Economic & Financial Markets Update
January 2021

Prices in most asset classes continued to recover over the six month period to December 2020 as confidence around vaccine trials accelerated and was then realised, the initial US election result was perceived to be ideal by investors, and leading economic indicator data was generally strong.

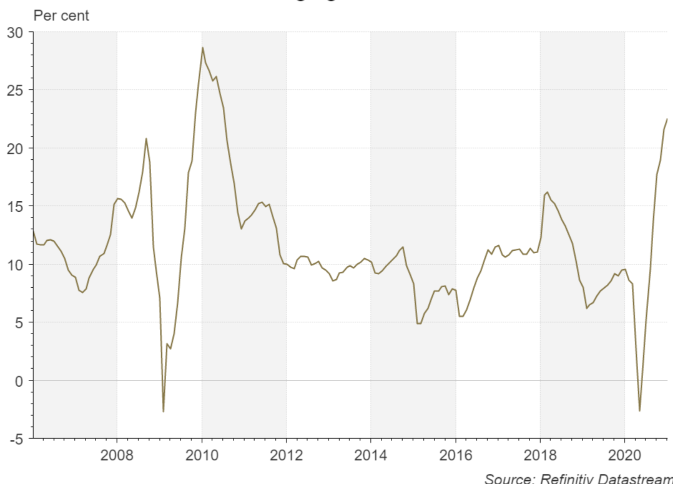
Market Benchmarks	6M	1YR	5YR
Australian Shares	13.7%	1.7%	8.8%
International Shares	9.7%	5.7%	10.9%
Australian Property	21.6%	-4.0%	7.4%
Australian Bonds	1.0%	4.9%	4.8%
International Bonds	1.5%	5.1%	4.5%
Cash	0.1%	0.3%	1.2%

To 31 December 2020 in AUD terms.

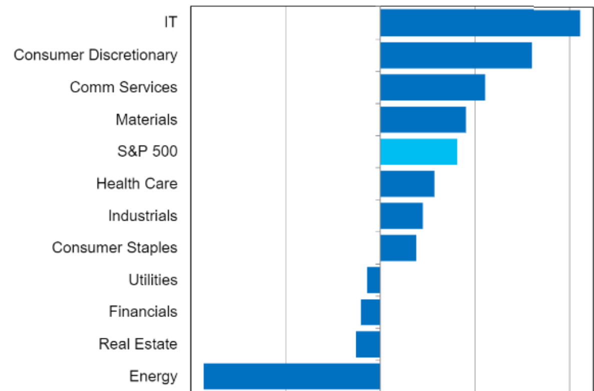
Financial Markets

Share markets generally look forward rather than focusing on the present and they enter 2021 with a strong sense of optimism for a rosier set of conditions 12 to 18 months from now. The following create the conditions to be positive about normalisation of daily life and a continued recovery in economic activity and corporate earnings:

- The incredible success of vaccine trials.
- A better understanding of the virus, how to manage it, and reducing virus related fear.
- Receding political uncertainty in the US and promises of substantially more stimulus from Democrats.
- The expectation of continued highly accommodative monetary policy.
- Strong forward looking (short term) economic indicator data and signs of pent-up demand.

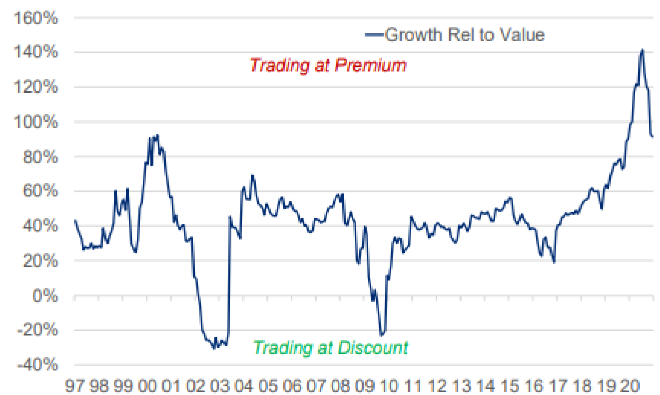


Whilst there has been a strong recovery in share market indexes, below the headline figures there are sizeable discrepancies between the winners vs the losers of the new world, and companies in essential sectors with reliable revenues vs economically sensitive sectors.



Source: Citi

Many of the sectors that have performed well since March 2020 were already expensive and have become more so resulting in an even more stark contrast when compared in valuation terms.



Source: Citi 8/1/21. Growth refers to companies that have strong outlooks and value refers to those that don't or have more economically sensitive businesses.

