Published April 2021

ISSUE DATE: 19-04-2021

Lonsec

Summary of Key Views

Structural pressures to keep inflation in check

Markets have been buoyed as signs of an economic recovery continue to be reflected in the economic data. The IMF has revised their projections upwards on global GDP growth with the US expected to growth by 6.4% in 2021 and China by 8.4% over the same period. Domestically, we have seen a similar trend with manufacturing and non-manufacturing sectors as measured by the PMI lifting in March and consumer sentiment also on the rise.

The rotation into cyclical and contrarian value stocks continued for the first two months of the quarter as the market digested the prospect of an economic recovery and the potential for an uptick in inflation. Lonsec's base case is that we may see a modest risk in inflation over the next 12 months, but that over the medium term inflation will remain under control as broader structural deflationary pressures, such as the continual impact of technology in society and the aging population, continue to weigh down on most developed economies. From an asset allocation perspective, we continue to favour risk assets over bonds, despite bond yields rising over the quarter. Over the medium term we believe that cash rates and bond yields will remain relatively low, which we believe will continue to be conducive for risk assets. From a dynamic asset allocation perspective we are favouring Australian equities and emerging markets, and within fixed income we are seeking to diversify away from duration risk.

Market developments during March 2021 included:

Australian Equities

Australian shares extended their rally through March, gaining 2.4%, but could not keep pace with global markets, which have been buoyed by the vaccine story. In Australia, very low levels of community transmission and the rollout of the vaccine program have delivered a boost to optimism, particularly for sectors directly linked to the re-opening of the economy such as consumer discretionary and industrials. Meanwhile, companies that benefited from Covid-19 (e.g. Coles and JB Hi-Fi) will have higher comparable sales to meet in upcoming result periods.

In stock-related news, Macquarie Infrastructure Group and Aware Super launched a bid for Vocus and the market received further details on Telstra's proposal to restructure its business model. AGL announced plans to create two energy businesses focused on executing distinct strategies via a structural separation. The 'New AGL' will deliver electricity, gas, internet and mobile services to more than 30% of Australian households. Sydney Airport released traffic performance numbers for February showing total passenger traffic down 79.8% on the prior corresponding period. China confirmed it will place a tariff of 175.6% on Australian wine exports in bottles and containers holding less than two litres. Treasury Wine Estates made plans last year to divert most of its high-end wine from China to other Asian markets.

Global Equities

Following the March 2020 low, the subsequent rebound in global markets was initially fuelled by growth companies in technology and healthcare that performed well as the pandemic swept across the globe and strict lockdown measures were implemented in most countries. As vaccines continue to roll out globally, the rebound has shifted to more cyclical areas of the market that are expected to perform strongly as the world returns to 'normal'. In the US, the style rotation has been most strongly depicted in the performance disparity between the 'old economy' Dow Jones Industrial Index, which rose 8.3% in the March quarter, and the 'new economy' NASDAQ Composite Index, which rose 1.8%. The rotation is being aided by rising bond yields, which challenge the lofty valuations that have been assigned to growth assets, especially in the technology sector.

Chinese shares remain under pressure as markets express concerns around potential policy normalisation as the economy recovers from the pandemic. In addition, uncertainty surrounding potential regulation for some industries and ongoing geopolitical tensions continue to dampen investor sentiment in the region. Emerging markets were weak in March, rising only 0.1% in Australian dollar terms, but have outperformed developed market shares over the past 12 months.

Fixed Interest

Once again, the bond market is proving a critical barometer of the market's mood. The US 10-year Treasury yield has risen from around 0.9% at the end of 2020 to over 1.7% at the end of March 2021, which is consistent with the ongoing improvement in economic data. However, the rise in yields also reflects the market's concern about inflation, which has been exacerbated by the speed and scale of stimulus measures and questions around the ability of governments and central banks to withdraw or scale back these measures responsively.

Demand for government bonds has proved resilient despite the flood of supply, although prices have been volatile and investors are watching how bond auctions play out following the lapse of bank regulatory exemptions that have done much to buoy the bond market since the start of the pandemic. In Australia, the RBA remains committed to the 3-year government bond yield target of 0.10%. The initial $100 billion government bond purchase program will finish in April and the second $100 billion program will commence. In the short term, the RBA expects CPI inflation to rise due to the reversal of some Covid-related price reductions, but beyond this anticipates that underlying inflation will remain below 2.0% in coming years.

REITs (listed property securities)

Debate in global property markets has turned to office markets and how the pandemic may have changed demand for office space on a permanent basis. While the return to work in CBDs is progressive, there is a growing realisation that more flexibility to include working from home arrangements is both possible and desired. As companies plan ahead and leases come to an end, there is already demand for core space plus an option for a flexible amount. After selling off heavily in

early 2020, retail property REITs have had bursts of recovery during the last six months as investors react to a vaccine-led recovery. Food and necessity-based shopping centres have continued to trade well and remain in demand by investors. Shopping strips and malls with a high proportion of discretionary spending have been hard hit, and owners face a period of readjustment in tenant mix and rentals.

In Australia, the residential housing market has been a surprising area of strength. The combination of a 'lower for longer' cash rate and a shortage of supply in the secondary market has seen prices escalate quickly, although this may seem at odds with the underlying economic conditions in Australia where JobKeeper and other support have now ended and banks require mortgages to be serviced after a brief hiatus for those in need.

Alternatives

Preliminary estimates for March indicate that the index increased by 1.6 per cent (on a monthly average basis) in SDR terms, after increasing by 3.1 per cent in February (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 increased by 1.3 per cent in March.

Over the past year, the index has increased by 28.2 per cent in SDR terms, led by higher iron ore prices. The index has increased by 7.8 per cent in Australian dollar terms.