Economic Snapshot

FY 2020/21 in review

CARDENA

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In summary

FY2020/21 was a dramatic year that started with serious concerns about public health and the global economy and finished on an optimistic note, delivering historic gains in equity markets along the way. Although Covid-19 continued to cause problems in many countries through the year, progress on developing and distributing vaccines helped mitigate concerns about the impact of further lockdowns.

Most importantly however, the massive fiscal and monetary stimulus applied across the world raised expectations of economic recovery. As the second half of 2020 unfolded the impact of this stimulus became apparent, with indicators of business conditions and activity improving and unemployment rates starting to fall. Equity market rallied further on this news. The election of President Biden, with the promise of more big fiscal packages, also helped push equity markets higher. Bond yields were drifting higher at the same time.

In the first half of 2021, markets started to worry that there might be too much growth and that economies could overheat and cause inflation. Bond yields rose quickly and there was a rotation within equity markets from growth stocks to value stocks. Banks outperformed strongly in this phase as yield curves steepened. Central banks, especially the US Federal Reserve, assured the markets there would be no sudden changes to monetary policy, but it is now expected that the normalisation of monetary policy from the emergency Covid-19 settings will begin sooner than previously expected.

Key investment themes/issues for FY2021/22 include:

- Central banks will begin normalising their monetary policy settings, starting with tapering their QE programs. This will have to be handled very carefully to avoid disrupting markets.
- Base case economic outlook suggests equities and credit will beat bonds, and the rotation from growth to value will continue.
- Returns across asset classes will be lower than in FY2020/21. In this environment, active management will be important.

Key risks include:

- If inflation goes up more than expected, both bond and equity markets would suffer.
- Success with global vaccination programs will be essential to put lockdowns behind us.
- If China's ambitions to take back Taiwan led to overt military action, equity markets would react very badly.

Key developments in FY2020/21

FY2020/21 was one of the most dramatic years we have ever seen. At the start of the year, there were many questions and concerns about how the global economy would be able to recover from the Covid-19 recession. By the end of the year, these had shifted to whether economies are now at risk of overheating and generating too much inflation. How did we get from one end of the spectrum to the other in so short a time and what did it mean for financial markets?

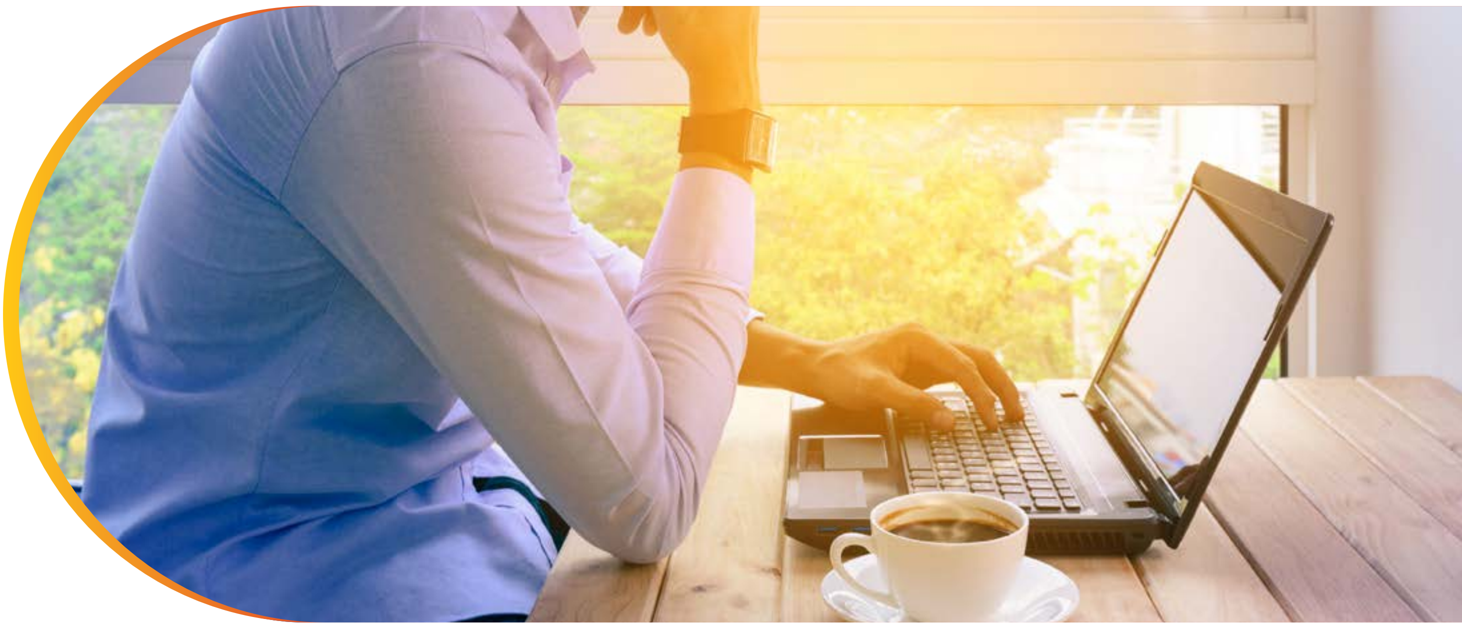
A year ago, it was already clear that central banks and governments would inject unprecedented amounts of stimulus into their economies. Interest rates had been cut to historic lows and budget deficits had ballooned, with the prospect of more to come. Financial markets, especially equities, had already reacted positively to this on the expectation that stimulus would deliver better growth, while at the same time, bond yields had also fallen to historic lows, which supported higher valuations.