It is important to understand that part of the discrepancy is driven by differences in earnings forecasts (winners vs losers), and part driven by interest rates. Expectations of persistent low interest rates and indications from the US Federal Reserve (the Fed) that they will allow higher than normal inflation before unwinding monetary policy support further increases the attractiveness of all assets relative to bonds.

Investors are lowering the return hurdle (technically referred to as the discount rate) that they require to justify an investment in these other assets and this pushes up their valuation. However, it pushes up the valuation of high growth companies more because under the mechanics of valuation formula the value of long dated cash flow is worth more when interest rates are lower.

Cashflow in 10 years time	$100	
Value today - required investor return 10%	$39	
Value today - required investor return 7%	$51	+32%
Value today - required investor return 5%	$61	+59%

Cashflow in 15 years time	$100	
Value today - required investor return 10%	$24	
Value today - required investor return 7%	$36	+51%
Value today - required investor return 5%	$48	+201%

Whilst this is not unreasonable there are two issues. Firstly there is often a wild assumption that interest rates will not rise in the future (more discussion below), and secondly irrational fervour around certain sectors and companies that have sexy narratives has been driving an ever increasing cycle of analyst upgrades to long dated profits. Perceptions of valuation are being magnified further. Analysts struggle to accurately forecast earnings 12 months in advance let alone beyond five years.

This is particularly evident in the technology sector where extreme bubbles have emerged. Telsa is the poster child but there is a substantial group of these companies, including in the Australian market.

	Toyota	Tesla
Market capitalisation (USD $bn)	$250	$770
Vehicles produced 2020 (m)	8.5	0.5
Forecast profit FY24 (USD $m)	$21,541	$8,968
Price to earnings FY24	11.6	85.9

Based on share prices and consensus earnings forecasts as at 12/1/21.

We do not dispute that many of these have great products, that they will innovate and disrupt further, and they may one day be great businesses with excellent profitability. This is particularly the case for those that are in sectors where one or two winners will take the market. However, history suggests that most will turn out to be poor investments. Valuation matters and all rationality around this and the distinction between a good product, a good business, and a good investment has been lost.

In addition, various behaviour signals in markets indicate that the pot may be close to boiling over. Whilst this is concerning there are large parts of the sharemarket that are not in a bubble, and we take comfort when we focus on the fundamentals of the companies that you own.

The following have strong tailwinds, excellent market power and competitive advantages, are generally COVID winners and taking additional market share, are highly profitable, and have solid balance sheets. Their valuations may be elevated but they are far from extreme. They deserve to be more expensive in a world of low growth and low interest rates and given the aforementioned characteristics. Recent results have been superb and we are optimistic that momentum in underlying businesses will continue.

Company	Price to earnings	EPS - 3YR compound growth rate
Alphabet	28.2	17.8%
Coles	23.6	6.8%
Goodman	26.8	10.1%
Microsoft	30.3	15.0%
Netwealth	61.3	21.7%
Resmed	41.1	11.1%
Sonic Healthcare	19.1	9.8%
Visa	36.1	17.3%
Wesfarmers	27.6	3.9%

Based on share prices and consensus earnings forecasts as at 12/1/21.

Having said this we are acutely aware that a correction in overheated segments could drag the total market with it. We expect that any such event will be a temporary blip in a 10 year plus investment journey in these great companies and an excellent opportunity to increase exposure further, and hence a normal part of share market volatility.

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Inflation

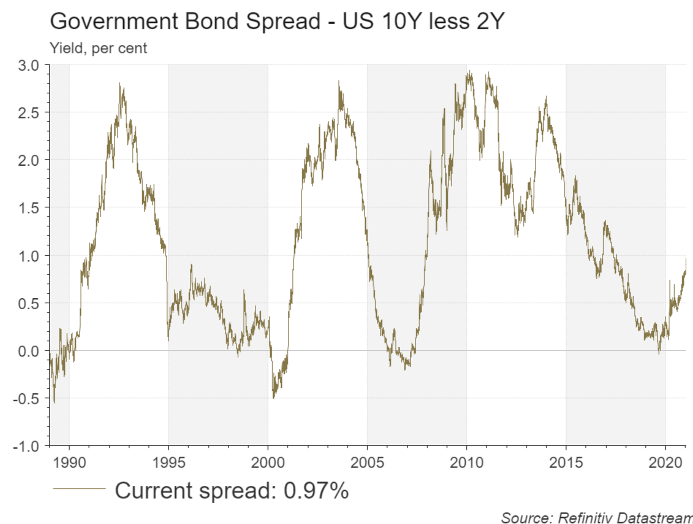
The most likely catalyst for a wash out of market excesses is changing expectations around inflation. The aforementioned relative attractiveness of assets vs bonds reverses if interest rates have to be raised to control inflation.

