ATCHISON
CONSULTANTS

Market Review – December 2020

2020 Year in Review

The year 2020 will go down in history as one of the most unprecedented and challenging years of modern times. From the Australian bushfires to COVID-19, Black Lives Matter and the US election, it has been a tumultuous year of change. However, 2020 did finally turn out far better for diversified investors than had been feared when the pandemic hit triggering plunging share markets and deep recessions.

US indices continued to hit record highs as the virus ripped through the country boosted by Thanksgiving get togethers however President Trump's signature on a massive stimulus bill was enough to stoke markets.

Europe and the UK finally agreed terms for the post-Brexit trade deal. The jury is still out on its content but the cliff-edge no deal scenario was averted just before Christmas.

A drifted dollar and an optimistic outlook also saw emerging market assets cap a good year with some healthy gains. Central banks continued to shower markets with stimulus gifts over the festive period, which provided further confidence to investors looking at riskier assets.

Data from The Economist on debt and capital raisings show the world's non-financial firms raised US$3.6t in capital from investors during the year, firmly outpacing new capital raised over the past decade, including the GFC. While cash held by the world's 3,000 most valuable listed non-financial firms has exploded to US$7.6t from US$5.7t last year.

COVID-19 has acted as a great accelerator of structural trends that were already in place – an increased focus on sustainability; widening wealth, income and health inequality; and the dominance of e-commerce and the demise of struggling bricks and mortar retailers.

Despite recording the worst drop-in economic activity since the Great Depression, 2020 turned out to be a positive year for financial markets. The MSCI World ex Australia Index (Unhedged) returned +6.3% and The MSCI World ex Australia Index (Hedged) returned +14.4%, led by the US market.

An effective response to contain COVID-19 allowed certain Asian economies to return to a degree of normality comparatively better than the rest of the world, sending their stock prices higher in the process. Stand-out markets included South Korea (+42.7%), Taiwan (+42.0%) and China (+29.7%). In fact, only 7 out of the 27 countries in the MSCI Emerging Markets Index posted positive returns in 2020, highlighting the narrowness of the EM rally.

It is expected that the average balanced growth superannuation fund would have returned 3% for the 12 months to 31 December 2020. This followed around 15% return in 2019 year. Balanced growth super funds returns have averaged around 6% pa over the last five years which is well above inflation and bank deposit returns.

2021 Outlook

Vaccine prospects are likely to make 2021 a recovery year. The vaccine announcements, the passing of U.S. election uncertainty and Brexit have removed three of the near-term worry points about the outlook. The major risk now is the amount of investor optimism since the vaccine announcements.

Shares

Thanks to COVID-19, 2020 turned out to be a memorable year for the ASX, though the record amount of support from central banks here and offshore as well as the Federal and state governments helped soften the blow and financed the turnaround in sentiment and share prices in the final 9 months of the year.

That rebound saved the markets from near implosion here and offshore and saw an odd sight of a stock market boom amidst recession, rising COVID infection numbers and a soaring death toll, especially in the US, UK and Europe as the year ended.

The ASX 200 index eked out a return of +1.4% for the 12 months to 31 December, not bad given the chaotic year.

Having hit a high of 7,162.5 points in February, the index plunged to a low of 4,546 points on March 23 as COVID-19 pandemic reached beyond China, ensnaring the rest of global life and the economy.

However, emergency support packages from the RBA, US Federal Reserve and other central banks and the trillions of dollars in spending by governments across the world, markets bounced from the depths of late March.

The ASX managed to pick itself up, surging +45% since March 23, and closed out the year +1.4% from where it ended 2019.

In Australia, the improved outlook for domestic housing construction, and supportive lending condition will help to counteract the loss of population driven growth thus reducing downside risk.

As a result, there is a relatively positive view on cyclical sectors (industrials, basic commodities, financials), which will benefit from either a return to trend growth and/or a rotation away for secular growth companies.

Global growth is expected to be un-even, the US should emerge with stronger than trend growth, but Europe may struggle with challenging demographic trends, political disunity and weaker than required fiscal policy. The Asian region suffered less during the pandemic and is further along the path to recovery.

It is likely that there will be a continuing shift in performance away from investments that benefitted from the pandemic and lockdowns - like US shares, technology and health care stocks and bonds - to investments that benefit from recovery - resources, industrials, tourism stocks and financials.