However, it took a while for concerns about Covid-19, vaccinations, and economic growth to start to dissipate, especially as the virus continued to spread widely around the world. After a second wave here in Australia in Q3 2020, the infection rate declined and remained under control. However, in many countries including the US, UK, parts of Europe, Japan and India, infections rose dramatically and in multiple waves over several months. This led to lockdowns and restrictions of varying degrees, with the UK implementing an extended national hard lockdown, and the US adopting a very mixed regional approach. This naturally raised fears that economic activity would continue to be disrupted and that policy makers might run out to ammunition to counter this.

It was not until late in 2020 that there was enough good news about several successful vaccines, and signs of economic improvement, for the markets to gain enough confidence that the combination of policy measures and vaccines would be enough to overcome the impact of Covid-19. During this time markets were characterised by very low bond yields and higher equity prices. Within equities, there was pronounced outperformance by so-called growth stocks which tend to do better in slow growth, low inflation/low bond yield environments. This included many well-known tech stocks, especially those seen to benefit from the increase in working from home and online shopping. Conversely, stocks adversely impacted by this work and shopping trends, including REITs, underperformed. Bank stocks also lagged during this phase under the impact of flat yield curves and concerns about lending growth.

Commodities and resource stocks performed very well in this phase. This was partly due to weakness of the US$ caused by the Federal Reserve's ultra-easy monetary policy and partly by stimulus measures in other countries around the world. For example, strong demand for iron ore from China helped push the price of iron ore up by more than 100% in 2020/21. Naturally, this helped both our resource stocks and the A$/US$ which rose nearly 10% in the June-December period. The price of gold also did well, rising 25% over six months. This was partly due to the weaker US$, but also partly due to speculation that traditional currencies would be less reliable in a post-Covid-19 world.

Another phenomenon that took off in this phase was the rise of the online traders. Cooped up at home, with money to spare and cheap new trading platforms to choose from, these traders poured billions of dollars into the markets. Social media gossip fuelled the activity and created so-called "meme stocks". All this activity contributed to pushing equity market prices and valuations up to historic levels. However, equities were not the only focus of these traders' attention. Crypto currencies became hugely popular and attracted much debate and disagreement. Are they money? Are they safe investments? Are they the way of the future? Whatever the answer, the volatility of crypto currencies showed they are not for the faint-hearted. Their performance over the past six months has many of the hallmarks of speculative mania.



As 2020 ended equity markets were buoyed by signs of better economic performance – notably very high readings of business conditions and activity surveys as well as good progress on reducing unemployment rates. Adding to the positive sentiment was the fact that the US election was out of the way, as well as the promising news about vaccines. Biden made it clear during his campaign that he would be enacting major fiscal programs, of which the first is underway and a second was sent to Congress. This, plus ongoing loose monetary policy, the prospect of opening up economies and upward revisions to official economic forecasts, all helped investors start shifting their focus. In bond markets, investors started to worry that economies would overheat and cause inflation, leading to an earlier tightening of monetary policy than previously expected. From December through to March/April government bond yields in the US and Australia rose quickly to levels seen just before Covid-19 started. Part of this rise on bond yields reflected an increase in expectations of inflation in the US.