Central banks and governments are throwing the kitchen sink at fighting deflation and there is increasing willingness to push new boundaries to do so. They are facing strong headwinds including demand impacts from the virus and lockdowns, excess labour, too much debt, ageing populations, rising inequality, and technology driven productivity enhancements.

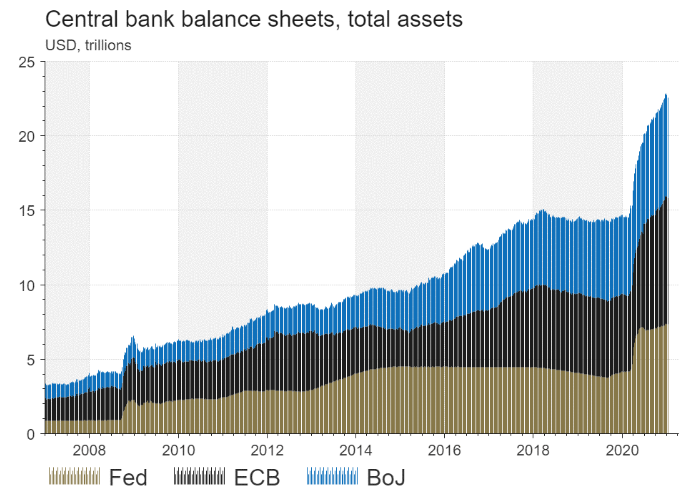
As discussed in our August 2019 newsletter there are views that we are at the beginning of a technology driven deflationary boom similar to the early 20th century when electricity, the lightbulb, the telephone and the automobile converged.

However, there is a risk to share and bond markets that central banks and governments do too good a job at stimulating the economy and inflation expectations gain momentum. Indeed, post the Democrats win of the Georgian run-off elections and subsequent promises from Biden to increase stimulus substantially ($1.9 trillion support package announced January 2021 and growth plans to be announced in February 2021) the narrative amongst market commentators has started to shift.

There are increasing expectations of inflationary pressures as stimulus intersects with the unleashing of pent-up demand as daily life normalises thanks to vaccines. This is evident in rising bond yields (prices of bonds go down when yields go up) and a quickly rising spread between the yields of long term and shorter-term bonds. This indicates rising optimism and inflation expectations.



Such is the newfound solidarity between governments to run large fiscal deficits (even the Germans are on board) and central bankers to print money and buy the debt to fund them that in our view higher inflation is a more probable risk than deflation, looking to the medium term. A period of low inflation between the GFC and COVID crisis, despite a never before seen quantum of money printing, has emboldened support for quantitative easing programs.



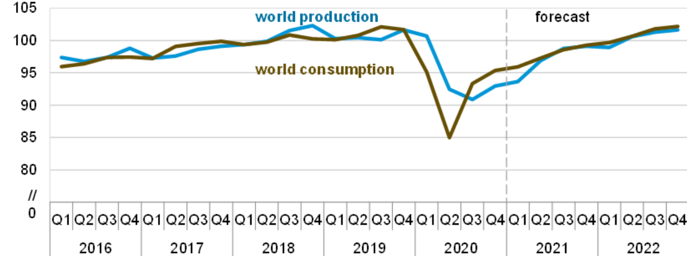
Outside of money printing and subsequent currency debasement there are also underlying inflationary drivers that may accelerate or emerge in the next five years. These include environmental sustainability policies, the rise of ESG (environmental, social, governance) investing and corporate responsibility, the impacts of geopolitical tensions including tariffs and the potential for western and Chinese supply chains to split, and inequality focused regulation including minimum wages.

In our role of following companies and markets we have observed an incredible rise in ESG focused investing over the past two years and money flows into funds focused on this has been accelerating. An increasing number of large companies now include ESG metrics in their reporting and are committing to carbon neutrality goals, albeit many are multi-decade based. Notwithstanding technology advancements are facilitating this shift there is potential for this to be a source of inflation. Historically being clean and good is more expensive and these costs should ultimately be passed on to the consumer.

Tensions between the west and China are increasing. Under the Trump-Pompeo Administration restrictions on Chinese companies, and particularly technology companies continued to ramp up in the last months of their office. The Biden administration is not expected to soften its stance substantially although there is high hope for a conciliatory approach.