Equities remain relatively attractive as we enter 2021, despite pockets of elevated valuations. The broad political support for pro-growth policies, rather than the austerity attempted in the aftermath of the GFC, should prevent a double dip.

Global shares are expected to return around 8% but expect a rotation away from tech heavy US shares to more cyclical markets in Europe, Japan and emerging countries.

Property

The low interest rate environment should support commercial property, which is offering historically high yields relative to bonds and equities. Industrial, logistics, and modest non-CBD office properties on a relative basis look the most attractive.

Australian home prices are likely to rise 5% or so this year being boosted by record low mortgage rates, government home buyer incentives, income support measures and bank payment holidays but the stop to immigration and weak rental markets will likely weigh on inner city areas and units in Melbourne and Sydney. Outer suburbs, houses, smaller cities and regional areas should see stronger gains in 2021.

Interest Rates

Low inflation pressure in most countries and dovish central banks should limit the rise in bond yields. Major central banks have made it clear that they will wait until after inflation rises before raising rates. This was highlighted by the recent move by the U.S. Federal Reserve (the Fed) to target average inflation and allow an overshoot of its 2% target. A slow-to-react Fed should limit the rise in the 10-year Treasury yield to between 1.1 to 1.4% from the current 0.85%. It is reasonable to expect similar increases of between 25 to 50 basis points in German bund and British gilt yields. Japanese government bond yields, though, are likely to remain close to zero with the Bank of Japan continuing with yield curve control.

The yield on 10-year Australian bonds ended 2020 at 0.97%, down 40 basis points since the end of 2019. That was mostly due to cuts in interest rates (0.65% of rate cuts in the year) from the Reserve Bank of Australia (RBA) and the bond buying campaign in November and December.

As a result of COVID-19, while Australians saved more than at any time in history, cut billions of their credit card debts and switched to debt cards and buy now pay later plans, Australians also hoarded cash, a record $14.5 billion over the course of 2020.

Expect short term yields to remain ‘anchored’ at all-time lows, but the long end of the curve may rise moderately as stimulus lifts inflation expectations from very-low levels. Without the tailwinds of failing rates, and with the prospect of a steepening curve, the returns on government bonds promise to be meagre or negative.

Cash and bank deposits are likely to provide very-poor returns, given the ultra-low cash rate of just 0.1%.

Low duration, floating rate securities and investment grade credit offer the best risk / reward profile.

As a result, there is a relatively positive view on cyclical sectors (industrials, basic commodities, financials), which will benefit from either a return to trend growth and/or a rotation away for secular growth companies.

Commodities

Positive on commodities in the short term but caution through 2022 and beyond, based on potential weakening China economic growth outlook.

Currencies

Further short-term appreciation in AUD is possible and may holdout further should US corporate earnings weaken and commodity prices fall.

The Global Economy

The most notable damage from the pandemic is rising government debt. The International Monetary Fund (IMF) projects that gross government debt for the G7 economies will rise by 23% of gross domestic product (GDP) in 2020. High debt makes government finances vulnerable to rising interest rates. This is unlikely to be a significant problem in the next couple of years, but it will matter when spare capacity is eventually exhausted, and inflation starts to rise.

There is speculation that governments will soon start to trim deficits through tax hikes and lower spending, slowing the recovery. This seems unlikely anytime soon.

Governments will come under pressure to reduce deficits only after bond yields rise meaningfully and markets question debt sustainability. Expect fiscal austerity and tighter monetary policy to be some years away.

In conclusion: Overall, Atchison Consultants see the following asset class implications for 2021:

- Equities should outperform bonds
- Long-term bond yields should rise, though with steeper yield curves likely limited by continued low inflation and central banks remaining on hold
- The U.S. dollar may weaken given its countercyclical nature
- Non-U.S. equities to outperform given their more cyclical nature and relative valuation advantage over U.S. stocks
- The value equity factor to outperform the growth factor. A return to normal by the second half of the year should help extend the rotation that began in early November away from technology/growth leadership toward cyclical/value stocks

