Market Update

July 2020

EXECUTIVE SUMMARY

- **Financial markets rebounded strongly over the quarter as central banks and governments implemented aggressive stimulus programs and liquidity.**
- **Markets now discounting an economic recovery, containment of Covid-19 and low interest rates. This appears somewhat optimistic and cash levels have been increased.**
- **The June qtr rally in the ASX200 of 12.4% has seen the 12 month forward PE increase from near 13x in late March to near 20x currently.**
- **The upcoming August reporting season will see a re-calibration of earnings expectations, and more surprises than usual.**
- **Market consolidation is expected ahead of the US elections and mixed Covid-19 trends in the US, Australia and elsewhere.**
- **Investment strategy remains cautious and defensive. Healthcare, Consumer Staples, Infrastructure, Technology, Resources (iron ore & gold) and Logistics are preferred.**

Exceptional Period in Share market History

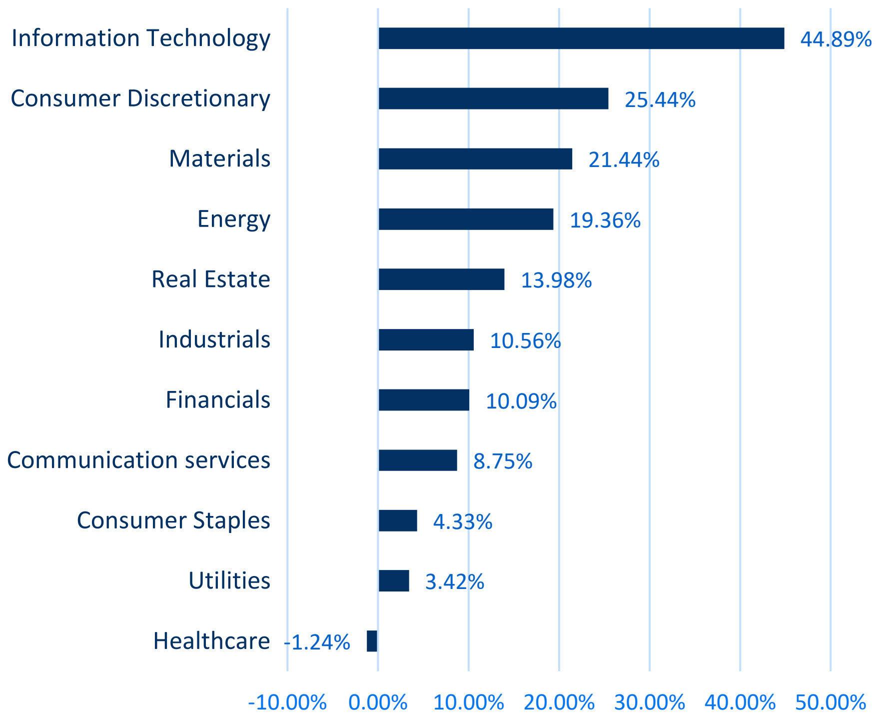
After a decline of 36% from the 20th February to 23rd of March, there followed one of fastest recoveries in history. In some cases, such as the NASDAQ and the S&P500, new highs have recently been established. In others such as the ASX200, we remain almost 20% below the February highs.

Strong Rebound During the June Quarter

Over the June qtr, the ASX200 increased 12.4%, with the strongest contributors being Information Technology up 45%, Materials up 21.4%, Consumer Discretion up 25% and Energy up almost 20%. Laggards included Healthcare down 1.2%, Utilities up 3.2% and Consumer Staples up just 4.3%. These trends were a reversal of those in the previous quarter.

Since the March lows, there have been 5 dips of 3% or more that lasted a matter of days before rebounding, according to Bell Potter. This reflects the significant levels of cash on the sidelines (see chart below) that, over time, is likely to find its way back into the market in search of yield or attractive capital raising opportunities.

ASX200 Returns by Sector (QTD to 30/06/20)



Source: Bloomberg

How Can Markets Rise in a Pandemic & Recession?

Understandably, many investors have been completely mystified by such a strong rebound in markets at a time when the news flow is terrible. Some of the reasons behind this include:

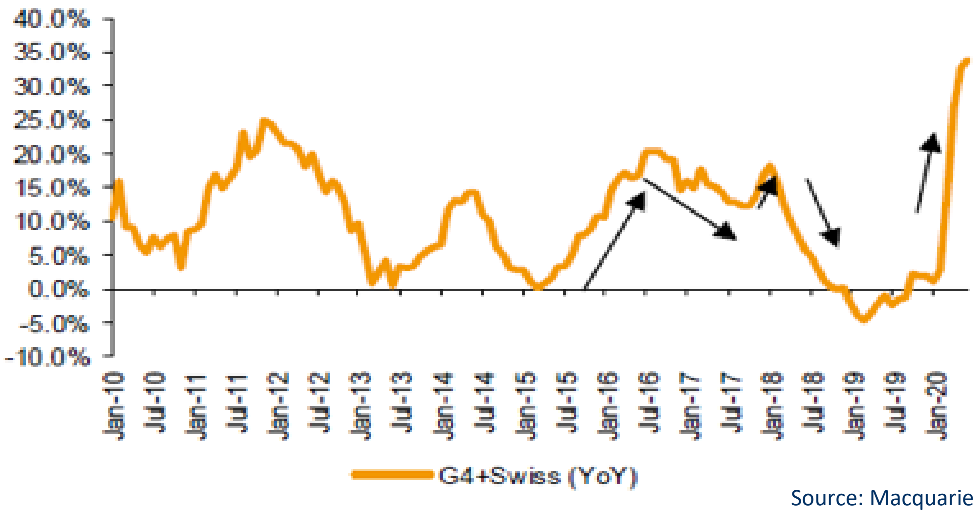
- As governments shut down economies to curb the spread of Covid-19, the loss of income from businesses and individuals was replaced by massive stimulus programs by governments and central banks. The chart below highlights the substantial increase in liquidity being injected into financial system by central banks.