There are views that if tensions escalate further there will be a genuine imperative for companies to shift their supply chains out of China and the world may split into a western linked supply chain and a China linked supply chain. This could be devastating for the Chinese economy and very positive for jobs in other alternative low wage emerging economies and result in a partial rebirth of manufacturing in western economies. However, a loss of economies of scale and accumulated productivity benefits, and increased regulatory compliance and (on balance) labour costs have the potential to create inflationary pressures. In flooding the world with cheap goods China has been an exporter of deflation for decades. The implications of a reversal of this could be meaningful.

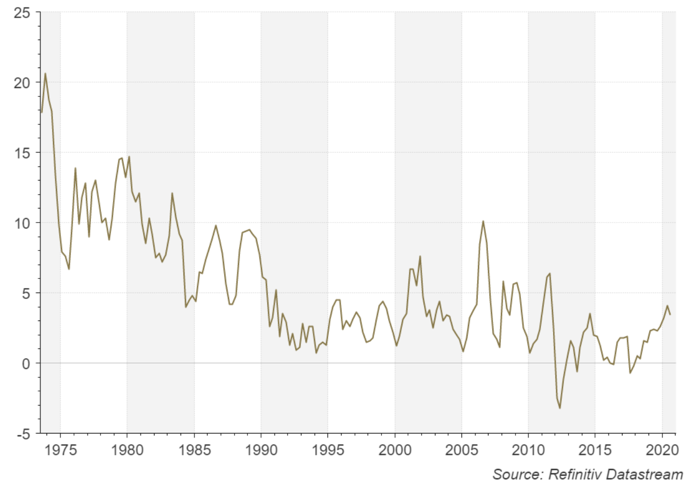
Oil is an input into the cost of everything and consequently rising prices are inflationary. Recovering global demand, production cuts from OPEC+ (mainly Saudi Arabia and Russia) and reduced production from non-OPEC countries (mainly US shale) is resulting in a rebalancing of the market. The world consumed an average of 92.2m barrels a day in 2020 vs 101.2m in 2019. It is estimated that a global inventory build of 3.3m barrels a day through to the end of May 2020 has now been reduced to 1.9m barrels a day.



Source: US Energy Information Administration 12/1/21

OPEC+ policy and adherence to this remains an ongoing wildcard. It is estimated that members will have ~5m barrels a day of excess production capacity in 2021 vs average global demand of ~98m barrels a day. Hence there is an ability to put strong downward pressure on prices if they choose to. Obviously the success of vaccine rollouts and the path to normalisation of daily life activities is key to realising a demand recovery.

Food prices could also be a structural source of inflation in the future and are important to watch. However, this may be more of a long-term issue and environmental change impacts could be offset by technology advancements. We are not across the detail but our perception is that current inflationary pressures are more transitory, such as availability of fruit pickers in Australia which is heavily supported by backpackers.

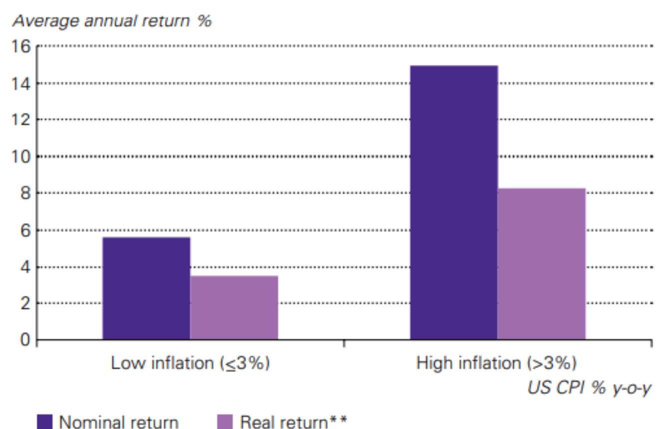


It may be less easy for central banks to manage these types of inflationary sources than reversing the liquidity driven inflation that they have created through monetary policy actions.

Notwithstanding this the tools at their disposal to combat inflation are more substantive than they have ever been given flexibilities around how they unwind the policies they have put in place.

One scenario that is possible is that global debt levels place a cap on inflation that allows an extension of the deficit and money printing experiment we are in. Higher interest costs from rising bonds is deflationary in itself as it reduces cash flow available to fund growth and consume. However, growing debt increases risks when (not if) inflation does re-emerge in earnest.

Increased money printing and higher inflation risk is the basis for our decision to begin to accumulate a position in gold which remains both an alternative currency and a finite resource.



