logical financial management

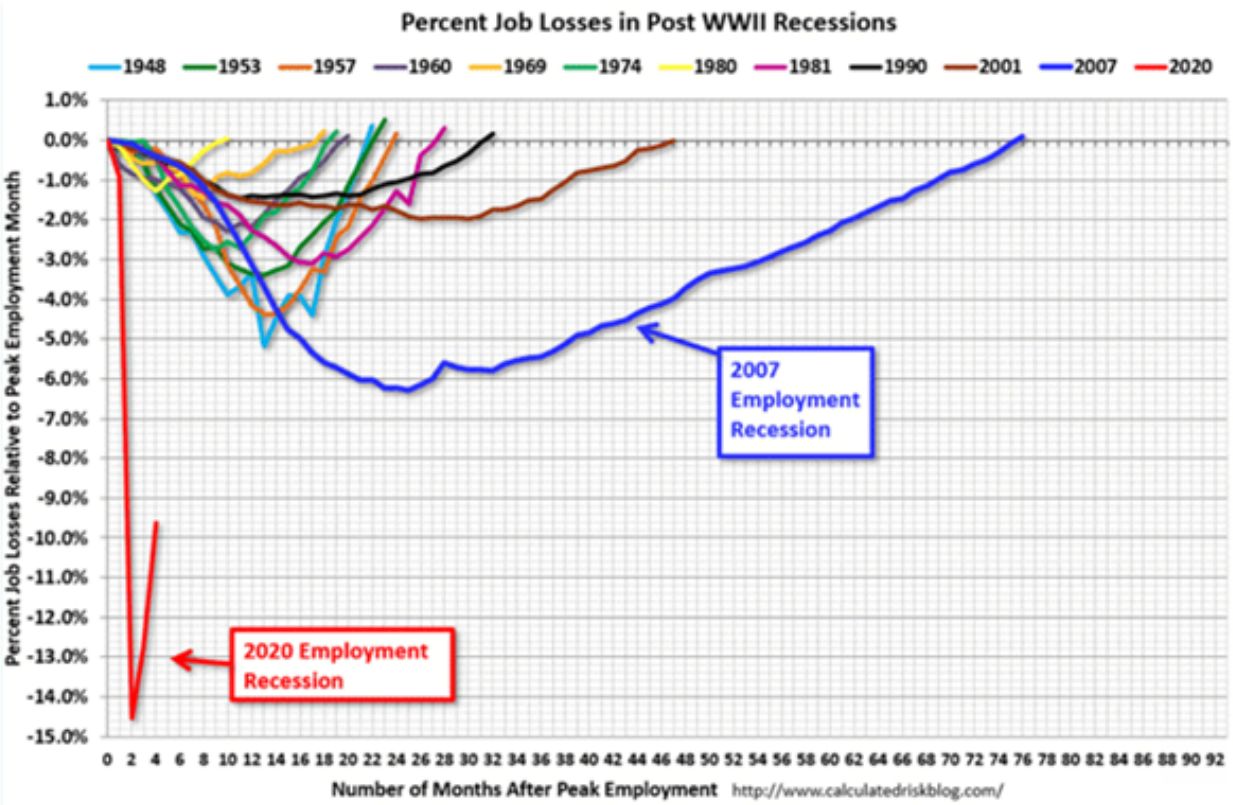
Logical Thoughts

TECH IN THE US AND THE ECONOMIC REALITY

The performance of S&P 500 US index is at odds with economic reality

There is a common misconception that the health of a stock market is always representative of the underlying economy. This is understandable, given wider macroeconomic conditions are circularly tied to the revenue, earnings/profit and cash flow of companies listed on an exchange — the key determinants of what the companies are worth, in turn make up the stock market. **However, there are times when a stock market's health is completely divorced from economic reality.**

You need to look no further than the current US job numbers to understand the disconnect between the US economy and US share market (S&P 500). The red line below shows the current pandemic and employment recession. While it seems to have hit the bottom, it is a long way back when the virus continues to threaten. Many companies will never return. If the experience of 2007-09 (GFC) is repeated where job creation took 76 months to recover, the US is looking to 2026 or 2027 to return to normal. That does not sound like much of a "V" shaped recovery, especially when about c. 33 million Americans are receiving unemployment payments, or c. 24% of workers, but the official unemployment rate is only 11%.



Source: Calculated Risk

While the US is in an employment recession, the S&P 500 index (USD) continues to set daily all-time highs. Judging by its performance since the start of 2020, and especially since the COVID-induced depth in late March, one may be forgiven for thinking "What virus?" or "What recession?". But delve a little deeper and from an Australian perspective you will find the resilience of the S&P 500 has been driven by the **Australian dollar and the technology sector in the US**.

Australian Dollar

The strength in performance of the S&P 500 has largely been determined by whether a portfolio was unhedged, hedged or partially hedged.

When the Australian dollar (AUD) is depreciating (falling), the returns from international share portfolios are enhanced if the portfolio is unhedged. When the Australian dollar is strongly appreciating (the last four to five months), then to avoid currency losses, it is better to have currency management (hedged/partially hedged back in AUD) in place.