- Several Asian countries demonstrated that well-orchestrated response campaigns could slow the spread of Covid-19 and see a relatively fast return towards normality

- Covid-19 has been an **Event driven** bear market, with a government led forced shutdown leading to a sharp recession. As the **Event** diminishes in its impact, markets recover quickly.

- Share markets are forward looking, typically focusing on expectations in 6 to 9 months. Consequently, market lows are normally set when current events seem terrible.

G5 Central Bank Assets (%YoY) – public sector liquidity at 30% -35% growth



Source: Macquarie

What Have Markets Priced In Regarding The Future?

In our view, the rebound in equity markets has priced in the following:

1. Trends in Covid-19 in most of the major economies will continue to improve, allowing activity to gradually recover.

2. Economic recovery during the second half of 2020. From Q2 a low, where GDP numbers will be shocking (ie US down 30%), a sharp rebound in Q3 is anticipated (US GDP up 25%-Goldman Sachs). Recent trends in leading indicators such as PMI's support this.

3. Interest rates to remain at record lows for the foreseeable future. Central Banks and governments are expected to remain supportive.

Key Risks to Market Optimism?

The Australian Prime Minister recently reminded Australians that short term support programs are not sustainable long term. As support programs are wound back during H2, we see risks of increased loss of jobs, business failures and other forms of financial stress increasing.

Covid-19, in the absence of a vaccine, will continue to be a risk. As activity returns to normal, there will be clusters of outbreaks, however these should be contained at a local or state level.

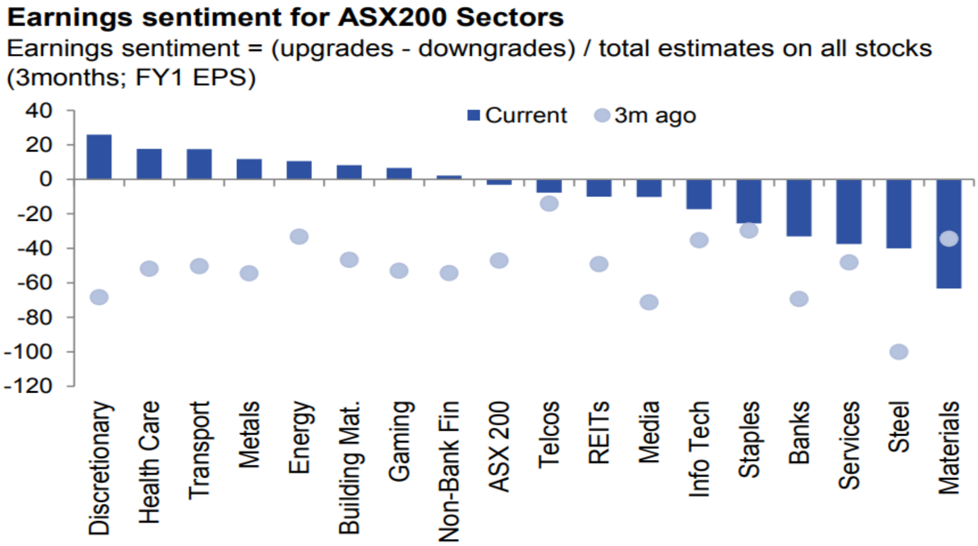
The US Presidential election is now 4 months way. While polls can change, at this stage Joe Biden is showing a clear lead over President Trump. Markets fair poorly in the years when the incumbent president is removed from office. With Joe Biden already committed to increasing taxes on election, markets are likely to be volatile ahead of November.

Market Outlook

From late July, corporate news flow will increase significantly as companies report results for the half year to June 30th. Following withdrawal by the regulators of the need for companies to provide continuous disclosure, the upcoming reporting season will be more enlightening than normal

In late March, valuations of the ASX200 were offering support below 5,000. Now above 6,000 that is no longer the case. According to Goldman Sachs since, the March lows, the 12-month forward PE has increased from 13x to 19x, reflecting a 20% reduction in earnings and a 30% rally in prices. A period of consolidation appears likely.

After the substantial reduction in corporate earnings forecasts in early 2020, Goldman Sachs chart below highlights a significant improvement in the ratio of upgrades to downgrades. Compared to 3 months ago, earnings sentiment has improved significantly, with upgrades and downgrades being almost equal.



Source: Goldman Sachs

Investment Strategy

A period of consolidation seems likely. Short of a vaccine being discovered, we think many of the positives have been priced into valuations, with the risk of disappointment leaving markets vulnerable to further downside risk. Seasonal factors and the US Presidential year support this. Where appropriate, cash levels are being increased.

We retain our defensive strategy based around companies that have reasonable earnings predictability, sustainable cashflows, reasonable balance sheets and management capable of generating consistent returns on capital.

Sectors meeting these criteria include Healthcare, Consumer Staples, Non-Bank Financials, Infrastructure, Waste Management, Logistics and Resources (iron ore and gold). International exposure include diversified Technology holdings and the Asian consumer.

Donations to Charities

In January, we indicated Peak would set aside $50,000 from fees to specifically allocated not for profit groups associated with those affected by bushfires and the drought, among others. Donations have been made to the following organisations: Beyond Blue, BlazeAid, Bush Heritage, Climarte, Eurobodalla Council Disaster Relief Fund, Girls and Boys Brigade, Kangaroo Island Disaster Relief Fund, Lifeline and the NSW Rural Fire Service Association.

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