak, with most economic indicators such as unemployment figures and PMIs continuing to show weakness. Finally, risk indicators such as the VIX and MOVE indices continue to trend down. Indeed the MOVE index, which measures implied volatility within bond markets, is back at pre COVID-19 levels.

While markets have shown strength, risks remain. The impact of COVID-19 on company earnings remains unclear at this stage. The market has been pricing in negative news, meaning any news regarding company earnings that is worse than expected will likely adversely impact markets. Geopolitical risks, while ever present, are in the spotlight again. Tensions between the US and China are elevated, and the path forward is unclear. This is against the backdrop of the upcoming US election in November and recent civil unrest within the US.

Despite the rebound in markets we believe portfolio diversification remains important. Having some defensive assets in portfolios remains warranted as we get a better picture of the impact of COVID-19 on company earnings. While we have neutralized our exposure to risk assets from a slightly underweight exposure, we have been further diversifying our portfolios from a bottom-up perspective both from a source of return and risk perspective.

Market developments during May 2020 included:

Australian Equities

Amid heightened volatility and ongoing uncertainty around how governments will manage the reopening of the economy, Australian shares were able to maintain momentum through May, posting a return of 4.4%. In the first week of May the ASX 200 Index briefly reclaimed the 6,000 mark but wasn't quite able to hold it. While confidence returned, investors were still coming to grips with the disruption caused to a number of sectors, with consumer facing and export-reliant businesses the hardest hit by the pandemic.

Wesfarmers (+7.1%) announced the results of the first phase of its Target review, which will involve the closure of stores and, where suitable, the conversion of Target stores to Kmart stores. Blackmores (+8.2%) announced a $117 million equity raising to strengthen its balance sheet and accelerate Blackmores' growth in Asia. While COVID-19 had seen a sharp increase in demand for its immunity products, this is a small part of its portfolio and has been offset by a lag in nonimmunity products due to lower shopping traffic. The government announced an extension of aid to the airlines to support a minimal domestic network as Qantas (+3.4%) CEO Alan Joyce said plane tickets would cost ten times as much if social distancing was enforced on flights, making it economically impossible to keep planes in the air.

Global Equities

Despite the remarkable comeback, many are warning against complacency given the threat of a second wave of COVID-19 infections, which could be highly disruptive to markets and forestall the 'V'-shaped recovery investors are hoping for. Positive economic news and unprecedented easing measures from central banks and governments have helped boost confidence, but further negative news from companies could see some bearish sentiment return. Another complicating factor is the rise in US-China tensions and the political climate in the US, which remains uncertain leading up to the presidential race in November.

US shares were boosted by mega-cap names like Apple (+9.8%) and Facebook (+10.0%), as concerns around valuations re-emerged. Of course, some companies have benefited from the change in work arrangements globally. Online video conferencing provider Zoom (+32.8%) saw a jump in revenue of 169% to US $328.2 million and doubled its revenue guidance for the year. Meanwhile, US airlines are still languishing, with American Airlines down 12.6% in May. Europe's share rally was supported by the European Central Bank's €750 billion Pandemic Emergency Purchase Programme, with European small cap shares performing especially well.

Fixed Interest

After reaching record lows in April, unprecedented action from central banks has helped restore order to credit markets, while positive economic news saw an uplift in yields. The US 10-year yield rose slightly over May from 0.64% to 0.65% before moving higher early in June to just under 0.90% on the back of positive jobs figures and service sector activity. The US Fed remains committed to buying Treasury securities and agency mortgage-backed securities in whatever amounts needed to support smooth market functioning. These purchases totalled more than $2 trillion at the end of May and are continuing, although at a reduced pace as the economy shows signs of improvement and liquidity returns to credit markets.

Since March, the Fed has announced the establishment of no fewer than nine new facilities to support the flow of credit to households and businesses, which has helped to restore confidence to financial markets. While the Fed has no explicit yield curve control measure in place, markets are banking on the Fed keeping yields low. In Australia, the RBA paused its bond buying as order returned to markets, having made around $50 billion in purchases. The Australian 10-year yield was flat over May, ending the month at 0.89% before rising to 1.09% early in June, while the 3-year bond yield held around the RBA's 0.25% target.

REITs (listed property securities)

The A-REIT sector came back strongly in May, extending April's gains but still down nearly 40% on February's high in price terms. Investors took heart from earnings and distribution guidance from major companies like Goodman Group (+16.9%) and Charter Hall (+26.7%), with growing confidence that the sector can weather the storm. Vicinity Centres (+8.1%) announced its intention to raise $1.4 billion of equity via a $1.2 billion institutional placement and $200 million share purchase plan, at $1.48 per share. The funds will be used to strengthen the balance sheet and provide flexibility to respond to the uncertainties caused by COVID-19. Vicinity decided not to pay a distribution for the second half of 2020 and noted that preliminary draft valuations indicate a reduction in aggregate asset value as at 30 June 2020 of 11–13% or $1.8–2.1 billion.

Charter Hall and joint venture partner Allianz Real Estate sealed a $648 million deal to acquire four distribution centres owned by discount supermarket Aldi. The deal makes Charter Hall the largest industrial landlord to the four major supermarket operators in Australia. Global developed market REITs were flat in May in Australian dollar hedged terms and the MSCI US REIT Index moved sideways in US dollar terms following April's rise of 8.1%.

Alternatives

Preliminary estimates for May indicate that the index increased by 1.8 per cent (on a monthly average basis) in SDR terms, after increasing by 2.4 per cent in April (revised). The rural, base metals and non-rural sub-indices all increased in the month. In Australian dollar terms, the index decreased by 1.7 per cent in May.

Over the past year, the index has decreased by 7.4 per cent in SDR terms, led by lower coal, iron ore, oil and alumina prices. The index has decreased by 2.5 per cent in Australian dollar terms.

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