In equity markets, this environment produced a rotation away from the growth stocks noted above, towards value stocks, which benefit more from an environment of higher inflation and bond yields. The improved growth outlook also benefited cyclical stocks more than defensive stocks. In our equity market, banks did very well in this phase. Also, although equity indices, including the ASX200, posted new highs in this phase, stronger earnings growth allowed P/E ratios to ease back and start and unwinding some of the very high valuation that had concerned many investors.

Although iron ore rose further in the first half of 2021, the A$/US$ lost ground. After climbing as high as US$0.797 in late February, the currency finished June 2021 around US$0.752. Despite a brief rally in April and May, the price of gold maintained its overall decline from the peak seen in August last year.

Looking ahead

The coming year will hopefully be less eventful that FY2020/21, but there will still be important themes and issues for the markets to deal with, including:

- **Monetary policy:**
  - It is becoming increasingly apparent that conditions in Australia, the US, and other countries are improving faster than central banks had expected. As a result, there is active debate about how soon the RBA and the Fed will start to lift interest rates. The central banks had said this was unlikely to happen before 2023, but markets now expect rates to start going up next year. Before that happens, the central banks will have to start slowing the pace at which they are buying bonds in the open market. This is called "tapering" and, if not handled carefully, has the potential to disrupt not only the bond markets but also equity and currency markets. This will be a key issue to watch in the coming year.
- **Bond and credit markets**:
  - Economies are unlikely to slow down enough to cause bond yields to fall much if at all. With inflation risks probably skewed to the upside, central banks are moving ever closer to the point where they have to start normalising monetary policy. However, at this stage it seems likely that bond yields will not rise so much as to deliver large negative returns on bond portfolios. However, the returns are likely to be very low.
  - Credit is expected to do better than government bonds in line with equities outperforming, but also with relatively lower returns than last year.

- **Equity markets:**
  - Equities have had a great rally but now have to consider the balance between high valuations and stronger profits growth. As equities rallied ahead of the economic recoveries, P/E ratios have risen to historically high levels which may be hard to sustain in the face of higher bond yields as central banks start to wind back QE programs. Equities need enough profits growth to offset the risk to valuations. At times, this will be a tricky balancing act.
  - Other issues for equities to grapple with include global regulatory pressure on the big tech stocks and, in the US, policy moves by the Democrats to increase labour's share of national income at the expense of capital's share. This would result in lower future profits growth for the equity market.
  - If current conditions of cyclical economic recovery with modestly higher inflation continue, then it is likely the rotation from growth stocks to value stocks will continue in both domestic and international equity markets.
  - Overall, equities are likely to outperform bonds in the coming year, but overall returns from equities will be much lower than in 2020/21. There will also be bouts of volatility in equity markets from time to time.
  - Currency markets: monetary policy will probably be the key driver in the coming year. A simple rule of thumb will be those countries where growth and inflation require the central bank to tighten monetary policy faster will see their currencies rise.

- **Risks:**
  - Inflation: this is one of the biggest questions for 2021/22. Central banks are saying current inflationary pressures are transitory, but markets are aware of the risk that inflation proves more sustained and stronger. In that case, markets would price even more aggressive monetary tightening leading to higher bond yields, potentially lower equity prices and a higher currency for the country seen to be needing the most monetary tightening.
  - US fiscal policy: it is unclear just how big the next US fiscal package will be, but the larger it is and the sooner it starts, the greater the risk that the US economy does overheat and cause sustained inflationary pressures. That, in turn, would likely undermine bond and equity markets, as well as drive the US$ up.
  - Covid-19: markets are clearly much less concerned about Covid-19 now than they were a year ago. The Delta variant is causing some concern but not enough to derail economies and equity markets. However, the persistence and variability of Covid-19 reminds us of the risk that a vaccine resistant variant, or some problem with the distribution of vaccines, would likely cause volatility across markets.
  - China: the Communist Party has just celebrated its 100th anniversary amid much nationalistic rhetoric. China remains resolute in its determination to take back Taiwan, as well as assert itself as a global power. Global equity markets, especially in Asia, would react very badly to overt hostilities against Taiwan.

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