

Client Newsletter

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Summary of Key Views

Winners and losers

It has been an interesting month in markets. The S&P 500 Index reached 12 month highs with markets brushing off March's COVID-19 panic. There have been many discussions about how narrow the rally has been in that a handful of stocks have driven the sharp rebound. In fact, just over 35% of stocks in the index have had a positive gain over the year. Leading stocks in the technology sector have been the winners, with Alphabet Inc (Google), Amazon.com Inc and Apple Inc rebounding strongly from March. Essentially, growth and quality stocks have been rewarded and the impact of COVID-19 on such companies has been minimal relative to other sectors. In some instances, the pandemic has accelerated growth for online retail businesses such as Amazon. On the other hand, there have been notable losers. Airlines, retail property and infrastructure assets such as toll roads and airports have been losers on the back of COVID-19. This divergence has been reflected in the recent Australian reporting season with companies such as JB Hi-Fi reporting record annual profits, while Qantas continues to cut more jobs as it prepares for a \$10 billion revenue hit.

A key challenge for investors at the moment is whether to continue to back the 'winners' and pay more for growth, or to look for value amidst some of the 'losers' and try to identify a bargain. From a portfolio perspective we have taken the view that the current market conditions are favourable to quality/growth companies particularly given the low interest rate environment. However we also continue to have some exposure to the value part of the market, as we believe that some of the bad news has lowered the price of some of these sectors and that over the medium to long term there is an opportunity for these stocks to rebound.

While the current market dynamics are different to what we experienced during the tech bubble what is very similar is some of the narrative. I recall prior the collapse of the tech sector we were in a 'new paradigm' where value investing was dead and growth companies prospered. History generally doesn't repeat but it can rhyme. Ensuring that your portfolios are not anchored to one part of the market and they remain diversified, particularly in an environment where uncertainty persists, remains important.

Market developments during August 2020 included:

Australian Equities

Australian shares rose 2.8% in August. IT and Consumer Discretionary were the top returning sectors. Once again earnings season was dominated by the dire

effects of COVID-19 as companies cut dividends and increased cash holdings. Appen (-2.6%) reported 1H20 results in September, with revenue growth of 25% on the same quarter last year. Relevance was the largest contributor, with revenue growth of 24%, however Speech and Image revenue fell 20% following a breakout result in 1H19.

IOOF Holdings (+1.5%) announced the acquisition of MLC for \$1.44 billion, which will be partially funded via an entitlement offer and placement. A2 Milk Company (-11.8%) reported revenue and EBITDA growth of 33% on the prior corresponding period. Infant formula was the main driver of the result, supported by a 65.1% increase in Chinese sales. CSL (+5.9%) announced in September it had signed Heads of Agreements with the Australian Government and AstraZeneca to supply two potential COVID-19 vaccines within Australia following successful clinical trials, however AstraZeneca has halted the trial to investigate an adverse reaction from a study participant in the UK.

Global Equities

The S&P 500 Index rose 7.2% in US dollar terms, ending August at record highs and fully recovered from its March low. The rebound in global equities has been led by large cap growth companies, which have benefitted from the persistent low rate, low growth environment.

However, the start of September saw some pressure taken out of extended valuations, especially among US technology shares. In the first week, the NASDAQ fell 6.4% in price terms from Wednesday's record high. Electric car manufacturer Tesla gained 74.2% in August and fell 16.1% in the first week of September but was still 400% higher on the start of 2020.

One of the heroes of remote work, Zoom Communications, released its June quarter results at the end of August, which included a 355% rise in revenue on the prior corresponding period, soundly beating expectations. Zoom's share price rose 28.0% in August but fell 19.2% in the first week of September. The MSCI World Ex-Australia Index gained 3.5% in Australian dollar terms in August, while the MSCI Emerging Markets Index fell 0.9%. European shares pushed higher, albeit not as strongly as their US counterparts, with the STOXX Europe 600 Index posting a 4.2% gain. In Asia, Japan's Nikkei 225 Index rose 6.6%, Hong Kong's Hang Seng Index rose 2.5%, and China's CSI 300 Index rose 2.8%.

Fixed Interest

Yields rebounded from fresh record lows in August as risk-on sentiment prevailed over the month. The US 10-year Treasury yield hit a low of 0.51% before rising to end the month at 0.71%, while Australia's 10-year yield rose from its low of 0.82% at the start of August to 0.98% at month end. As widely expected, the Reserve Bank of Australia left the cash rate and yield curve control target

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unchanged at 0.25% at its September meeting, but increased its Term Funding Facility (TFF) to \$200 billion and extended its availability until the end of June 2021. The TFF was established in March to provide up to \$90 billion of credit to banks at a fixed rate of 0.25%.

Commenting on the outlook, the RBA noted the government has balance sheet scope for continued fiscal support while also stating it is considering further monetary policy measures to support the economy.

The US Federal Reserve issued a revised Statement on Longer-Run Goals and Monetary Policy Strategy, which introduces flexible average inflation targeting (coined FAIT by some) to compensate for periods where inflation runs below the 2 percent target (such as following an economic downturn). Yield curve targeting, which is used by some central banks including the RBA, went unsupported, with the consensus view that it “would likely provide only modest benefits in the current environment.”

REITs (listed property securities)

Australian listed property gained 7.9% in August but remains down 17.7% over the past 12 months. Scentre Group (+10.8%) announced 1H20 results, reporting a statutory loss of \$3.6 billion, largely due to property devaluations of \$4.1 billion. Excluding devaluations, EBIT fell 32.7% to \$637.4 million after accounting for an expected credit charge of \$232.1 million in relation to likely uncollectable rents and additional credit risk

associated with tenants due to COVID-19. While not in a position to provide guidance, Scentre outlined trading activity is showing signs of recovery, with 93% of stores trading and customer visits up to 84% on the prior corresponding period (both figures excluding Victoria).

Charter Hall Group (+18.9%) was another of the top gainers in August, reporting a jump in operating earnings of 46.3% to \$322.8 million with net profit climbing 47% and distributions up 6% to 35.7 cents per share. Globally, developed market REITs returned 1.8% in Australian dollar hedged terms. In the US, REITs were flat over August, with hotels (+10.8%) and regional malls (+6.7%) the biggest gainers. Despite near-perfect rent collection through the pandemic, office property (-3.1%) is battling the ‘work from home’ paradigm, which is putting pressure on the long-term outlook.

Alternatives

Preliminary estimates for August indicate that the index increased by 0.5 per cent (on a monthly average basis) in SDR terms, after increasing by 0.1 per cent in July (revised). The non rural and base metals sub-indices increased in the month, while the rural sub-index decreased. In Australian dollar terms, the index decreased by 0.4 per cent in August.

Over the past year, the index has decreased by 9.2 per cent in SDR terms, led by lower coal and LNG prices. The index has decreased by 12.2 per cent in Australian dollar terms.

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