Market Update

January 2021

Peak Investment Partners

EXECUTIVE SUMMARY

- **Share markets finished 2020 strongly as confidence grew over a recovery in economic activity, stronger corporate earnings, abundant liquidity, vaccine roll-out and low interest rates. The last 9 months reminded us that markets are forward looking.**
- **This has seen cyclical sectors such as Materials, Financials and Energy strongly outperform growth and defensives sectors such as Healthcare, Infrastructure, Consumer Staples, Utilities and Gold over the quarter. These trends are expected to continue.**
- **After the strong finish to 2020, equity markets are vulnerable to weakness in early 2021 as lockdowns increase in the US, UK & Europe, particularly if the recovery is delayed or corporate earnings disappoint.**
- **Markets appear to be factoring in a strong rebound in economic activity in H2. This could potentially trigger higher inflation, long term interest rates and tighter liquidity.**
- **While there is pent up spending demand, valuations are historically high to reflect this strong earnings recovery in 2021. Markets are susceptible to any tightening of liquidity.**
- **We continue to focus on a balance between long term Growth (Technology, Renewable Energy, e-Commerce, Semiconductors, 5G, Electric Vehicles) and Cyclicals (Resources, Banks, Online Services).**

2020 A Year of Extremes

Unsurprisingly, having lost 24% during Q1 (worst quarter ever), the ASX200 index rose more than 12% during Q4, the strongest gain since Q3 2009. From the lows of 4546. On March 23rd, the index rose 45% to close the year at 6700. The AUD opened the year at 72c, fell to 57c in March and closed the year at 78c. The US 10-year bond opened the year at 1.8%, touched a low of 0.4% and closed the year at 0.9%. NASDAQ started the year at 8900, hit 6994 in March and closed the year up 44% at year end. Just the most extraordinary of years. After underperforming Growth for much of the post GFC era, Cyclical stocks significantly outperformed over the last quarter.

Source: Macquarie Research

How Sustainable is the Rebound?

In our October Market Commentary, we highlighted a strong rebound in Leading Indicators was pointing to more of a "V-shaped" recovery than consensus had initially expected. As the quarter evolved, the data increasingly supported the case for a strong recovery in late 2020 and into 2021 both in Australia and elsewhere. We have been somewhat surprised at how well economic activity has held up, even in countries where COVID-19 has been far worse than Australia and likely reflects greater flexibility within services based, digitised economies. The rebound has been supported by early approval and release of several vaccines across the globe. This should support a strengthening and broadening of the recovery into 2021.

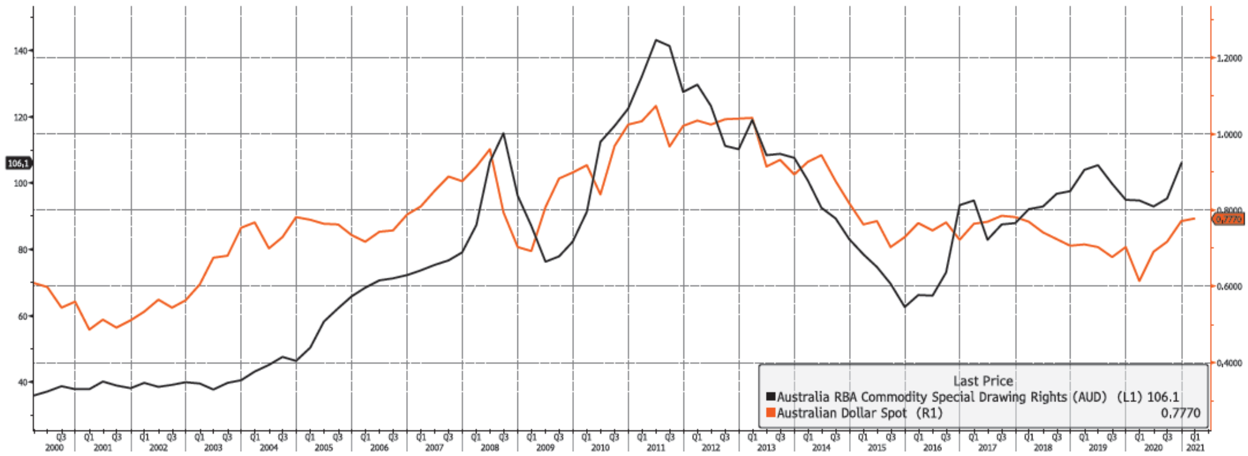
Cyclical Rebound & Secular Trends Supporting Commodities

