Market Update

April 2021

EXECUTIVE SUMMARY

- The ASX200 Index increased 3.1% in Q1, with Banks continuing to outperform. The MSCI World Index rose 4.6% as the synchronised global recovery gathered momentum, along with acceleration in COVID vaccine rollout.
- Stronger growth prospects raised inflation expectations. In the USA, Australia and NZ 10 year bond yields rose from 1% in early Jan to circa 1.8% + at qtr end. Upgraded earnings prospects prevented an equity market selloff.
- While favourable growth prospects should carry markets higher near term, tighter policy settings & liquidity later in 2021 may pressure market performance in 2022. Increased speculative market behaviour also represents a risk.
- Given the strength of the global recovery, Cyclical stocks continue to outperform. Should growth momentum wane later in 2021, Growth stocks relative performance may well improve.
- We continue to recommend a balance between Growth via Healthcare (CSL, RMD), Technology (MSFT, AAPL, ETF's), Ce-carbonisation (LIT, ICLN), Logistics (GMG, QUB) & Cyclicals such as Resources (preference for Copper, Nickel, Lithium), Banks and On-line service companies (REA, SEK, CAR).

Strong Start To 2021

Share markets got off in a strong start to 2021 with the MSCI World Index (ex Aust) rising 4.6% in Q1. The S&P500 increased 5.8%, Cyclicals outperformed Growth as the DJI rose 7.8% and the NASDAQ underperformed with a 2.8% increase. The ASX200 increased 3.1%, with Financials up 11.3%, Consumer Discretionary up 7.4% and Communication Services up 7.1%. Laggards included Information Technology (down 11.5%), Healthcare and Utilities.

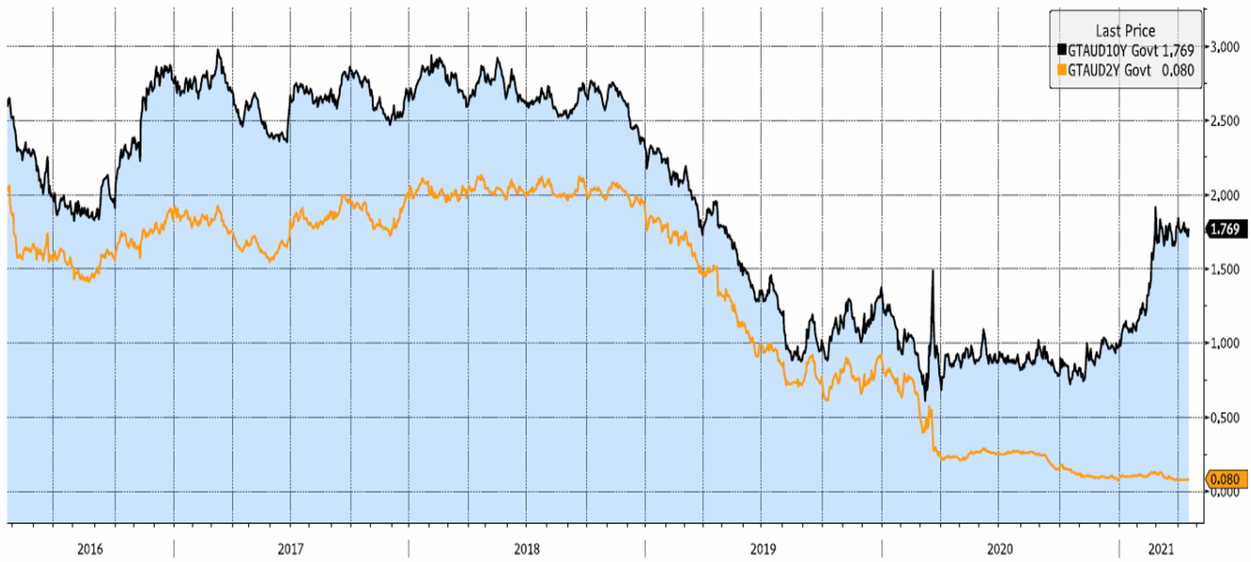
As the rollout of COVID-19 vaccination programs gathered momentum in the UK and the US, so too did confidence grow on the pace and strength of a synchronized global economic rebound. Last week the IMF up-graded its growth forecast for global GDP growth from 5.5% to 6%.

