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Australian market commentary

The S&P/ASX 200 Accumulation Index returned 1.5% during the month. Australian equities underperformed key offshore markets as a strong reporting season was offset by a surge in 10-year bond yields late in the month on the back of inflationary expectations. The global roll-out of COVID-19 vaccines and US fiscal stimulus saw the reflation trade take hold. In major global developed markets, the UK's FTSE 100 was up 1.6%, the US S&P 500 was up 2.8%, the DJ Euro Stoxx 50 was up 4.6% and Japan's Nikkei 225 was up 4.8%, (in local currency terms). In Australia, value outperformed growth for the fifth month in a row.

Monetary policy settings remained unchanged in February, as the Reserve Bank of Australia (RBA) maintained both the cash rate and 3-year yield target at 0.10%. The RBA also indicated it will purchase an additional AUD100 billion of bonds when the current bond purchase program is completed in mid-April.

Domestic economic data releases in February were mostly upbeat. Employment rose by 21,900 positions in January. The unemployment rate ticked lower to 6.4%, which was better than expected. The NAB Survey of Business Conditions fell to 7 in January. Business confidence however jumped to 10, which is well above the long run average. Retail sales were down 4.1% in December. National CoreLogic dwelling prices saw a fifth consecutive monthly rise in February, ending the month up 2.1%, with regional housing values continuing to outpace capital cities, although the gap has narrowed.

Despite COVID-19, the February reporting season was one of the best in many years. This was largely due to the cautious approach going into reporting season due to COVID-19 related uncertainty and a lack of guidance in 2020. Approximately 51% of stocks beat on EPS. The banks were a highlight, reporting significant beats due to lower impairments but also generally better than expected underlying results. Energy was the weakest sector, recording more misses than beats. Overall, FY21 EPS ended up being revised up by 5.0% over the course of the month. Dividend forecasts were also revised upwards.

Sector returns varied widely in February. The best, and only positive sectors, were materials (7.3%), financials (5.2%) and energy (2.4%). All remaining sectors underperformed the index: communication services (-0.3%), industrials (-1.8%), real estate (-2.6%), consumer discretionary (-2.9%), health care (-2.9%), consumer staples (-4.6%) and utilities (-8.0%). Information technology (-8.9%) was the worst performing sector.

The materials sector outperformed with commodities enjoying continued strength on the expectation of resilient demand as global economies benefit from stimulus, USD weakness and the progressive rollout of COVID-19 vaccines. The key contributors to sector performance were BHP (12.8%), Rio Tinto (15.3%) and Fortescue Metals (10.6%).

The financials sector outperformed on the back of rising bond yields and having exceeded expectations during reporting season, thanks to lower impairments and better than expected underlying results. The key drivers included the following: Westpac (12.7%), ANZ (10.4%), National Australia Bank (4.6%) and Macquarie Bank (8.4%).

Despite a poor showing during reporting reason, the energy sector outperformed on the back of a rise in oil prices. Key drivers of sector performance included Santos (12.0%) and Oil Search (9.3%).

Consumer staples underperformed as the market is adjusting to the reality that once COVID-19 passes, some businesses are likely to report weaker results. The key detractors included Coles (-14.0%), Woolworths (-3.6%) and A2 Milk (-16.0%). Coles was the worst detractor, having commented in their outlook that sales growth will be low or possibly negative once the COVID-19 impact rolls off.

The utilities sector underperformed as a result of surging bond yields. Key detractors included AGL Energy (-14.8%), APA Group (-5.1%) and Spark Infrastructure (-7.3%).

The information technology sector was the worst performer, in part due to rising bond yields. Key drivers of underperformance included Afterpay (-11.5%) and Xero (-8.8%).

Australian market outlook

February's reporting season was one of those rare situations where we were better off than when we started. The changes to EPS growth expectations for FY21 have increased six percentage points to 16.8% and all forecast years appear to have risen. Dividends were the highlight, having grown more than earnings. The understandable lack of guidance from many companies during 2020 had arguably led market earnings forecasts to be cautious going into reporting season which contributed to the record high in "beats". However, there is no doubt that a strong recovery is taking hold.

Resources and banks were the standout during the month. Banks reported significant beats driven primarily by much lower impairments, often helped by write backs. However, the underlying results were also better, with margins surprising to the upside as competition in deposit pricing has reduced. Incredibly, there were a number of stocks that beat on EPS, DPS and sales relative to pre-pandemic forecasts. These included the largely immune iron ore related companies such as BHP, Rio Tinto, Fortescue Metals, BlueScope Steel and Mineral Resources together with the COVID-19 winners such as JB Hi-Fi, Nick Scali, Super Retail, Dominos and Ansell.

Overall, earnings are still down relative to pre-pandemic levels, but the market is now expecting to recover to FY19 levels by FY21. This is an extremely fast and rare rebound of earnings out of a recession.

The ongoing global COVID-19 situation remains fluid. Vaccinations continue to be rolled out across Australia and the rest of the world. However, the sheer scale of the task at hand means that the pathway back to normality will be long and bumpy.

The global business cycle remains strong with strong Purchasing Manager's Index (PMI) and Institute of Supply Management (ISM) data helped by the unprecedented and rapid government interventions. The latest data shows Australian GDP growth remaining strong with Q4 expanding 3.1% over the quarter which was much better than consensus. Incredibly, Australia's GDP is only 1.1% below the level in Q4 2019, compared to the global median decline of 3%.

Interest rates have essentially been anchored by central bank intervention globally while inflation expectations are showing strong signs of recovery from low levels. Yield curves have steepened substantially globally which has been historically positive for value, as the under-priced and economically sensitive cyclical and financial stocks do well.

Despite the rotation and sharp rally in value that began in late 2020, it has still materially underperformed growth over the past 12 months and has a long way to reverse this underperformance, let alone the underperformance of the last few years. Value typically outperforms for at least 12 months after a major trough in earnings and we see little reason for this outcome to not be repeated.

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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