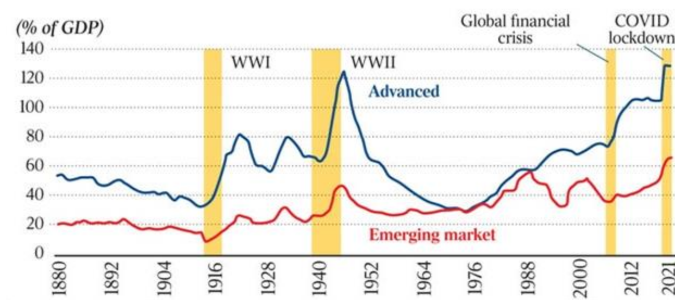
Source: World Gold Council, 1971 to 2019

We will leave Bitcoin, now being referred to as 'digital gold', to others. The formula that limits its supply could be changed and new cryptocurrencies continue to be created, to this day it is unknown who created and controls it, and it is likely to be regulated into obscurity by nations who see it as a threat to their sovereignty. This doesn't bode well.

Ultimately the combination of inflation and keeping real interest rates (cost of borrowing less inflation) low or negative may be the only way out of the global debt malaise. Indeed this is what governments are doing. The real yield on 10 year government treasuries around the world is as follows. Wealth is effectively being transferred from savers to borrowers.

%	10YR yield	CPI	Real yield (cost of borrowing)
US	1.1	1.4	**-0.3**
Germany	-0.5	-0.3	**-0.2**
UK	0.3	0.3	**0.0**
Japan	0.0	-1.0	**1.0**
Australia	1.1	0.7	**0.4**

Keeping interest rates low and creating some inflation also provides the benefit of lower interest costs, higher taxes and higher GDP which assists in reducing the relative debt load. As such central banks do want inflation to be towards the top end of their targets or slightly more. Inflation assisted with working down debt loads after World War II albeit strong demographic tailwinds (baby boomers) also assisted, and they lost control in the sixties and seventies and had to ratchet interest rates up aggressively. This is a key medium to long term risk.

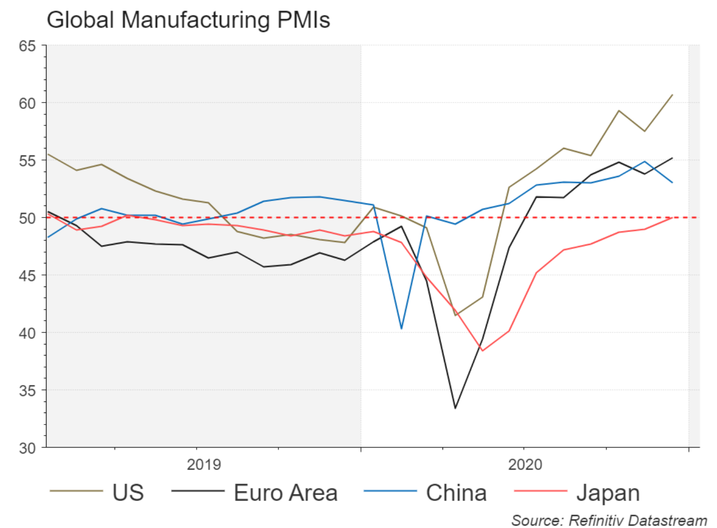


Source: The Australian, IMF July 2020

We remain of the view that increased taxation will be required to reduce debt loads. There seems no substantial appetite at this stage although European taxes on technology companies and the policy agenda of the Biden administration indicate starting points.

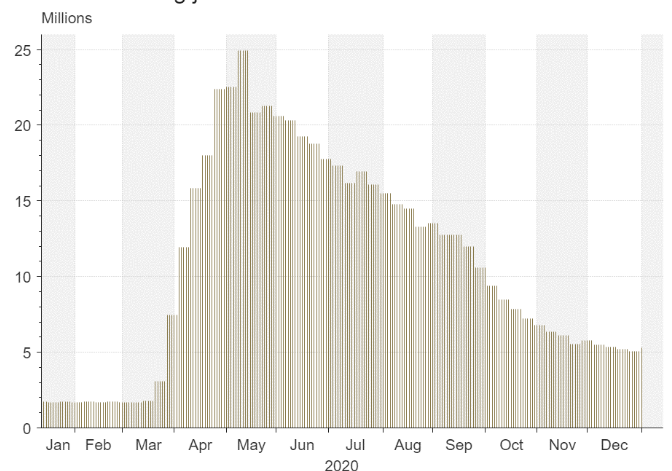
Economic Outlook

Leading economic indicators generally strengthened through the second half of 2020. This was assisted by government support programs combined with reducing restrictions on activity, albeit there was some re-emergence of restrictions in the northern hemisphere late in the year.