Initial Onset Of The Covid-19 Pandemic

During the COVID-19 crisis the Australian dollar relative to the US dollar fell back to c. USD 0.55 (levels not seen since December 2002) and unhedged international share portfolios were provided with substantial currency gains that cushioned all the negative returns from the S&P 500 over this period.

For example, an unhedged S&P 500 portfolio over the 12 months to the end of March 2020, returned +7.96%, currency added a return +13.60% (remember: though the AUD fell against the USD, it enhances (+) performance for an unhedged portfolio). In this case, you are fully exposed to exchange rate fluctuations on your investments (see table below).

However, a hedged S&P 500 portfolio over the same period returned -8.44%, as the introduction of a hedge on the S&P 500 portfolio reduced the impact of exchange rate fluctuations (AUD/USD) on investments. In this case the returns of the portfolio were driven only by the underlying assets and not by exchange rate movements (see table below).

Rebound In Markets Post The Initial Onset Of Covid-19

On the back of rising commodity prices and a weak USD, the AUD against USD has risen 16.51% in the last four months (as at end July 2020). A rising AUD will enhance performance if a portfolio is hedged. On a hedged basis, the S&P 500 generated a total return in AUDs over the last 4 months of 22.78% with a large proportion of that gain being driven by currency (see table below). However, if a S&P 500 portfolio remained unhedged, then a rising AUD detracted from performance and the portfolio returned only +8.68% over the same period.

S&P 500 - Total Return

(12 months to end March 2020 - Falling AUD)

PERIOD RETURNS		
For Periods Ending 31 March 2020		
APIR Code	Product Name	1 Year
IHVV	iShares S&P 500 AUD Hedged ETF	-8.44
-	S&P 500 TR Index AUD	7.96
-	AUD/USD Spot Rate	-13.60

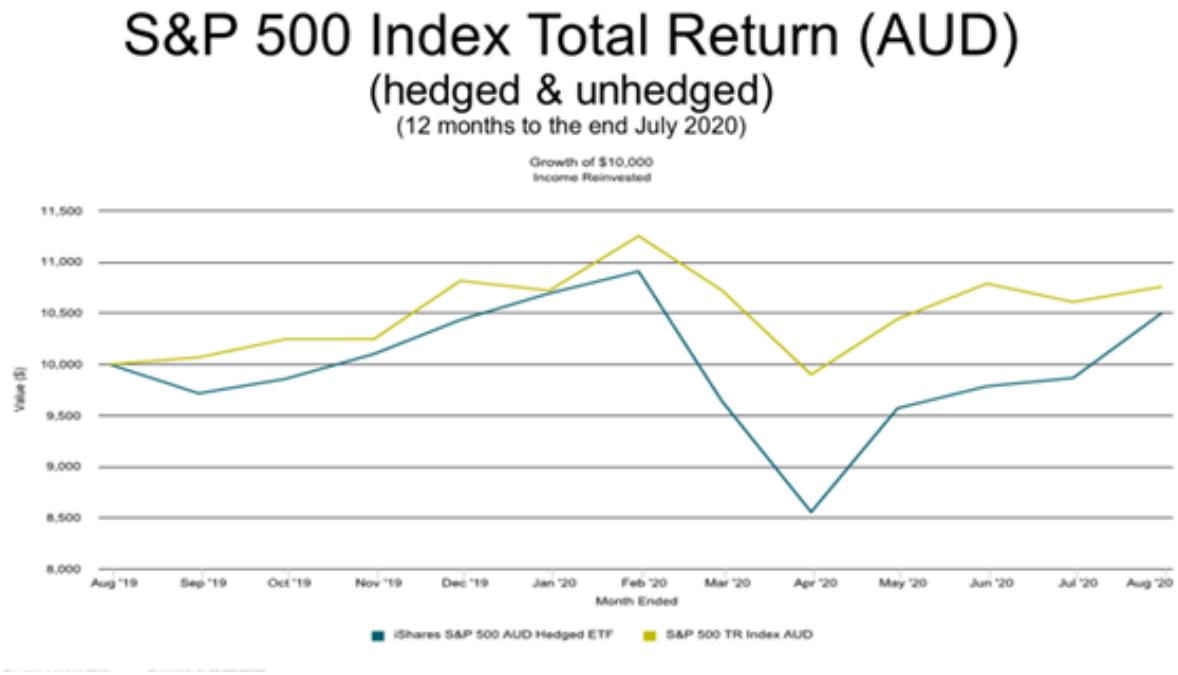
(4 months to end July 2020 - Rising AUD)

PERIOD RETURNS		
For Periods Ending 31 July 2020		
APIR Code	Product Name	4 Months
IHVV	iShares S&P 500 AUD Hedged ETF	22.78
-	S&P 500 TR Index AUD	8.68
-	AUD/USD Spot Rate	16.51

Investment of $10,000 in S&P 500 (hedged and unhedged)

The chart below highlights some of the following key points:

- Due to the appreciating AUD against USD, a hedged portfolio is recovering the initial COVID-19 losses at a faster rate than an unhedged portfolio.
- Both portfolios are yet to erase all losses from the sell-off in COVID-19, even though in USD the S&P 500 continues to hit all-time highs.
- In the initial COVID-19 sell off, the value of the unhedged portfolio fell less than the hedged portfolio due to the fall in the AUD.



