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Lonsec

Summary of Key Views

Insights from our CIO: Feel the heat

August was another strong month for equity markets however some storm clouds have reappeared amidst the collapse of Evergrande, one of China's biggest property developers, as the Chinese government sought to stem excessive borrowing leaving the heavily indebted company with over $400B in debt. The main concern is that the collapse may have a flow on effect on the Chinese property market, which has grown at an incredible rate, and ultimately impact the Chinese economy. We have seen some evidence of contagion reflected in high yield markets and other property markets such as Hong Kong. Markets are also watching what direction central banks will take on their asset purchases programs and whether they will seek to taper the programs and if so to what extent.

From an asset class perspective, we are still supportive of risk assets despite some of the risks mentioned earlier, as bonds, including government and corporate bonds, offer limited relative value in the current environment. However, we continue to see asset valuations rise notably in Australian equities. We continue to monitor valuations looking for opportunities to take profits where applicable.

We are also observing an increase in the dispersion in returns on an asset class, country and stock level. We believe that such an environment is increasingly supportive of an active approach to asset management. We also believe that ensuring that portfolios are diversified in their exposures will become more important in the coming 12 months. One of our main challenges is identifying diversifying assets in the current environment and Lonsec's investment committees are working hard to identify appropriate assets.

Market developments during September 2021 included:

Australian Equities

The Australian share market finished lower in September, ending an impressive 11-month run of gains, with the S&P/ASX 200 losing 1.9% for the month. The Energy sector benefitted from rising coal and oil prices, with the sector up 16.7% for the month. The Utilities sector also finished higher with a 2.5% gain. Materials (-9.3%), Health Care (-4.9%) and Information Technology (-3.9%) were the biggest drags on the Index. For the quarter the S&P/ASX 200 gained 1.7%, with Energy the standout sector (+9.2%), whilst falling iron prices weighed on Materials (-9.9%).

Value was the only factor to produce a positive return in September, finishing 0.9% higher. Momentum and Quality finished the month 6.4% and 4.9% lower respectively. Over the quarter, Value was the best performing factor producing a return of 4.6%, whilst Growth was the worst performing factor falling 1.4%.

Falling iron ore prices, which have been impacted by Chinese production cuts across the steel manufacturing industry, have weighed on local mining heavy weights which account for roughly a fifth of the Index. Iron ore prices have also been adversely impacted by the financial woes of Evergrande, China's second largest property developer. The Chinese construction sector accounts for roughly half of all China's steel consumption and should Evergrande fail, the impact is expected to be felt across other Chinese property developers, which will likely contribute to a further reduction in demand for iron ore. Additionally, investor sentiment was dented by rising energy inputs and a change in central bank rhetoric, many of whom have begun striking a more hawkish tone, including the Fed who have signalled that the time to taper back on extraordinary levels of stimulus may be near. Bond yields have risen in anticipation of higher inflation which has unsettled investors in recent weeks, leading many to question if current valuations are sustainable.

Global Equities

September saw an evaporation to the gains made in global markets over the last three months, with developed and emerging markets receding by 3.1% and 2.8% in Australian Dollar terms, respectively. Over the one-year period, Global small caps led comparative markets, returning 38.7% compared with 27.8% for global large caps and 17.3% and for emerging markets in Australian dollar terms.

Contraction in performance over September was primarily driven by fears of a global financial contagion stemming from the worlds most indebted company, Evergrande Group based in China, after news that it was renegotiating coupon repayments on its US$300b of outstanding debt.

The outlook for global growth remains somewhat negative with the US Fed announcing it will begin tapering asset purchases by the end of the year. This coincides with an already poor environment for global growth with rising energy prices and a global supply chain gridlock, not to mention the ever present spectre of the delta Covid variant.

The release of Fed policy discussions drove a further sell off in developed market equities over the month as global asset managers reposition for a higher discount rate environment. Despite this, the Fed remain committed to keeping the Fed Funds rate within the current 0-0.25% target range until labour market conditions and inflation levels are maintained within their target ranges.

Fixed Interest

September saw a sharp reversal in the performance in Fixed Income markets, with the trend of decreasing yields that had

defined the prior months coming to a screeching halt. Increasing inflationary expectations, and growing fears that the current high levels of inflation may not be transitory have driven yields upwards with the yield of 10-year Australian Government Bonds having risen by more than 30bps from the end of August to the end of September. As the shorter end of the curve has remained suppressed due to the RBA's yield curve control, this rise in the long end has resulted in a substantial steepening of the curve. Credit spreads also widened over the course of September, which combined with the changes to the risk free rate resulted in a month of poor performance in Fixed Income markets, which can be seen in the Bloomberg AusBond Composite 0+ Yr Index returning -1.51% over the month.

Internationally, the story is very similar, as continued supply issues drive fears of protracted inflationary pressure, resulting in rising yields. As such, the Bloomberg Barclays Global Aggregate Index (AUD Hedged) Index returned -0.97% over the course of September, with the unhedged variant having returned -0.62%

REITs (listed property securities)

The S&P/ASX 200 A-REIT Accumulation Index returned -2.18% in September, mainly fuelled by a couple of days of selling towards the month end. Global real estate equities (represented by the FTSE EPRA/NAREIT Developed Ex Australia Index (AUD Hedged)) sold off during September, with the index closing 5.41% lower. A-REIT's had a quieter month with regards to announcements following the August reporting month. Dexus (ASX: DXS) announced a $1.5bn expansion in industrial platforms via the acquisition of a portfolio alongside APN Industria REIT (ASX: ADI). The acquisition includes Jandakot Airport, Perth, and some other industrial portfolio properties including circa 80 hectares of developable land, a logistics facility leased to Australia Post in Truganina, VIC and a fund-through development located at Kemps Creek in NSW.

Abacus Property Group (ASX: ABP) is now included in the FTSE EPRA NAREIT Global Real Estate Index Series, which became effective Monday 20th September.

Nationally, the housing market continued to increase in value, despite somewhat slowing quarterly increases, with the CoreLogic 5 city aggregate recording a 1.45% increase for September. The recent house price rise, 12 months to August, equates to the largest rate of annual appreciation since mid-1989 (as reported by Core Logic).

Alternatives

Preliminary estimates for September indicate that the index decreased by 7.0% (on a monthly average basis) in SDR terms, after decreasing by 4.3% in August (revised). The rural and base metals sub-indices increased in the month, while the non-rural sub-index decreased. In Australian dollar terms, the index decreased by 7.2% in September.

Over the past year, the index has increased by 37.4% in SDR terms, led by higher LNG, coking coal and thermal coal prices. The index has increased by 36.7% Australian dollar terms.

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