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Australian market commentary

The S&P/ASX 200 Accumulation Index returned 0.3% during the month. Australian equities outperformed most key offshore markets during the month as equity markets saw a pull-back late in the month. COVID-19 cases passed the 100 million mark globally and many countries continued to struggle with COVID-19 variant strains and vaccine supply issues. In major global developed markets Japan's Nikkei 225 was up 0.8%, the UK's FTSE 100 was down -0.8%, the US S&P 500 was down 1.0% and the DJ Euro Stoxx 50 was down 1.8% (in local currency terms).

Monetary policy settings remained unchanged in January, as there was no Reserve Bank of Australia (RBA) meeting during the month. The cash rate remains at 0.10%, as does the 3-year yield target.

Domestic economic data releases in January were mostly upbeat. December quarter inflation exceeded expectations to be up 0.9%. The annual inflation rate also stands at 0.9%. Employment rose by 50,000 positions in December, in line with market expectations. The unemployment rate ticked lower to 6.6%, which was better than expected. The NAB Survey of Business Conditions showed further improvement, rising to 14 in December. Business confidence however fell to 4, reflecting the impact of Sydney's December COVID-19 outbreak. Retail sales were up 7.1% in November. National CoreLogic dwelling prices saw a fourth consecutive monthly rise in January, ending the month up 0.9%, with regional housing values continuing to outpace capital cities.

In stock specific news, there were a number of strong results/trading updates. These included retailers such as JB Hi-Fi and Super Retail. Reliance Worldwide also provided a trading update showing strong sales growth across all regions, including the US, Asia Pacific and EMEA. All eyes will now be on results season taking place in February.

Sector returns were mixed in January. The best performing sectors were consumer discretionary (4.7%), communication services (2.7%) and financials (2.2%). Consumer staples (2.1%), energy (1.3%) and information technology (0.4%) also outperformed the index. Utilities (-0.1%), materials (-1.1%), health care (-1.9%) and industrials (-3.0%) underperformed the broader market. Real estate (-4.4%) was the worst performing sector.

The consumer discretionary sector outperformed, driven largely by Wesfarmers (8.4%). The Wesfarmers share price reached record highs at the end of January, following strong retail sales results from businesses that have benefitted from COVID-19 effects. Bunnings, which is a key driver of Wesfarmers' profits, is just one of the beneficiaries.

Communication services outperformed, driven largely by sector heavy weight, Telstra (4.7%). Despite a lack of specific news, there is increasing confidence in the market that Telstra's dividend will be maintained which saw support for the stock.

The financials sector outperformed with the key drivers being the big four banks: Westpac (9.1%), National Australia Bank (4.2%), ANZ (4.4%) and Commonwealth Bank (1.7%). The banks benefitted from a combination of positive global macro news, resulting in a steeping yield curve, and positive local news on loan deferrals and new loan growth that substantially reduces any tail risks from loan impairments.

The health care sector underperformed with the key driver of underperformance being CSL (-4.1%). CSL lagged the market as investors rotated in favour of more cyclical stocks as confidence in the economic outlook improved.

The industrials sector underperformed with the key detractors being Sydney Airport (-10.8%), Transurban (-3.1%) and Qantas (-7.2%). Rising bond yields negatively impacted infrastructure stocks and renewed state border closures hurt travel-related stocks.

Real estate was the worst performer, again due to rising bond yields. The key detractors included Goodman Group (-6.5%), Lendlease (-8.3%) and Mirvac (-9.8%).

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 the 20th 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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