Table 1: Market Performance – Periods to 31 December 2020

Sector	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa
Australian Shares	1.2	13.7	1.4	6.7	8.7
Australian Shares Small Cap	2.8	13.8	9.2	6.6	10.5
International Shares Ex-Aus (Unhedged)	-0.5	5.8	6.3	11.8	11.6
International Shares Ex-Aus (Hedged)	3.6	12.4	14.4	10.9	12.3
Emerging Markets (Hedged)	6.1	16.1	19.5	8.5	13.0
Emerging Markets (Unhedged)	2.6	11.3	8.1	7.0	11.9
Australian Listed Property	0.4	13.3	-4.6	5.4	7.0
International Listed Property (Unhedged)	-2.5	-10.6	-13.6	-0.8	2.6
Australian Direct Property*	0.3	0.7	7.0	5.8	8.9
Australian Fixed Interest	-0.3	-0.1	4.5	5.4	4.6
International Fixed Interest (Hedged)	0.4	2.3	6.7	5.5	5.9
Cash (BAUBIL)	0.0	0.0	0.4	1.3	1.5
		Change over the month			
Australian Govt. 10 yr Bond Yield	0.97%	-0.06 bps			
AUD/USD	$0.77	+$0.08			

*as at 30 November 2020

Australian Shares (S&P/ASX 200 Accumulation Index)

The S&P/ASX 200 Accumulation Index climbed +1.2% in December and managed to finish the year with a gain of +1.4%. The S&P/ASX 200 recorded one of the fastest bear markets in history falling -36% over a month, to be followed by a remarkable rally with equity prices rising circa 45%. By the end of the year the Australian bourse was almost back to its previous peak, despite a 15% decline in earnings per share (EPS) and a deeper deterioration of dividends declining @ 25%.

By sector in December, Information Technology (+9.5%), Materials (+8.8%) and Consumer Staples (+2.3%) outperformed in Australia, while Utilities (-5.4%), Industrials (-5.4%) and Health Care (-4.9%) underperformed the most.

At the end of December, the index finished trading at a P/BV of 2.2x and a P/E Ratio of 22.5x and equity yield (dividend) of 2.8%.

The VIX was at 13.90 (the average since 01.10.2010 is 16.4) indicating below average level of market volatility.

Australian Shares Small Cap (S&P/ASX Small Ordinaries Index)

Australian small caps (stocks 101-300 in the ASX) reached record highs in December returning +2.8% for the month, performing in line with large caps over the December quarter and closing out the year +9.2% higher than at the end of 2019. Over the year small companies being clear winners compared to larger companies +9.2% compared to a return of +1.4% for the ASX 200 Accumulation Index).

The highlight in the month was the performance from the commodities sector including iron ore and lithium miners and service providers such as Mineral Resources (+50.3%) and NRW Holdings (+43.8%).

At the end of December, the trailing P/E Ratio was at 22.3x at the end of the month, P/BV is at 2.0x and equity yield (dividend) of 2.3%.

International Shares (MSCI World ex Australia Index, Net AUD and the MSCI World ex Australia Index, Net LCL)

The MSCI World ex Australia Index (Unhedged) returned -0.5% for December whilst the MSCI World ex Australia Index (Hedged) returned +3.6%. The best performing market over the year was the Nasdaq which rose +35.6% thanks to its high weighting to technology stocks (which were winners during the year due to remote working and stay at-home restrictions).

The small cap versus large cap return differential over the year was just as pronounced as in Australia. In the US, the Russell 2000 Index returned +8.8% versus +7.2% by the S&P 500 while in the UK the FTSE 100 lost -16% versus smaller losses of -10.2% by the mid and small cap FTSE 250 index.

In Asian markets, the Shanghai Composite Index in China returned for the year +10.4% with China being first region out of the pandemic. Japan's TOPIX index returned +2.5% while the Nikkie rose +1.4% for the year.

At the end of December, the index ended trading at a forward P/E Ratio of 26.3x and P/BV of 2.8x and equity yield (dividend) 1.8%.

US markets: US equities lost -0.6% unhedged but gained +4.1% on a hedged basis in December buoyed by vaccine news. The developments eclipsed Joe Biden's win in the US presidential election, as well as a $900 billion stimulus package announced in late December. The Federal Reserve nonetheless reinforced its supportive message, stating it will continue with current levels of quantitative easing. Economically sensitive sectors made the strongest gains, with more defensive sectors making more modest progress.

UK markets: UK equities performed well over the month reversing some of the underperformance that they suffered versus other regions during the global pandemic's initial stages. The market responded well to November's vaccine news and then again to the Brexit trade deal, with domestically focused areas of the market outperforming.