The final point we should make on currency is this:

Over short time frames the disparity between the returns of a hedged vs unhedged portfolio can be wide as we have shown, however, over long time frames this disparity reduces significantly.

US Tech Stocks

Besides the Australian dollar (hedged), the resilience of S&P 500 has almost entirely been underpinned by the technology sector. The “can do no wrong” cohort have returned 20.40% so far this calendar year (versus S&P 500 of 2.38%) and now makes up 27.5% of the US index) on a market capitalisation-weighted basis, nearly double the next largest, the Health Care sector, which has a 14.6% weighting.

As of March 31, 2020, the following are the twenty largest S&P 500 index constituents by market capitalisation, with the 5 largest technology stock contributors to performance noted in red:

1. Microsoft Corp
2. Apple Inc.
3. Amazon.com Inc
4. Facebook Inc
5. Berkshire Hathaway
6. Alphabet Inc- A shares and Alphabet Inc- C shares
7. Johnson & Johnson
8. JP Morgan Chase & Co
9. Visa Inc.
10. Procter & Gamble Company
11. Mastercard Inc.
12. Intel Corp.
13. UnitedHealth Group
14. Bank of America
15. AT&T Inc.
16. Home Depot
17. Exxon Mobil
18. Walt Disney Company
19. Verizon Communications
20. Coca-Cola Company

"Year-to-date, two-thirds of the move in the S&P 500 can be explained by just five stocks: ***Facebook, Apple, Amazon, Alphabet (Google) and Microsoft.***

Market leadership has never been this narrow in the US. Market cap concentration is at a 30-year extreme, as is breadth – currently only 20% of stocks are outperforming the index". (Jacob Mitchell, Chief Investment Officer & Lead Portfolio Manager - Antipodes).

It is worth noting that Jacob warns that these extremes have historically signalled a turning point in markets "where less popular, lower multiple stocks begin to outperform the current winners – typically coincide with a cyclical economic rebound, combined with some larger shift in the underlying investment cycle such as when the commodities super-cycle replaced the dot-com bubble".

Putting this into perspective, in Australia, the technology sector's influence on the S&P/ASX 200 index is small by comparison, it represents only 3.6% of the Australian share market.
The reality is, the composition of the Australian market is still in the shape of a barbell, with financial services to the left (26.8% of the S&P/ASX 200 market capitalisation), resources/ basic materials to the right (24.3%) and healthcare stuck in the middle (11.7%).

Granted, the S&P/ASX 200 benchmark return of negative -9.9% (12 months to the end of July 2020) has lagged the S&P 500's positive +7.96% (unhedged, AUD), but it is still a commendable performance given the absence of the giant technology stocks such as Microsoft + FAANG stocks and our high exposure to banks in Australia (note, the share prices for NAB, ANZ and Westpac are all still around c. 40% below the peaks hit in late February this year….CBA 20%).

"This month, Commonwealth Bank reported an 11 per cent fall in full-year earnings and cut its dividend by 31 per cent. Earnings for ANZ, NAB and Westpac have all retreated in 2020 with NAB and ANZ cutting their interim dividends by 70 per cent while Westpac cancelled it altogether" (leading bank analyst - Brian Johnson).

Final Comments

In the U.S there is a large discrepancy between the share market (S&P 500 Index) and underlying economic data. The S&P 500 (USD) continues to set daily all-time highs despite economic data in the US revealing a continued historically high level of unemployment rate, whilst second quarter GDP fell at an annualised rate of 32.9%, the largest recorded annualised fall in history. So, is this trend likely to continue and should our clients be concerned with the stark contrast in share market and economic performance and possible impact on their portfolio?

As discussed, the US share market (AUD) is being driven higher by our Australian dollar (hedged) and five technology stocks. The result is US growth stocks like Apple now seem expensive, but that depends on how you look at it. So, are these trends likely to continue – and how should our client's position across different equity investment styles?

At Logical we believe that volatility will stay elevated and market risks are much greater today, given valuations, macroeconomic and regulatory risks (such as potential legislation for the technology industry). It is for this reason that we intelligently diversify across international shares and include specialist investment managers with different investment styles (growth, value, core).

We include growth managers that invest in companies with solid balance sheets and low levels of debt that do not depend on the economic cycle for growth candidates to pull through a crisis. On the value side, we include value managers who look for stocks with attractive valuations (often unloved) that have high quality balance sheets and cash flows and low price to earnings.

If there is a correction, whether it is in the broader market or technology stocks we are more than hopeful that the other assets in your portfolio should absorb the volatility and hopefully generate positive total returns.

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Gavin brings with him a wealth of knowledge and experience, including:

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