One of the early beneficiaries of the Cyclical upturn has been commodities. The recovery has been broadly based across the complex from Iron Ore, Copper, Nickel, Oil, LNG to soft commodities such as Wheat, Cotton, Lamb and Sugar. The combination of strengthening demand against a backdrop of low levels of investment in exploration and new capacity is likely to remain supportive of prices. Soft commodity prices are reflective of several drought years reducing inventory in supply chains in major producing countries like Australia.

Given the relationship between commodity prices and the $A, it is unsurprising to see a sharp rebound in the currency. Having touched a low of $0.57 in March 2020, the $A recently traded above $0.78, up 37% and up over 10% in the December quarter. Such a rebound in the $A is unhelpful for commodity producers and companies with significant overseas earnings.

Commodities are also a beneficiary some of major secular trends that are gathering momentum. In a world that is committed to decarbonising via a transition from fossil fuels to renewable energy, commodities such as lithium, graphite, nickel, copper and cobalt are seeing new sources of demand. Given trends of the latter part of 2020 in China and Europe re EV production, it appears likely growth in demand for these commodities will continue to accelerate over the next decade.

AUD v's Australian Commodities



Source - Bloomberg

Political Fog Clears in the USA, Thickens in China

Resolution recently to the US elections has seen a clean sweep to the Democrats. This is the first time since 2010, that one party has controlled the White House, the Senate, and the Congress. Markets have responded positively to this outcome, reflecting stimulus in the short term. The longer-term negative of rising taxes, increased regulation may well be partly offset by increased spending finally on infrastructure and renewable energy.

In contrast, political risks have ramped up in China. While enjoying a mild impact from COVID-19 and a strong economic recovery, there appears to have been a change in the political landscape. Events such as the crackdown in Hong Kong, stopping the Ant Financial IPO and a multitude of trade spats with several countries including Australia are concerning. In the meantime, the China's CSI has risen more than 50% from March lows.

From an investment perspective several stocks we have had in portfolios have been impacted by recent events. Alibaba has done extremely well for long term holders, however we are now reassessing our stance as the prospects have become much less clear and government oversight seems likely to increase within its businesses. This may reduce longer term investment returns. Other stocks directly impacted have included Treasury Wines, A2 Milk (more COVID related) and several thermal coal producers (no exposure).

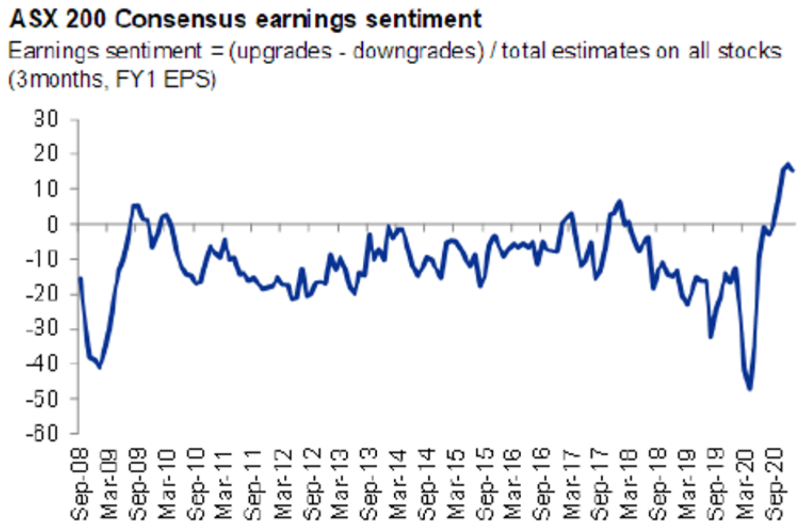
Australian Outlook Favourable-Strong Dollar a Headwind

There has been a strong recovery in housing approvals, setting the stage for an increase in construction activity through 2021. Car sales have experienced a strong recovery. Infrastructure spending remains at historic highs, with a large backlog of work to be done. Commodity prices have been strong, especially iron ore, partly offset by a stronger $A. The rural sector has seen the drought and bushfires of a year ago turn into a bountiful grain harvest, recovery in pasture coverage following onset of La Niña weather pattern delivering high rainfall.