To December 2020. Above 50 indicates economic expansion and below 50 contraction.

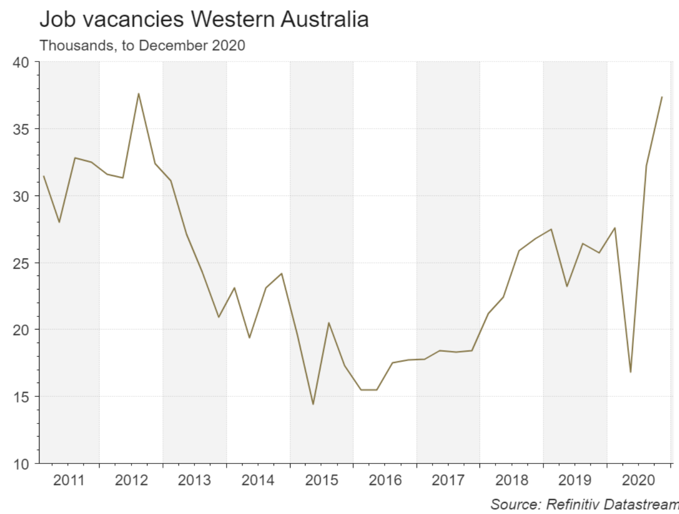
This support has reduced potential structural economic damage and allowed for a quicker recovery in jobs, notwithstanding that numbers continue to be masked by employment retention policies such as the Paycheck Protection Program in the US and JobKeeper in Australia.



We do not subscribe to views that governments will abruptly end support programs and allow sentiment to drift and unemployment to begin rising again. This is a nonsense. It is highly probable that they will continue to run budget deficits and unwind these when self-supporting economic activity can fully resume.

Herd immunity, whether acquired artificially through vaccines (more below) or naturally is a pre-requisite to this for as long as governments persist with containment strategies. To this end there is some risk that the Biden Administration seeks to impose more draconian measures. Financial markets would not react positively to this.

In Australia governments are persisting with a virus elimination policy and success in doing so has emboldened proponents of this approach. We are certainly enjoying the fruits of this success in Western Australia with daily life activities able to return to normal quickly and a commodities and housing construction driven employment boom.



As we have been forecasting for some years the Australian Federal Government has used its strong balance sheet to support the economy in the event of a global shock. The Australian Treasury forecast net debt to GDP forecast to be 34.5% at June 2021, rising to 43.0% by June 2024, before starting to drift downwards. This remains moderate relative to global peers.

Homebuilding incentives outlined in our July 2020 newsletter have kickstarted construction activity which is so important to employment, and whilst figures remain vague reports suggest that returning Australians are filling some of the void of demand from immigration. Clarity on immigration policy remains key to the economic outlook for Australia.

Offsetting this the cumulative impacts of the trade dispute with China may begin to weigh on the Australian economy at some stage. Our top 25 exports and services to China accounted for nearly 10% of national GDP in 2019 and excluding iron ore nearly 6%. More commoditised sectors that have been targeted may be able to easily place their product into alternative markets and avoid job impacts.

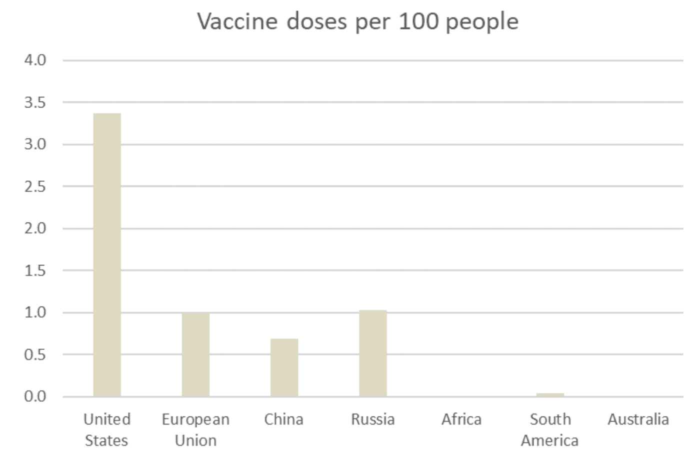
Surprisingly the data below suggests the removal of Chinese capital flows does not represent as substantial a risk to economic activity as one may have expected. Of the ~$3.8 trillion of foreign investment in Australia less than 6% is from China and Hong Kong.