Tussle Between Earnings Growth & Higher Bond Yields

One consequence of stronger than anticipated growth prospects has been a sharp increase in 10 year bond yields. During Q1, yields in Australia, New Zealand, the USA and Canada increased more than 0.8%. Australia and the US saw rates rise from 1% in early Jan to 1.8%-1.9% at quarter end. Such moves are historically large, and potentially destabilizing for financial markets. Meanwhile, Central Bank activity continues to hold shorter term rates close to zero (see chart below)

To date, the increase in nominal bond yields has primarily been driven by rising **inflation expectations** rather than increases in **actual inflation**. As a result, real interest rates (nominal interest rates less actual inflation) have experienced modest increases. Higher real interest rates would likely be detrimental to share market performance.

Long & Short Term Rates Diverge



Source: Bloomberg

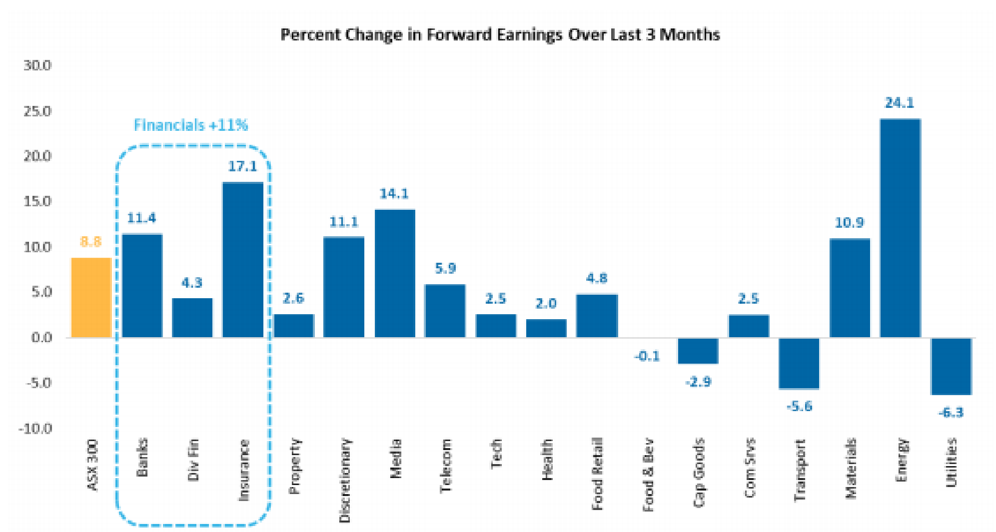
Factors that will determine how actual inflation evolves over the period ahead include:

- Labour market recovery and wages growth
- Money supply trends
- Liquidity trends
- Changing work preferences
- Commodity prices
- Rising asset prices (housing & share markets)
- Technological developments (eg robotics, AI)

Normally such a steep increase in long term interest rates could be expected to put pressure on share markets. So far that hasn't been the case. While there have been some sectors negatively impacted-long duration assets such as utilities, profitless technology, infrastructure, strength elsewhere has seen markets remain near all time highs.

Strong momentum in corporate earnings expectations have been sufficient to offset the impact of rising bond yields. Macquarie recently published a chart that highlighted how strong the upgrades to earnings forecasts have been by sector over the last 3 months.

Fig 2 Forward EPS rising the fastest in cyclical sectors (energy, financials, and discretionary)



Source: FactSet, Macquarie Research, April 2021

Will 2021 Be As Good As It Gets?

While there is much to like about the current macro environment, its worth remembering that markets are forward looking. From that perspective, its worth considering how some of the key factors such as interest rates, inflation, currencies, fiscal policy will be at the end of 2021. On the balance of probabilities, it would seem reasonable to expect long term interest rates and inflation to be higher at year end. Central banks are more likely to be reducing stimulus. Governments in the US and the UK have already foreshadowed tax increases. After an exceptionally strong rebound in GDP and corporate earnings through 2021, a more "normal" outlook for 2022 could reasonably be expected. Perhaps the most important investment conclusion from this is to ensure investment strategy is biased towards longer term growth trends.

Australia in a Good Place

Australia has found itself in a very favourable position. COVID-19, while challenging in some states, has been far less disruptive than in many developed countries. Strong financials have enabled the government to provide a substantial assistance program that provided the basis of a strong economic rebound.