As the COVID-19 vaccine is rolled out during 2021 some of the laggard sectors such as tourism and education (Sydney Airports, Flight Centre, IDP) should see further recovery. In summary, Australia is entering 2021 in good economic health and is set for a much better year than 2020.

Investment Outlook

As we enter 2021, the outlook for equities appears favourable, although markets clearly have priced in much of the good news. Policy rates are anchored at near zero or lower in most of the developed world. Resolution of the US elections and a Democrat clean sweep provides the first opportunity in a decade for an administration to get things done, although acknowledge a very polarised country and thin electoral majorities. The financial system is full of liquidity. COVID-19 vaccines are being rolled out, bringing hope that life will return to normal during 2021. Consumer savings rates are at record highs, suggesting significant pent-up demand. From deep recession in mid-2020, 2021 will see global growth of more than 5%, paving the way for strong growth in corporate earnings.

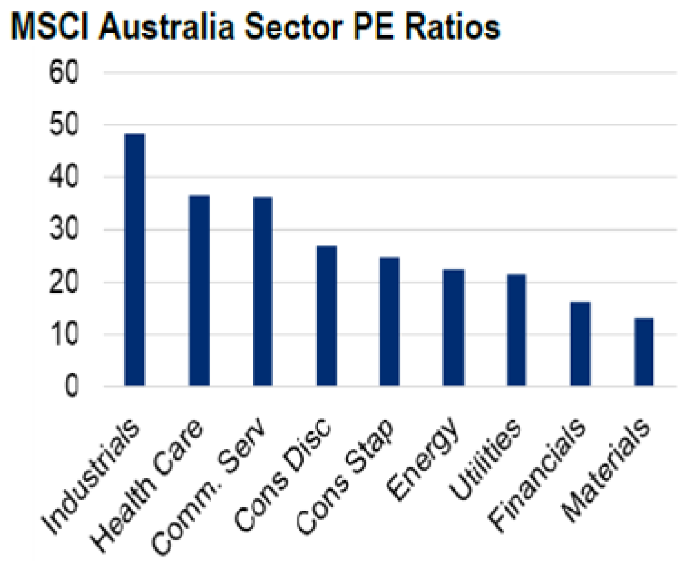


Source: Goldman Sachs

The Valuation Debate

We find the valuation debate far more complex than some high-profile commentators conclude. At a high level, equities generally are not cheap, but represent much better value than bonds. Equities are at the beginning of a strong economic recovery and earnings forecasts are in upward revision mode. Meanwhile interest rates are near historic lows. There are clear pockets of markets that appear overvalued. Some work by Citi shows that most major markets are currently trading above 15-year averages based on PE's. Current valuations are also being distorted by a strong recovery in corporate earnings. Over CY21, Citi are forecasting US EPS growth 20.3% and a PE of 23.4x (PEG 1.15x). For Australia, Citi are forecasting 19.8% EPS growth and a PE of 19.1x (PEG <1x). The chart below highlights Cyclicals such as Financials and Materials offer much better value than higher Growth sectors such as Industrials, Healthcare and Technology. It is worth noting that while Cyclicals may be better value based on short-term earnings trends, most don't offer superior long-term growth.

Consensus 2021E PE



Source: Citi Research

Where are the Risks?

The three most obvious are rising **interest rates**, **rising inflation**, and **reducing levels of liquidity** being provided by Central Banks & Governments.

Regarding interest rates, Central Banks with the exception of the PBOC (Public Bank of China), have committed to holding short/medium term rates at close to zero for the next 1-2 years. Although this makes sense from where we have come from, it may prove dangerous from where we are heading.

