Lonsec Client Newsletter

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PORT PHILLIP FINANCIAL

Summary of Key Views

Things look positive, but the biggest risk is complacency

The recent increased number of Covid-19 cases in Australia and in some parts of the globe highlights how quickly things can change and why it is critical that your portfolios are diversified and have some protection.

Markets have continued to be buoyed by strong performance and despite continuing concerns regarding inflation, the markets had some relief as bond yields pulled back over the quarter. Key Central banks have taken the view that much of the rise in CPIs is attributed to supply/demand imbalances caused by Covid, these imbalances will diminish and alleviate some of the current inflationary pressures. Lonsec's base case in aligned to this view and while we expect inflation to rise over the next six months, we believe that it will subside.

Policy setting also remains conducive to equity markets, with interest rates remaining low as inflation subsides. In addition to supportive monetary policy, fiscal support also remains a continuing theme. Economic indicators such as employment figures, PMIs and consumer confidence all suggest that the economic recovery in well on track, with some indicators exceeding pre Covid levels.

Market developments during July 2021 included:

Australian Equities

The Australian share market reached all-time highs in July, with the S&P/ASX 200 gaining 1.1% for the month. The Materials sector was the clear standout, benefiting from solid gains in both industrial and precious metals, which saw the Materials sector up 7.1% for the month. Industrials also performed strongly with a gain of 4.3%. Information Technology gave up some of the impressive performance seen in June, with the sector retracing 6.9%. Energy and Financials were also weaker in July, both falling 2.5% and 1.4% respectively.

The value rotation continued to show signs of weakening, with the S&P/ASX 200 Value Index down 0.3% for the month. Despite the recent weakness, value remains the leading factor year to date (+15.1%). Investors continue to favour quality as lockdowns are reinforced across the country amidst rising COVID cases, casting doubts over the pace of Australia's economic recovery. The S&P/ASX 200 Quality Index was 3% higher for the month.

Attention now turns to the reporting season which commenced late last month. Investors will be eagerly awaiting results to ascertain whether the impressive market rally from the COVID induced lows of last year has been justified. Equally paramount will be any commentary offered by companies on their expectations for the future, given the dearth of outlook statements provided last year.

Rio Tinto reported earnings on 28 July 2021; one of the more highly anticipated reports given the impressive rise in iron ore prices over the past year. The miner didn't disappoint, reporting record half-year earnings which more than doubled from last year. Rio reported underlying earnings of US$12.2bn compared with US$4.8bn a year earlier. The company will pay out an impressive US$9.1bn in dividends, consisting of a special dividend of US$1.85 per share and an interim dividend of US$3.76 per share.

Global Equities

July saw a contrast in global equity performance across regions, with emerging markets posting a 4.7% decline in Australian dollar terms over the month, whilst developed markets continued their strong performance, climbing by 4%.

Losses in emerging markets were driven by a deep sell-off in Chinese technology and education stocks towards the end of the month as Chinese regulatory officials confirmed a leaked policy document banning for-profit tutoring, an industry with an estimated value c.US$120 billion. This began a sell-off in Chinese education stocks which spread to the Chinese technology sector, shaving off a combined US$1.0 trillion in company value, with the MSCI China index posting its largest decline since March 2020. Hong Kong was not immune to this mainland decline, with the broader Hang Seng index declining by 9.6% over the month. Heightened regulatory risks for the region are expected to remain in the medium term as the market struggles to price in this regulatory uncertainty which has always been a risk of Chinese equities.

Developed markets continued to rise over July, buoyed on by vaccine rollout which has helped a strong Q2 2021 US corporate earnings results. Of the 89% of S&P500 companies that have reported actual results for Q2 2021 to date, 87% have reported EPS results above analyst estimates. Going forward, developed markets remain supported by near term fiscal policy initiatives with US Senate close to finalisation of a bi-partisan US$1 trillion infrastructure bill, whilst EU member states reached final approval of a €800b EU recovery fund support package.

Fixed Interest

The Bond rally that started in June has continued throughout July, as yields plummeted. The Australian Sovereign 3 and 10 year yields fell by 16 and 30 basis points respectively. The 10 year rate ended the month at 1.19%, approaching the level it was at prior to February's large selloff. July's fall in yields can be attributed, at least in part, to ongoing concerns over the impact of the Delta variant of COVID, and markets doubting whether the Reserve Bank of Australia will continue to slow down their Quantitative Easing program as Sydney remains in lockdown.

This same uncertainty has impacted credit markets, as credit spreads widened over the month, as can be seen by the iTraxx Australia Index increasing by slightly over 4 basis points from the start to the end of July. This increase in spreads pales in comparison to the sharp fall in the risk-free rate however, which resulted in the AusBond Composite 0+ Yr Index returning 1.8% over the month.

Globally, the story is much the same, with yields falling as the world grapples with the Delta variant of COVID. This has resulted in the Bloomberg Barclays Global Aggregate Index (AUD Hedged) Index returning 1.3%, or 3.5% for the unhedged variant, over the course of July.

REITs (listed property securities)

A-REIT's advanced slightly during July, with the S&P/ASX 200 A-REIT Accumulation Index (XPJ) achieving 0.3% for the month. This is considerably less than the prior month of June, where the index advanced 5.5%. The lower monthly return can largely be attributed to the COVID-19 Delta variant outbreak, causing continued lock-downs across Sydney, and shorter, periodic lockdowns across Brisbane and Melbourne. Global property, as measured by the FTSE EPRA/NAREIT Developed Ex Australia Index (Hedged to AUD), gained 4.2% for July and the Federal Reserve's Senior Loan Officer Survey for August 2021 indicated that there is stronger demand for commercial construction loans, multifamily properties, and other secured non-residential real estate, indicating strength in the sector.

No news was good news for some of the A-REIT's during July. Goodman Group (GMG), the largest constituent of the XPJ, advanced by 6.7% and Charter Hall group (CHC) achieved 4.9%, both of which released no price sensitive announcements to the market during the period. Other news included Cromwell Property Group (CMW) appointing Jonathan Callaghan as the new CEO and Dexus (DXS) acquiring a 49% interest in a holding unit trust which owns Capital Square Tower 1 in Perth for a total consideration of $339 million. Dexus also entered into binding terms to fund, develop and invest in Atlassian's new headquarters on Lee Street in Sydney. The 40-level building is expected to cost $1.4bn with commencement in early 2022 and completion in early 2026. Atlassian has taken a 15-year lease.

CoreLogic's July 2021 update stated Australian dwellings rose by 13.5% in the 2020-21 financial year, being the highest annual growth rate since April 2004. Rents in June continued to increase, with year to June growing by 6.5%. In July, the 5-capital city aggregate advanced by 1.61%, with Sydney, Melbourne and Brisbane achieving 1.9%, 1.3% and 2.0% respectively.

Alternatives

Preliminary estimates for July indicate that the index increased by 5.5% (on a monthly average basis) in SDR terms, after increasing by 6.0% in June (revised). The rural and non-rural sub-indices increased in the month, while the base metals sub-index fell. In Australian dollar terms, the index increased by 7.7% in June.

Over the past year, the index has increased by 59.9% in SDR terms, led by higher iron ore prices. The index has increased by 55.0% Australian dollar terms.