logical
financial management

Logical Thoughts

YEAR IN REVIEW: TALE OF TWO HALVES

Our last 'Logical Thoughts' for 2020 looks at the year that was and the recent shift in market leadership as investors rotated out of growth stocks into value stocks. Finally, it provides you with our investment thoughts for 2021.

Introduction

2020 was the year when several records were broken. New peaks were achieved early in the new year; the fastest bear market (-20%) in history in March; the fastest run to bull territory (+20%) between April and May; and the best November performances for many global markets, with new all-time highs being registered in US markets.

It was a year of trials and tribulations, where patience was tested but those clients in for the long haul were ultimately relieved and rewarded. April provided some rare opportunities for those investment managers who stayed composed and invested rationally.

The COVID-19 crisis and market dislocation has presented the best investment opportunities of the past decade and in some cases the last 20 years. Investing is a test of endurance and 2020 proved to be one of the most challenging in many decades. Despair and then euphoria.

2021 is unlikely to be a repeat. Markets could begin the year with an extension of the current upswing, but as it unfolds several questions will undoubtedly be asked about the progress of the economic recovery and the relationship to risk asset (shares, property, infrastructure etc.) valuations.

Market environment

The new year will launch off an elevated platform for market indices. All US indices are currently at or near record levels. Expectations are sky high as investors ignore any semblance of bad or disappointing news. The US November jobs report was a classic example. Despite non-farm job creation of 245,000 meaningfully missing expectations of 460,000, investors were heartened the disappointment may, not will, ultimately force warring Democrats and Republicans to a stimulus deal which is now in its fifth month of negotiation. But as share prices continue to rise, so some valuations become even more stretched and therefore exposed and vulnerable to disappointment.

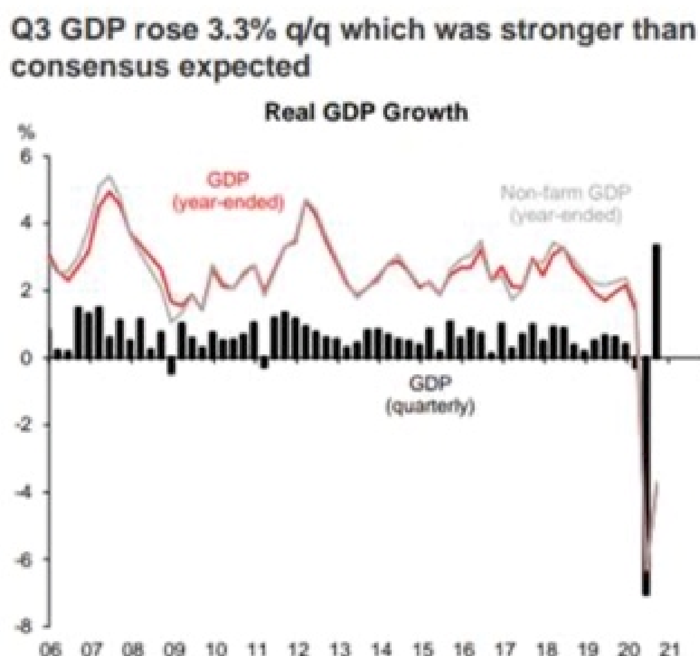
Other global markets are also elevated, most within 10% of their respective high-water marks and while momentum is still positive, failure of economies to respond to the availability of a vaccine in a sustainable manner could quite easily trigger a correction. Widespread vaccinations will be the key to halting the virus. All this as the rate of new infections surges to new peaks with the onset of colder weather in the northern hemisphere.

In most markets, a fully-fledged recovery is already priced in. Debt levels are at historical highs and continue to climb. Central bank action is encouraging risk taking on a wide scale and equity investors are embracing “there is no alternative” mantra while ignoring skinny low risk-adjusted returns. These returns are relative to low risk-free bond yields.

In Australia, the co-ordinated policy initiatives by the Government and Reserve Bank of Australia (RBA) has driven a strong recovery in our economy. The government’s fiscal policy has provided money to households and businesses to drive consumption and added jobs lost earlier in the year. While the RBA’s monetary policy of lower interest rates and quantitative easing has created jobs, stimulated economic activity and enabled wealth creation opportunities.

The effectiveness of these policies where confirmed in the latest gross domestic product (GDP) data for the September quarter, with our economy in recovery mode. Australia officially exited its technical recession and expanded by a robust 3.3%, well ahead of market forecasts of 2.5% and the highest quarterly rate since 1976 (44 years).

Driving this expansion was household consumption (+7.9%) after collapsing by 12.1% in the June quarter. The jump in household consumption, which makes up about 60% of GDP, was driven by a 9.8% increase in services spending. This included a 49.7% rise in hotels, cafes and restaurants as COVID-19 restrictions were eased (see chart below, source: ABS, Macquarie Macro Strategy). Not bad given that the economy contracted by -12.5% in the June quarter 2020. We expect strong growth ahead in 2021 and 2022 at around +4% per annum, assuming Covid-19 case numbers remain contained. The strength in iron ore prices is a key driver of net export growth but this is expected to pull back in 2021.



