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Australian market commentary

The S&P/ASX 200 Accumulation Index returned 1.2% during the month. Australian equities lagged key offshore markets during the month. Despite COVID-19 cases rising exponentially in the US and Europe, the start of the vaccine roll-out and further certainty regarding the US election result saw equities move higher. In major global developed markets Japan's Nikkei 225 was up 3.8%, the US S&P 500 was up 3.7%, the UK's FTSE 100 was up 3.1% and the DJ Euro Stoxx 50 was up 2.0%.

The Reserve Bank of Australia (RBA) maintained monetary policy settings in December after having delivered a rate cut and additional measures to support the recovery at its November meeting (where the cash rate was cut from 0.25% to 0.10%, as was the three-year yield target). The parameters of the Term Funding Facility and the government bond purchase program were also maintained in December.

Domestic economic data releases in December were mostly upbeat. Q3 GDP exceeded expectations to be up 3.3%, partially recovering from the record -7% recorded in Q2. Employment rose by 90,000 positions in November, which exceeded market expectations. The unemployment rate ticked lower to 6.8%, which was also better than expected. The NAB Survey of Business Conditions showed improvement, rising to 9 in November, and is now at above average levels. Business confidence also improved, rising to 12. Retail sales were up 1.4% in October. National CoreLogic dwelling prices saw a third consecutive monthly rise in December, ending the month up 1.0%, and closing the year 3.0% higher.

Sector returns were mixed in December. The best performing sectors were information technology (9.5%), materials (8.8%) and consumer staples (2.3%). Sectors that underperformed the broader market included consumer discretionary (1.0%), real estate (-0.2%), financials (-0.5%), communication services (-0.6%), energy (-0.9%), industrials (-2.7%) and healthcare (-4.9%). Utilities (-5.4%) was the worst performing sector.

The information technology sector outperformed with Afterpay (24.2%) and Xero (10.8%) the key contributors. Both names benefitted from the announcement of changes to the S&P/ASX Indices in December, that saw Afterpay added to the S&P/ASX 20 Index, and Xero to the S&P/ASX 50 Index.

The materials sector outperformed as commodities surged in December on optimism for China's ongoing strong demand for raw materials, supported by positive macro data, and hope for a vaccine led ex-China recovery. Key drivers of the sector's performance included BHP (11.5%), Fortescue Metals (28.5%) and Rio Tinto (12.3%).

The consumer staples sector also outperformed the market with the key contributors being Woolworths (6.3%), Treasury Wine Estate (9.4%) and Metcash (17.3%). Metcash outperformed as the company released a strong first half result in December.

The industrials sector underperformed with the key detractors being Qantas (-9.9%), Transurban (-1.5%) and Sydney Airport (-4.5%).

The healthcare sector underperformed as defensives lagged the market. Key detractors from sector returns included CSL (-4.8%), Cochlear (-14.3%) and Mesoblast (-45.9%). CSL fell as rising COVID-19 infections in the US is again impacting plasma collection volumes.

The utilities sector again underperformed with AGL Energy (-11.5%), APA Group (-4.4%) and AusNet Services (-5.4%) posting negative returns. AGL underperformed after reducing earnings guidance late in the month. Spark Infrastructure (6.1%) bucked the trend to post a positive return.

Australian market outlook

The ongoing global COVID-19 situation remains fluid with countries such as the US and UK experiencing record high COVID-19 fatalities, while many European countries are back in lockdown due to second and third waves. Vaccination has begun in a number of countries, but the sheer scale of task at hand means that the pathway back to normality will be long and bumpy.

Nevertheless, the prolonged period of elevated risks has reduced as uncertainties around COVID-19, the global trade war and US election —to name a few—are clearing up. We always believed that two conditions precedent were required for the value rotation to take hold; namely, clearing the US election and positive news on either a vaccine or therapeutic protocols. Both of which have now occurred with vaccinations underway and the US Electoral College confirming Joe Biden as president-elect in mid-December and his inauguration due on 20 January.

The global business cycle continues to surprise on the upside with strong Purchasing Manager's Index (PMI) and Institute of Supply Management (ISM) data helped by the unprecedented and quick government interventions. The vaccine rollout will help start the long road of recovery out of the pandemic induced economic shock.

Interest rates have essentially been anchored by central bank intervention globally while inflation expectations are showing a recovery from low levels. This setup has historically been positive for value as bond yields trickle up, resulting in a steepening of the yield curve.

M&A is likely to be part of the recovery process given the low interest rate environment, and cash position of private equity and corporates. The earnings yield to debt yield gap remains wide and thus corporates can buy earnings growth very cheaply with debt.

Despite the rotation and sharp rally in value in late 2020, it has still materially underperformed growth over the past 12 months and has a long way to reverse this underperformance. We have seen in the past that value typically outperforms for at least 12 months after a major trough in earnings.

The tough decade for value investors has created attractive investment opportunities that a well-disciplined value investor can harness. Our process is well positioned to take advantage of the opportunity set that requires a long-term investment horizon that looks through the current uncertainty, and a detailed bottom-up focus that identifies attractively priced companies that we believe are positioned to be rewarded in the economic recovery.

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