Country	%
United States	25.6
United Kingdom	17.8
Belgium	9.1
Japan	6.3
China and Hong Kong	5.7
All other	35.5

Source: Department of Foreign Affairs, May 2020. Includes direct, financial asset and other investments. Belgium hosts a major clearing house for Euro denominated Australian debt.

Vaccine Rollout

The pace and effectiveness of the rollout of vaccines in the developed world is critical to the economic and financial market outlook. Sadly, it would seem that in the undeveloped and developing world herd immunity is more likely to be reached naturally before vaccines can arrive. In any case economic impacts are less relevant to financial markets that callously focus on developed world corporate earnings.



Source: University of Oxford Open World in Data, as at 14/1/21

Commentary suggests that there is increasing potential for mutations to become more resistant to current vaccines, and additionally it is possible that vaccine rollouts accelerate the mutations. At present there is confidence that the Pfizer and Moderna mRNA technology based vaccines can be adjusted relatively easily as these occur, but this is less the case for alternative technologies such as Astrazenca's adenovirus based vaccine.

The issue with this is that the mRNA based vaccines are not presently a global solution as they come with production and logistical challenges. Pfizer is targeting 2bn doses in 2021, but two doses are required per person and the longevity of protection remains uncertain. There are also issues with storage given -70°C temperature is required to maintain stability.

Similarly Moderna is targeting 600m to 1bn doses in 2021 but two doses are also required. Temperature control is less of an issue with stability at +2°C to +8°C, but there are questions around longevity of antibodies created and its inexperience in manufacturing vaccines at scale.

Trial results from Astrazenca suggest 70% to 90% efficacy versus ~95% efficacy for the above mRNA based vaccines. However, it can scale more quickly as it uses more traditional vaccine technology, is much lower cost and can be stored at 2°C to 8°C for up to six months. It is currently considered the best mass market solution amongst the three western world vaccines that are currently receiving approvals from health authorities.

There are a total of six vaccines emanating from China, Russia and India that have received approvals in their country of origin and a small number of other places. Some of these are also claimed to have high efficacy.

Looking forward there are currently 173 vaccine candidates in pre-clinical trial development and 63 in various stages of clinical trials across 10 technology platforms, including 16 with Phase III programs.

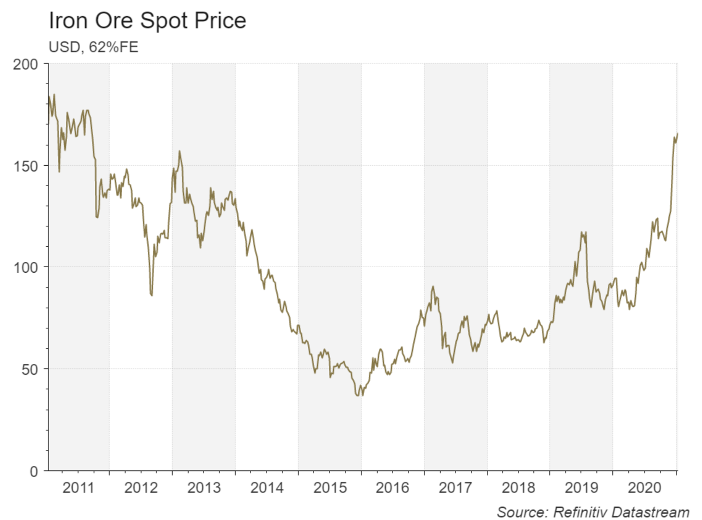
We believe that the breathtaking success of vaccine trials announced in November 2020 was a game changer for the economic outlook, as per the reaction of share markets. However, this is a moving ball and rollout, take-up, efficacy and long-term health side effects will be ongoing uncertainties. This will be difficult to monitor given scientific complexity and a degree of speculation will remain.

At this stage the Australian government has contracted for 10m doses of the Pfizer vaccine and 53.8m of the Astrazenca vaccine. Rollout will begin in February 2021.

