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Australian market commentary

The S&P/ASX 200 Accumulation Index returned 1.9% during the month. Australian equities were supported by the release of the Federal Budget early in the month which saw increased spending and tax cuts to aid the economy as it recovers. Australian equities outperformed developed markets during the month, as rising COVID-19 cases in Europe and the US weighed on those markets. In major global developed markets Japan's Nikkei 225 was down 0.9%, the US S&P 500 was down 2.7%, the UK's FTSE 100 was down 4.7% and the DJ Euro Stoxx 50 was down 7.3%.

In October, the Reserve Bank of Australia (RBA) reaffirmed its commitment to support the financial system through a historically low cash rate of 0.25% and yield curve control to keep 3-year bonds at 0.25%. The RBA's Term Funding Facility has extended AUD 83 billion in funds to date. These measures are intended to keep funding costs low and sustain credit availability.

Domestic economic data releases in October were somewhat better than expected. Employment fell by 29,500 positions in September, exceeding market expectations. The unemployment rate ticked up to 6.9%, which was also better than expected. The Q3 headline CPI rebounded, to be up 1.6% for the quarter, while the annual rate stands at 0.7% which was in line with consensus expectations. The NAB Survey of Business Conditions showed improvement, rising 6 points to 0 in September, with business confidence also rising to -4 (from -8). Retail sales were down 4.0% in August. National CoreLogic dwelling prices put the brakes on recent declines, ending the month up 0.2%.

Merger and acquisition (M&A) activity was on the rise in October, with Link Administrative Holdings receiving a non-binding indicative proposal from a consortium comprising Pacific Equity Partners and Carlyle Group to acquire 100% of the shares in Link Group. Coca-Cola Amatil announced that it had received a non-binding indicative proposal from Coca-Cola European Partners plc. On the last trading day of the month, AMP confirmed that it had received a non-binding, conditional proposal from US based private equity firm Ares Management to acquire 100% of the shares in AMP Limited.

Sector returns were mixed in October. The best performing sectors were information technology (9.0%), financials (6.3%) and consumer staples (4.8%). While delivering positive returns, consumer discretionary (1.5%), healthcare (1.2%) and real estate (0.2%) lagged the market. Communication services (-0.6%), energy (-0.8%), materials (-1.2%) and utilities (-1.5%) also underperformed the broader market. Industrials (-3.9%) was the worst performing sector.

Information technology was the best performing sector, unlike its US tech peers which underperformed. Key drivers of performance included Afterpay (20.9%), Xero (9.3%) and Link Administration (27.9%), with Link benefitting from a proposed takeover by a private equity consortium.

The financials sector also outperformed, driven by strong performance from the big four banks: ANZ (9.2%), Commonwealth Bank (8.5%), Westpac (6.4%) and National Australia Bank (4.8%). The banking sector was supported by the prospect of a loosening of responsible lending laws and expectations that bad debts may be better than first feared.

The consumer staples sector outperformed after lagging in September. Key contributors included Woolworths (4.7%), Coles (4.4%) and Coca-Cola Amatil (30.8%). The surge in Coca-Cola Amatil was driven by the proposed takeover offer received during the month.

The materials sector underperformed, as commodity prices eased slightly in October, with BHP (-5.1%) the biggest drag on sector performance. Newcrest Mining (-6.4%) and Rio Tinto (-2.0%) also underperformed.

The utilities sector underperformed with AGL Energy (-8.4%) and Spark Infrastructure (-3.2%) posting negative returns.

The industrials sector underperformed during October. Transurban Group (-4.6%), Sydney Airport (-7.0%) and Brambles (-8.6%) were the key drivers of sector underperformance.

Australian market outlook

The ongoing global COVID-19 situation remains fluid with some European countries locking back down due to the second and third waves whereas Australia and other countries are emerging from lockdowns. Many governments remain hopeful of a vaccine solution by late 2020 or early into 2021 to help allow a pathway back to normality.

Economic shocks like we are currently experiencing typically result in social and economic adjustments. Ultimately the impact on long-term earnings estimates and valuations will be a function of the depth, duration and damage inflicted during this period of enforced subdued activity.

Some of the more obvious potential transformations include the following:

1. Employees working from home for all or part of the week
2. Possible reduction in required office space, given the work from home theme
3. Reduction in the use of public transport and increase in car travel
4. Potential decline in business travel as virtual meetings increase on the back of improving technology
5. An accelerated shift in market share of e-commerce and omni-channel retail
6. Low interest rates and government stimulus that have been surprisingly positive for housing with early signs of increased interest in moving away from the inner CBD suburbs

It is still too early to be confident that these adjustments will be longstanding or perhaps a short-term minor adjustment.

The 2020/21 Federal budget delivered out of season in October was, as expected, one of the most stimulatory budgets we've ever seen. Echoing the RBA's explicit statement that reducing unemployment is a "national priority", the budget outlined a commitment to provide continuing extraordinary fiscal support until Australia's unemployment rate is below 6%. A broad strategy of spending to drive economic growth and job creation across many sectors via tax cuts, wage subsidies, infrastructure spending and investment incentives together with a boost to housing and a reboot to manufacturing. The spending was widespread across defence, health, technology, university research, the energy sector and in regional areas. The stimulus and low interest rates have helped the economy recover through the mandated COVID-19 shutdowns and early indications from the banks are that both consumers and small businesses are doing better than expected and thus the credit cycle expected sometime in 2021 may be less severe.

It now appears that Joe Biden will be the new US President albeit there is still a number of court cases being fought around the legitimacy of voting and mandatory recounts in some of the battleground states. The Democrats look unlikely to have won control of the Senate and have lost seats in the House of Representatives which means that the proposed huge stimulus, wind back of tax cuts and other "progressive" policies will be more difficult to get passed in the probable lame-duck Congress.

The very low interest rates that are now baked in for several years are leading to a typical M&A cycle as corporates look to buy growth and private equity firms start to deploy their large cash reserves.

The combination of extreme positioning and valuation differentials that are still evident in the market always provides strong forces when the market reverses. Recessions are typically the catalyst for style leadership to change and our expectation is for history to repeat with value outperforming – particularly when the world becomes less sensitive to the COVID-19 situation via a vaccination or therapeutic solution. Like other large market corrections, it is always difficult to pick the bottom and thus rotating slowly into some of the beaten down value names funded by reducing and exiting the outperformers is an approach that we have found has worked well in these types of markets.

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