European markets: European equities gained sharply in December, again on the news of effective vaccines. Sectors that had previously suffered most severely from the pandemic, such as energy and financials, were the top gainers. However, rising Covid infections saw many European countries tighten restrictions. EU leaders approved the landmark €1.8 trillion budget package, including the €750 billion recovery fund, after overcoming opposition from Hungary and Poland. The EU agreed a Brexit trade deal with the UK.

Chinese markets: China finished in positive territory, but the market was curtailed due to the launch of an anti-trust investigation into Alibaba and further escalation in US-China tensions dragged on sentiment.

Asian markets: Asian equity market performance was positive over the month as investors continued to favour risk assets despite rising COVID-19 cases and an increase in local lockdowns.

Within the region, the Korean market was among the top performers as its vaccination programme led to higher visibility surrounding its economic outlook. The Taiwanese market also outperformed thanks to the strength of the tech sector which benefited from a better pricing environment for tech components.

Emerging markets: Emerging market (EM) equities generated strong return over the month, with US dollar weakness amplifying gains. Korea, Brazil and Mexico all outperformed. The rally in commodity prices was supportive of EM net exporters. Conversely, Egypt, where daily new COVID-19 cases accelerated, posted a negative return.

South Korea was the best-performing index market, aided by strong gains from the tech sector. Indonesia, Taiwan, the Philippines and India also performed well in December. Malaysia, China and Hong Kong generated more modest gains and underperformed.

Emerging Markets Shares (MSCI Emerging Markets Index, Net AUD)

Emerging equity markets enjoyed a strong end to 2020 by extending their healthy year-to-date gains returning +2.6% for December and +8.1% for the year. Despite concerns surrounding the emergence of a mutant strain of COVID-19 in the UK, the MSCI Emerging Markets index climbed to its highest level since 2007.

Q4 marked the best quarterly performance (Q4 +11.3%) since the end of 2009 after the market reversed a significant part of its losses after getting off to the worst start to a year on record.

At the end of December, the index ended trading at a forward P/E Ratio of 19.5x and P/BV of 2.1x and equity yield (dividend) 2.0%.

Australian Listed Property (S&P/ASX 200 A-REIT Accumulation Index)

The S&P/ASX 200 Property Accumulation index returned +0.4% in December, underperforming the S&P/ASX 200, which returned +1.2%. For 2020, A-REITS returned -4.6% underperforming the broader share market, which returned +1.4%. S&P/ASX Industrial A-REITS returned +1.9% in December, S&P/ASX Retail A-REITS returned +0.3%, S&P/ASX Office A-REITS returned 0.0% and S&P/ASX Diversified A-REITS returned -0.5%.

The best A-REIT performers over the month were Charter Hall Group (CHC) at +8.5% and BWP Trust (BWP) at +4.6%. Key underperformers were Abacus Property Group (ABP) at -7.3% and Stockland Corporation Limited (SGP) at -4.7%.

At the end of December, the index was trading on a dividend yield of 4.0% with a P/BV 1.2x and a P/E Ratio 19.0x.

International Listed Property (FTSE EPRA/NAREIT Developed ex-Australia Index, AUD)

Globally, REITs were down -2.5% of December and -13.6%. The UK was the top-performing region (+6.3%). The worst-performing region over the month was Hong Kong (-0.8%).

At the end of December, the index was trading on a dividend yield of 4.0% with a P/B 1.5x and a P/E Ratio 22.8x.

Australian Direct Property (Atchison Consultants Unlisted Property Funds Index)

Australian direct property posted a return of +1.7% over the November 2020 quarter. Capitalisation rates across property sectors continued to trend downwards. Cap rates across office, industrial and retail properties range are 5.6%, 5.9% and 6.4% respectively.

Australian Fixed Interest (Bloomberg AusBond Composite Bond Index)

Australian fixed interest fell by 0.27% over the month. Australian government 10-year bond yields increased by 0.06bps to 0.97%. At this point, 10-year Australian bonds yields were 10bps above US 10-year yields. 3-year single A corporate credit spreads tightened from 0.57% to 0.51%.

International Fixed Interest (Barclays Global Aggregate TR Bond Index, Hedged to AUD)

International fixed interest returned +0.4% over the month. The 10-year US government bond yield increased by 10bps to 0.92% while the US corporate investment-grade credit spread tightened from 1.43% to 1.30%.

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