Low and stable inflation have been supportive of financial markets over the long term. Trends towards De-Globalisation, rising cost of capital, higher commodity prices and potentially higher wage costs seem likely reverse some of these historically favourable trends.

Abundant liquidity from Central Banks and Governments has been a key feature of both the GFC and now COVID-19. But current emergency measures in place are not sustainable. The Taper, the wind back of support measures, the prospect of higher rates and withdrawal of liquidity all lie ahead. None of this is positive for financial markets.

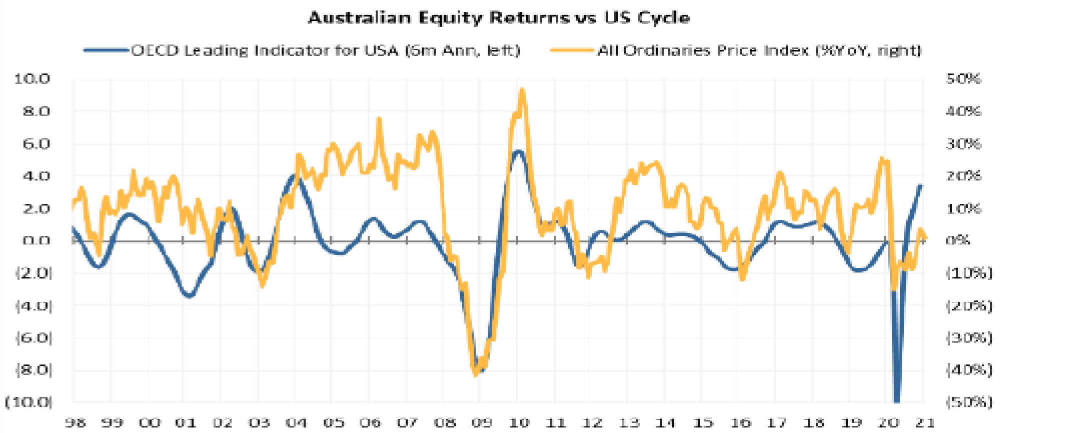
There are also signs of “irrational exuberance” in some aspects of markets. As Jeremy Grantham of GMO points out, there have been record numbers of IPO’s, many rising sharply on listing. There has been an acceleration in the rate of change in rising share prices, consistent with a final “blow off” phase. The emergence of many speculative vehicles such as SPAC’s (Special Purpose Acquisition Companies) raises concerns over reduced investor discipline. There has been a large increase in the number of small sized trades-indicating high participation by small, less experienced investors. This is highly cautionary for markets if the recovery and liquidity momentum for markets reverses.

Investment Strategy

Last quarter, we retained our portfolio structure with a balance between Growth, Defensive and Cyclical sectors. We believe this diversified approach should continue into 2021.

During the last quarter and in January, we have increased our exposure to the Banking sector through adding CBA and Westpac. Many of the concerns for Banks in the COVID-19 aftermath have proved to be far less negative than initially expected. We are likely to reduce somewhat the exposure levels to Defensive stocks now that the COVID-19 risks begin to recede and the recovery gathers momentum. We have also been increasing exposure to Resources on recovery demand amid a weakening US$. We will look to increase exposure to some of our favoured long term International thematics such as Renewable energy, Batteries & Electric vehicles, Technology - through Semiconductors, AI, Payment platforms, Ecommerce, and International Healthcare. Gold will continue as a hedge against higher inflation and unexpected events.

In summary, as we enter 2021 following a very strong end to 2020, markets are somewhat vulnerable to any adverse surprises re COVID-19, vaccine rollout or deferral of the economic recovery. The investment landscape is expected to be less favourable as rising interest rates, inflation and tighter liquidity become of increasing concern. On balance, we expect equity markets to have another reasonable year as COVID-19 is brought under control, the high levels of savings are used to satisfy pent up demand, facilitating a broadening out of the recovery, with a few challenges along the way.



Source: Macquarie

Ian Wenham
Director

Richard Nicholas
Director

Andrew Martin
Director

Contact details
Level 11, 56 Pitt Street, Sydney NSW 2000 **Phone: (+61 2) 8274 5800**
Email: info@peakinvest.com.au **www.peakinvest.com.au**