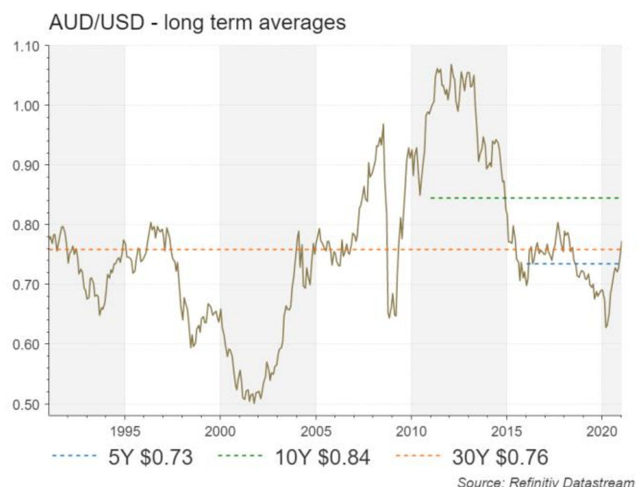
Australian Dollar
As the global economic recovery gathers pace there is an increasing expectation that funds will flow out of the USD, the world's safe haven reserve currency, and into higher risk currencies. The potential for capital to shift into alternative asset markets and increased currency hedging may exacerbate this.

This, combined with relatively less money printing, a stronger economic outlook thanks to virus containment to date, very strong commodity prices and government stimulus backed by a healthy government balance sheet, could result in continued appreciation of the AUD.

The impact of commodity prices should not be underestimated. The Chinese are spending on infrastructure again (albeit more digitally focused) and there seems to be greater potential for talk about infrastructure stimulus in the US and Europe to translate into actual activity. These may continue to place upward pressure on commodity prices and the AUD. Copper prices are elevated and futures for 62% FE iron ore are now above US$120 all the way out to June 2022.



Overall we maintain a balanced view of the outlook for the AUD but see a possible scenario where it continues to appreciate in the short to medium term. However, so called tail risk is heightened at present given the complexity of issues that the world currently faces. Additionally it is possible that the Fed begins to change its language around the timing of monetary support unwinding sooner than expected as the quantum of stimulus the Democrats rolls out accelerates. This could drive flows back to the USD.



Concluding Remarks

As illustrated by the above commentary the environment we find ourselves in is very complex. Virus, political, geopolitical, regulatory, technological disruption and behavioural change impacts overlay challenging financial market and economic outlooks. Core structural issues of too much debt and too many people relative to jobs and sustainability remain unresolved.

Whilst it is important to stay abreast of this landscape and understand how it impacts your portfolio it is very difficult to forecast the path forward.

We feel that it is important to recognise that everything is just a cycle and life will go on regardless of the conditions. To this end we feel that it is critical to bring ourselves back to the fundamentals of the assets we are investing in. We constantly ask ourselves whether the companies you own are world class, are financially robust, and do their earnings outlooks justify their valuations.

For the vast majority the answer is yes (unfortunately there are always a couple of laggards in portfolios). This gives us strong confidence that individual long-term investment cases are intact and can translate to reasonable risk adjusted returns over the investment cycle. However, there will be surprises and as such a balanced view of the outlook and diversification are very important.

The alternatives of cash, term deposits and long-dated fixed rate bonds remain highly unattractive and are increasingly at risk of being wealth destructive in a world where higher inflation may be a growing possibility in the medium term. At current returns they are only useful for providing short term protection against volatility or if deflation takes hold.

We continue to consider the management of your portfolio in deflationary, high inflation and potentially stagflationary (high inflation, low growth) environments.

In addition to quality, valuation, and diversification we remain highly focused on investment liquidity to ensure that there is an ability to pivot if there is a sudden change in the fundamental outlook.

A largely unhedged exposure to foreign currencies (mainly USD on a look through basis) also assists with protecting your capital from so called tail risks. As discussed in our July 2020 newsletter we now have a more balanced view of the outlook for the AUD, although if the recovery continues it is probable that it continues to appreciate and be a headwind to portfolio returns.

Outperformance of cyclical companies and sectors heavily impacted by lockdowns and border closures is also likely to result in under-performance of your portfolio (potentially substantially in combination with an appreciating AUD) as shorter-term focused investors continue to rotate to these.

This could accelerate if uncertainty around key events and issues lift, such as; the transition of power to Biden; real evidence of a transition to more diplomatic US foreign policy and a cooling of US-China relations occurs; the Biden Administration and European governments announce hard details of infrastructure plans; vaccine rollout programs gather pace and show evidence that they are working; and scientists provide confidence that there are solutions to virus mutations.

We view the potential outperformance in cyclical and heavily impacted companies in this perfect recovery scenario as temporary and have strong confidence that advantage companies with extremely high quality investment cases will provide superior returns with lower risk over the long-term (10 years+).

We will continue to take a measured and active approach to the quantum of exposure to shares relative to defensive investments to provide some protection from short term share market volatility. Your agreed investment strategy sets the guidelines for how this is managed.

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