The recovery is broadly based, cutting across housing, infrastructure, commodities, agriculture, non-residential construction, jobs growth and more recently services including domestic tourism. Personal financial conditions are in good shape courtesy of government support programs, extraction of funds from retirement savings accounts and not travelling overseas.

China remains an issue for Australia. While our overall trade position remains robust despite a number of bans on the likes of wine, lobsters, barley etc, risks continue to build. China accounts for around 40% of our exports, with iron ore being dominant.

Market Prospects

From the above discussion, it is clear that the outlook for equity markets, including Australia, remains favourable, with earnings momentum remaining supportive. Upgrades continue to run ahead of downgrades, both in Australia and the early stages of the US reporting season. Stronger earnings results have at least matched higher share prices and to some extent higher bond yields. At the end of Q1, based on Macquarie Research numbers, 12 month the forward PE remained relatively stable at 18x.

Following an 80bps point increase in 10 year bond yields over Q1, we see a period of consolidation. This, together with a crystallisation in higher reported earnings should ease some of the recent near term pressure on valuations. Technically April has been one of the strongest months in the investment calendar. As the chart below highlights, the ASX200 has been through two phases of consolidation and has broken out to the upside. A retest of the all time high of 7197 in Feb 2020 seems likely.

ASX200 TO RETEST 2020 HIGH?

Source Coppo report

Cylicals v's Growth

Over the last 6 months, strongest performing sectors have been Banks and Resources, with growth sectors such as Healthcare, Information Technology and Consumer Staples underperforming. While much of the relative outperformance has been driven by strong earnings growth and improved dividend prospects, trends may become less favourable heading into 2022. Conversely Healthcare and Information Technology appear set to enjoy improving earnings momentum heading into 2022, providing the basis for improved relative performance.

It has been a similar story in the US where, over the last quarter the technology based NASDAQ increased 2.8% underperformed the more broadly based S&P500. A recent Citi survey of fund managers found that 80% expected Value to outperform Growth. Typically when such a strong consensus of view persists, events often turn out differently. Judging by the way several leading technology stocks have performed in early April, evidence is supporting a counter-cyclical view.

Investment Strategy

For the moment we remain relatively fully invested across most mandates, while acknowledging April tends to be a seasonal peak in the annual share market cycle. Key indicators we are watching for signs that overall exposure to markets should be reduced include the following:

- Changesn to monetary and fiscal policy (ie CB's becoming less accommodative or tax increases, regulatory tightening)
- Increasing signs of inflation breaking out to the upside (higher wages, costs, shortages, supply chain disruptions)
- Higher bond yields and potentially higher cash rates
- The potential for destabilising speculative activity via SPAC's, Crypto currencies, increased margin trading, increased retail market participation

Cyclicals have continued to outperform Growth over the last quarter with Banks turning in another stellar performance. Following a 50%+ rally over the last 6 months, we anticipate a pause in relative performance in the current quarter. We remain positive on resources, especially copper, nickel, lithium and rare earths. Gold has been a laggard recently, and now showing signs better performance, with stocks fundamentally attractive.

To conclude, investment success is generally all about the long term. Selection of the right sectors that offer superior long term growth, the right companies in those sectors, the right management teams within those companies and the right performance metrics that management is benchmarked against.

In this addition, we discuss some of the sectors that we are focussing on that we expect may deliver long term superior investment returns. We will continue to evolve our research on these across the above parameters going forward.

Investment Strategy Focused on Long Term Thematics

Through much of COVID-19 equity market recovery phase, owning shares served investors well. Given the strength of the rally experienced since the March 20 lows, we see a need to be much more selective around stocks and sectors. While we continue to see opportunities in the "opening up" space such as travel, leisure, hospitality, the most attractive investment prospects are based around there long term, secular growth trends.

- Decarbonisation - EV's, Electricity v Fossil Fuels, Storage, Infrastructure, Disruption
- Digitalisation - Artificial Intelligence, Robotics, Autonomous Vehicles, FinTech
- Semiconductors - Explosion of demand for chips
- 5G-Industrialisation of Digital Networks
- Logistics - E-commerce changing supply chain networks
- Commodities-Old commodities (coal, oil, lead) v New commodities (copper, lithium, rare earths)
- Healthcare - Confluence of big data and Computing power, AI and Genomics

We look forward to catching up with you soon to discuss your portfolio and any change of circumstances or issues that we might be able to help you with.

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**