Lonsec

ISSUE DATE: 22-09-2020

Summary of Key Views

Reconciling the market disconnect

There continues to be a question as to whether markets are reflecting economic reality as they continue their upward trajectory.

Within our investment committee process we remain focused on assessing asset valuations, where we are in the cycle and shorter-term sentiment indicators. We have observed a reduction in valuation opportunities within equities, given that share markets, most notably in the US, 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. However, within A-REITs we believe that being selective on a sector and security level is important.

Liquidity and policy settings remain favourable as central banks and governments continue to prop up economies via monetary easing and fiscal measures. Cyclical indicators remain weak, with most economic indicators such as unemployment figures and PMIs showing weakness, although some data coming out for June has been better than expected. Finally, risk indicators such as the VIX and MOVE indices appear to have stabilised. Indeed, the MOVE index, which measures implied volatility within bond markets, has returned to pre COVID-19 levels.

We have not changed our asset allocation settings and remain relatively neutral to risk assets.

While markets have shown strength, risks remain. The extent to which there is a disconnect between share markets and what is happening on the ground remains a focal point. Geopolitical risks, while ever present, continue to impact market volatility. Tensions between the US and China are elevated, and the outcome of the US presidential election in November remains uncertain.

Finally, the rise in the number of COVID-19 cases globally continues to create uncertainty as to the shape of any recovery. An important factor in the coming months will be the extent to which governments continue with fiscal measures to support the economy.

Market developments during July 2020 included:

Australian Equities

The recovery in Australian shares was cut short in July amid reports of growing Covid-19 cases and anticipation of harsher restrictions in Victoria. Early in August, the Victorian government announced a state of disaster and moved to stage four lockdown, which will see an estimated 1 million people restricted from going to and from their workplace for at least six weeks, while only essential businesses including supermarkets and pharmacies may remain open. The S&P/ASX 200 Index gained 0.5% over the month, dragged down by the energy and health care sectors.

Materials performed well over the month, with strong returns from Fortescue Metals Group (+25.7%) and Oz Minerals (+24.4%). In early earnings reporting, Rio Tinto (+4.2%) announced that 1H 2020 EBIDTA fell 6% on the prior corresponding period due to lower commodity prices during the half but reconfirmed its 2020 production guidance across all commodities. Wesfarmers (+3.8%) gave a Covid-19 update following Victoria's lockdown announcement: all of the group's retail businesses will continue online operations through home delivery and contactless click and collect, while Bunnings will remain open for trade customers only. In FY20, Wesfarmers derived approximately 17% of retail sales from stores within metro Melbourne.

Global Equities

Global shares continued their march higher in July, rising 0.6% in Australian dollar terms and 3.5% in local currency terms. With around half of S&P 500 companies having reported at the time of writing, it is clear earnings have been severely affected by the pandemic, although not as badly as anticipated. The US share market has been supported by the 'big four' tech giants (Amazon, Apple, Facebook, and Google), all of which beat estimates.

Amazon (+14.7%) was arguably the biggest winner, reporting the largest quarterly net profit in its history, nearly double that of the corresponding quarter in 2019. Apple (+16.5%) reported revenue of US$59.7 billion, above estimates of US$52.2 billion, while every major product line saw year-on-year growth and beat analyst expectations. Microsoft shares (+0.7%) posted modest gains as the company tried to salvage a deal to buy TikTok's US operations. Across the Atlantic, EU leaders have been relatively successful in containing the Covid-19 virus and providing much-needed fiscal support. In July the European Council approved a €750 billion package to fund fiscal transfers between member states.

Since March, the euro has been on the rise against the US dollar as investors see European assets as increasingly attractive.

Fixed Interest

July saw further compression in yields and a tightening in spreads as central bank liquidity continued to flood the market. In the US, the Fed intends to hold the funds rate near zero until the economy has weathered the pandemic. Broad support from the Fed and its presence in the ETF market have helped to tighten spreads across both investment grade and high yield segments. The Fed also includes 'fallen angels' in its corporate bond purchases, while the European Central Bank has been more targeted in its approach, resulting in euro high yield being more exposed to volatility.

A hunt for yield in the US market has also seen investors shift up the credit curve. The return on US high yield corporate bonds was 4.7% in July in US dollar terms, the highest monthly return since October 2011. According to the RBA, Australian government bond markets are functioning normally and have seen a solid increase in issuance. The yield on 3-year government bonds has been mostly in line with the RBA's 0.25% target, although it has been slightly higher in recent weeks, prompting the Bank to resume purchases in the secondary market. The yield target will remain in place until the RBA is satisfied it has brought the inflation and unemployment rates in line with its objectives

REITs (listed property securities)

Australian REITs were mixed over July as the economic pain from the pandemic rolled on. Shopping centres, which play a prominent role in the A-REIT index, remain affected by reduced foot traffic and struggling tenants. Scentre Group (-6.0%) gave an update on its half year results, noting that the carrying value of its property portfolio as at 30 June 2020 will be down approximately 10% from the end of 2019, with Covid-19 impacts the overriding reason. Meanwhile, some diversified and industrial funds have held up reasonably well during the crisis. Charter Hall's Long WALE REIT (+8.2%) has been spared the worst despite one of its tenants, Virgin Australia, vacating its Brisbane headquarters.

Centuria Industrial REIT (+3.8%) has similarly weathered the storm, reporting funds from operations per unit of 18.9 cents in FY20, in line with its revised guidance. Centuria will launch a $341 million rights issue to fund the purchase of the Telstra Data centre in Clayton, Melbourne. In the US, REITs returned 3.6% in US dollar terms, boosted by warehouse and industrial REITs (+12.5%) and dragged down by shopping centres (-10.2%) and hotels (-7.8%). Globally, developed market REITs returned 1.4% in Australian dollar hedged terms.

Alternatives

Preliminary estimates for July indicate that the index increased by 0.9 per cent (on a monthly average basis) in SDR terms, after decreasing by 0.2 per cent in June (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 0.2 per cent in July.

Over the past year, the index has decreased by 12 per cent in SDR terms, led by lower coal, iron ore, LNG and oil prices. The index has decreased by 12.1 per cent in Australian dollar terms.

IMPORTANT NOTICE: This document is published by Lonsec Research Pty Ltd ABN 11 151 658 561, AFSL No. 421445 (Lonsec). Please read the following before making any investment decision about any financial product mentioned in this document. Disclosure at the date of publication: Lonsec receives a fee from relevant fund manager or product issuer(s) for researching financial products (using comprehensive and objective criteria) which may be referred to in this Report. Lonsec may also receive a fee from the fund manager or product issuer(s) for subscribing to research content and other Lonsec services. Lonsec receives fees for providing investment consulting advice to clients, which includes model portfolios, approved product lists and other financial advice. Lonsec's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios, or in approved product lists. Lonsec may hold any financial product(s) referred to in this document. Lonsec's representatives and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the analyst(s).
Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is a "class service" (as defined in the Financial Advisers Act 2008(NZ)) or limited to "general advice" (as defined in the Corporations Act 2001(Cth) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of his or her financial circumstances or should seek independent financial advice on its appropriateness. If our financial advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.
Disclaimer: Lonsec provides this document for the exclusive use of its subscribers. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by Lonsec. Financial conclusions, ratings and advice are reasonably held at the time of completion (refer to the date of this report) but subject to change without notice. Lonsec assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, Lonsec, its directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.
Copyright © 2015 Lonsec Research Pty Ltd (ABN 11 151 658 561, AFSL No. 421445) (Lonsec). This report is subject to copyright of Lonsec. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of Lonsec.
This report may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to Lonsec copyrighted material, applies to such third party content.