The underlying strength in the Australian economy is reflected in positive consumer sentiment data and Australian job advertisements.

Consumer confidence rose for the fourth consecutive month to its highest level since October 2010. The Westpac-Melbourne Institute Consumer Sentiment Index rose 4.1% in December, driven further by the news of a technical recession being over and better prospects for a vaccine. Business confidence, according to NAB survey (conducted Nov 17-27th), bounced back strongly to 12.4, well above the long-term average of 5, and business conditions hit 8.8, also well above long-term average of 5.2. Confidence is sitting at a 20-month high, whilst conditions are at a 31-month high.

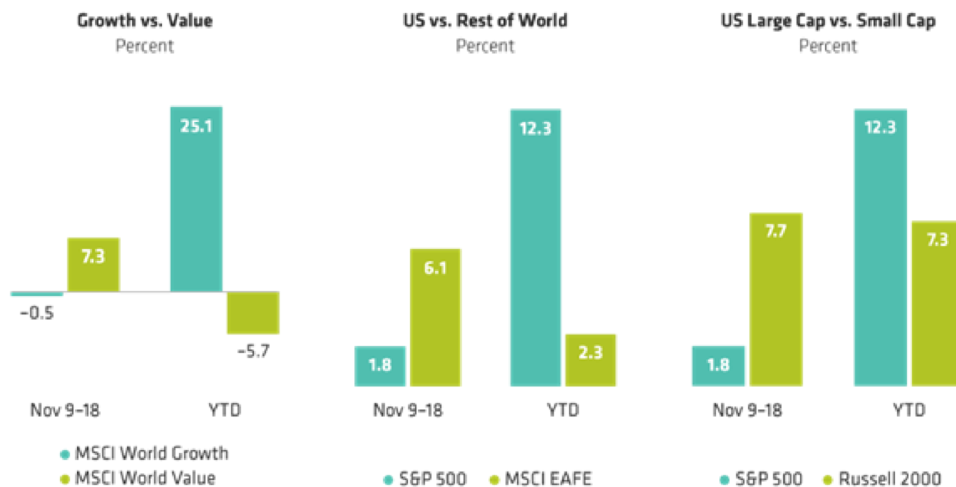
Australian job advertisements have had an impressive 'V' shape recovery with a 13.9% month on month in November 2020 (see chart on the next page).

Source: SEEK, Dept of Education Skills and Employment, Macrobond, ANZ Research

Investment style (Value vs Growth) rotation

In November 2020, a series of breakthroughs in the development of a COVID-19 vaccine from Pfizer/BioNTech and Moderna saw a sudden rotation in market leadership out of growth stocks into value stocks by investors. These value stocks were deemed to be well-positioned for the reopening of economies and the hope of a return to normality, while many growth stocks were sold off or underperformed their relevant benchmark (e.g. technology stocks, FAANGS etc.), value stocks rallied strongly (energy, resources and financials).

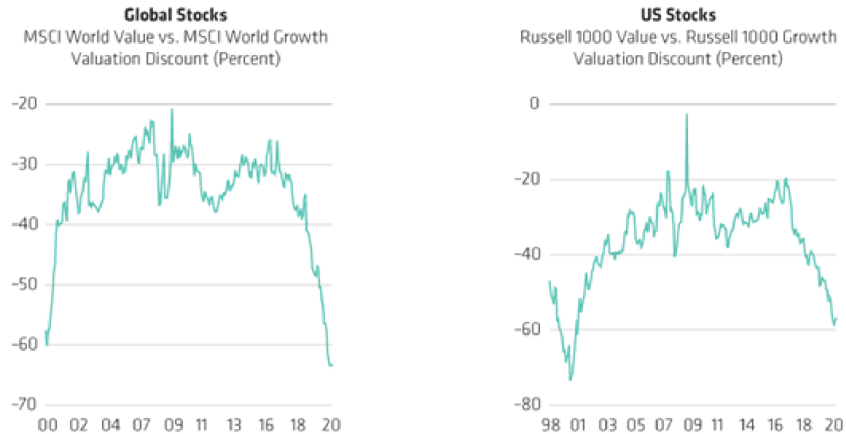
The Energy sector surged in most markets on the back of this news and in line with oil price increases, +34% in the US and +30% in Australia. Financials led the way within the Industrial segment of the market, gaining 16%, with the major banking benefiting from higher bond yields and amount of loans of deferral continuing to decline sharply.



Past performance does not guarantee future results.
As of November 18, 2020
Source: FTSE Russell, Morningstar, MSCI, S&P and AllianceBernstein (AB)

Before the recent shift, equity return patterns had created big imbalances in markets. In style terms, for example, by the end of October, the MSCI World Value was 63% cheaper than the MSCI World Growth, based on a combination of three value metrics: price/sales, price/cash flow and price/forward earnings. That's the deepest discount in 20 years. In the US, the Russell 1000 Value Index traded at a 57% discount to its growth counterpart —also close to historical low levels.

