Client Newsletter

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Summary of Key Views

Markets up, but caution remains

April saw a rebound in risk assets as markets were buoyed by the prospect of economies slowly reopening for business as the number of new Covid-19 cases appear to have passed their peak in many key economies around the world. Markets were also supported by ongoing policy actions from central banks and governments, which has seen liquidity in markets significantly shift from being problematic a couple of months ago to being flush with liquidity as central banks ramped up their asset purchasing programs.

Economic news however continues to be poor. The Australian unemployment rate rose from 5.2% to 6.2% in April. What this figure does not factor in is the number of people who have effectively exited the labour force as well as people who are underemployed as a result of their work hours being reduced. In the US, unsurprisingly retail sales took a significant hit dropping 16.4% in April, with clothing sales down by about 80% since the end of February. Only food consumption was up by 10%, which was no doubt fuelled by 'panic buying'. Amidst the negative news Chinese industrial production continued to show signs of rebounding.

A key question we are asking ourselves is to what degree the negative economic news has been priced into the market and to what extent will markets continue buy into the central bank liquidity story. We believe that markets have factored in some of the bad economic news however much will depend on how quickly economies can reopen and that the rate of Covid-19 cases remains stable. Central banks have responded rapidly, and the scale of response has been unprecedented. However, a spike in cases and economies re-entering a 'lockdown' scenario would be negative for markets.

Our most recent asset allocation change was to move towards our neutral weight to equities reducing our alternatives and cash allocation. Our asset allocation views take a 18 month to 3 year view and while we see risks ahead and economic news is expected to be poor, we are also seeing valuation opportunities in some asset classes, policy and liquidity is conducive to risk assets and risk indicators such as the VIX Index have been moderating.

However, we remain cautious and from a bottom-up investment perspective we have been focused on further diversifying our portfolios. Within equities we are seeking to increase our exposure to managers, sectors and stocks which have a bias towards companies with more sustainable earnings and sound balance sheets. In terms of income we are factoring in a 30% reduction in income from dividends and we are seeking to diversifying our sources of yield to certain segments of the credit market particularly within our retirement focused portfolios. Finally, we have been adding a small exposure to gold within our multi-asset and listed diversified portfolios. Gold provides defensive characteristics during deflationary periods and times of economic uncertainly, additionally it can act as a good hedge against inflation, which while not a concern today may be an issue in the future given the scale of monetary and fiscal stimulus supporting economies currently.

Stay safe and healthy.

Market developments during April 2020 included:

Australian Equities

Despite the recovery in April, the magnitude and duration of the disruption remains uncertain and near-term expectations remain heavily discounted. Over half of ASX 200 companies have downgraded or withdrawn earnings guidance due to the lack of visibility in assessing the extent and severity of the COVID-19 outbreak. Dividends for banks, property and infrastructure shares are expected to decline as companies attempt to counter demand shocks through rapid cash conservation measures, while capital raisings have intensified as businesses move to strengthen balance sheets.

Coles Group (+2.3%) announced its March quarter results with Comparable Sales Growth (CSG) of 12.4%, benefitting from a shift in consumer behaviour following the outbreak. Likewise, JB Hi-Fi (+25.6%) reported it experienced an acceleration in sales in late March. Despite closing its three airport stores and seven CBD locations, sales grew 11.6% for the quarter, while all The Good Guys stores remained operational and delivered sales growth of 13.9%. Westpac (-1.3%) reported cash earnings (excluding notable items) of $2.3 billion, down 44% compared to the previous year, largely driven by a $2.2 billion impairment charge. The IT sector bounced back strongly in April, with key stocks AfterPay (+66.0%) and Appen (+31.2%) returning to their pre-outbreak levels.

Global Equities

Based on broadly accepted measures, the US equity market has endured a bear market and a bull market in the space of two months. In price terms, the S&P 500 declined 34% from February's record high to its trough on 23 March, before rallying 32% to the end of April. The initial sharp sell-off partly reflected a 'rush for the doors' as many equity investment strategies were forced to sell down, while the prospect of a significant economic and earnings shock resulted in additional fundamental-based selling.

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After turning negative for a few days, oil prices surged as investors speculated that demand would soon return with more countries announcing plans to reopen economies, bringing the WTI crude spot price to just above US$18 per barrel at the end of April, versus US$61 at the start of 2020. US oil producers bounced back in April but remain beaten down, with many now struggling to manage high levels of debt. Markets have stabilised significantly since March, with the CBOE Volatility Index falling from its March peak of 82.7 to 34.2 at the end of April, although it remains at an elevated level. In the UK, the FTSE 100 Index rose 3.9% in April and Germany's DAX 30 Index rose 9.3%. Across Europe, the hardest-hit sectors like travel and leisure bounced back but remain beaten down.

Fixed Interest

The dislocation in the credit markets was pronounced through March and April, with market stress also spreading to sovereign bonds, which are typically immune from indiscriminate selling. Action from central banks helped restore order, with the US Federal Reserve committed to purchasing not only government bonds and agency mortgage-backed securities, but also corporate bond ETFs, including sub-investment grade bonds. It remains to be seen if the Fed will follow through on this commitment, but words alone may be powerful enough to restore confidence.

Given the recent improvement in markets in late April and early May, the Fed began slowing the pace of government bond purchases. The US budget deficit is expected to expand to around US$4 trillion in 2020, prompting the US Treasury to boost the size of bond auctions to record amounts, and revive the 20-year bond, which was last issued some 30 years ago. In Australia, the RBA has embarked on its own bond-buying program, which totalled around $50 billion at the time of its May meeting. The Australian 10-year government bond yield rose in April from 0.76% to 0.89%, while the 3-year bond yield was steady at 0.25% in line with the RBA's target.

REITs (listed property securities)

After being hit hard in March, Australian listed property was able to enjoy a recovery in April, with the S&P/ASX 200 A-REIT Index returning 13.7%. However, in price terms the index remains down 33% on its February high, and social distancing and other measures implemented to curb the spread of the coronavirus have hit the A-REIT market hard. Retail assets have been particularly impacted by the mandated closure of non-essential businesses, while some large national retail groups have been forced to temporarily reduce their bricks and mortar footprints.

Vicinity Centres (+44.0%) released its March quarterly update and response to COVID-19, which showed portfolio sales for the quarter down 16.5% on the previous year, with sales falling 35.1% in speciality stores and 19.9% in mini-majors. While initial government restrictions and voluntary store closures resulted in reduced trading, Vicinity reported that 50% of stores were now open, with 530 stores reopened in the week prior to its update. As the economic fallout from COVID-19 widens, other key sectors – including office and industrial – may increasingly feel the impact of falling business confidence and GDP. In April, global developed market REITs rose 5.9% in Australian dollar hedged terms and the MSCI US REIT Index rose 8.1% in US dollar terms.

Alternatives

Preliminary estimates for April indicate that the index increased by 1.4 per cent (on a monthly average basis) in SDR terms, after decreasing by 3.8 per cent in March (revised). The non-rural sub-index increased in the month, while the rural and base metals subindices decreased. In Australian dollar terms, the index decreased by 0.3 per cent in April.

Over the past year, the index has decreased by 8.1 per cent in SDR terms, led by lower coal, oil, iron ore and alumina prices. The index has increased by 2.2 per cent in Australian dollar terms.

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