Before Vaccine News, Stock Market Valuations Looked Imbalanced



Historical analysis does not guarantee future results.
Through October 31, 2020
Valuation discount based on an average of price/sales ratio, price/cash-flow ratio and price/forward-earnings ratio. For global stocks, valuation discount and monthly percentile rank measured from May 31, 2000, to October 31, 2020. For US stocks, valuation discount and monthly percentile ranks measured from November 30, 1998, to October 31, 2020
Source: FactSet, FTSE Russell, MSCI and AllianceBernstein (AB)

This rotation is reflected in the November monthly performance numbers of many of the underlying equity investment managers and shares/ETFs in our portfolios. See the table below for some examples:

Manager/Stocks	November 2020 (1-month performance)	Sector/Style
L1 Capital Long Short Fund (flexible currency hedging)	30.8%	Value
Antipodes Global Fund (flexible currency hedging)	7.3%	Value
Woodside Petroleum	27.7%	Energy
ANZ Banking Group	20.4%	Financials
Westpac Banking Group	12.4%	Financials
iShares S&P/ASX 20	10.3%	ETF Top 20 by Market Capitalisation (value bias)
BHP Group Limited	12.7%	Resources
IML Equity Income Fund	10.8%	Value
Allan Gray Australian Equity Fund	18.0%	Value
SYD Airport	23.1%	Transport/infrastructure
Magellan Global Fund (unhedged)	-1.27%	Growth
Hyperion Small Growth Companies Fund	4.94%	Growth
Magellan Global Fund (100% hedged to $AUD)	3.30%	Growth
Munro Global Growth Fund (50% hedged to $AUD)	2.71%	Growth
Hyperion Australian Growth Companies Fund	5.61%	Growth

It's too soon to say for sure, but the vaccine news may well prolong a switch into stocks that are more sensitive to economic growth (value). Conversely, technology, health and consumer companies, which benefited from the effects of global lockdowns, might look less attractive in relative terms if economic life is likely to return to normal sooner rather than later (growth). This has significant implications for the performance of different sectors and regions, as well as for different style factors in our client portfolios.

Conclusion

- Momentum is clearly with equities and we expect equities to outperform bonds and cash entering 2021. Sustainability of the advance will be influenced by earnings and interest rate trends (watching for inflation trends). Any disappointing earnings results and higher interest rates will at some stage force stock prices down.
- We expect emerging markets to continue to outperform developed markets based on cheaper valuations and relative economic strength and weak US dollar.
- Current yields uptrend consistent with the increasingly decisive reflation trend, reflective of stronger economic growth. Although intervention by global Central banks will continue to place downward pressure on the yield curve.
- It is expected the Australian dollar will continue to strengthen against the US dollar in the short term on the back of stronger commodity prices, higher Australian yields, weaker US dollar and a more risk on environment in markets. As a result, it is widely thought that an Australian dollar above 75 cents to the US dollar will act to some degree as a brake on the Australian economy.
- It is likely stocks that are more sensitive to economic growth (value) will perform better than growth stocks in 2021. These sectors may include Energy, Infrastructure, REITs, Financials, and Industrials/Transport.

As with 2020, stay the course in 2021. It is imperative that investors look beyond the positive and negative commentary and concentrate on achieving long-term goals. Many adjectives and considerable emotive language have been used in 2020 to describe the outbreak, the vaccine, and their impact. All of these have the potential to impact significantly on your investment decisions. It's easy to be caught up in the noise and shot term market volatility and forget the big picture.

At Logical, we build bespoke investment portfolio strategies tailored to your circumstances and appropriately in line with specific objectives. We have incorporated international and domestic value manager(s) into your portfolio that provide diversification benefits across asset classes, sectors, stocks and time horizons. As proven in November, these value managers will add value to your portfolio at different stages of the business cycle and if as expected, will do so in 2021.

Gavin Shepherd
Portfolio Construction & Investment Research Manager

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

- Head of Multi Manager Strategies ING
- Head of Australian Equities ING
- Research Manager
- Economic Research Manager

Looking for Financial Advice?

In an ever increasingly complex financial and legislative world, our mission is to provide you with clear, concise and tailored strategic advice.

t 02 9328 3322
f 02 9328 3323
e team@lfma.com.au
w www.logicalfinancial.com.au

Suite 21, Level 2, 8 Hill Street,
Surry Hills NSW 2010
PO Box 103
Darlinghurst NSW 1300

DISCLAIMER: This newsletter contains information of a general nature only. The reader should not act on the information contained in this newsletter, but should seek professional advice tailored to their personal situation, needs and objectives. Whilst every care has been taken as to the accuracy of the contents published herein, no warranty is given, or liability accepted by Logical as to the correctness of the information.