Market Wrap

February 2021

- The rollout of Covid-19 vaccines has begun in Australia and is progressing rapidly elsewhere. More than 20% of the US population has had a first dose, for example.
- This is boosting hopes that restrictions will increasingly be lifted in the months ahead, paving the way for a strong rebound in global growth.
- President Biden has prepared a massive new stimulus program, designed to support an anticipated rebound in the US. Growth forecasts for the world's largest economy for 2021 and beyond were upgraded by leading brokers as a result.
- Bond yields soared as attention turned towards the prospect of rising inflation and, in turn, upward pressure on official interest rates. This resulted in negative returns from bonds and saw major equity markets dip towards month end.

- **US**: The prospect of quickening inflation was the key theme in global markets in February. Inflation is expected to be influenced by the aggressiveness of monetary and fiscal policy, and how well they work together in tandem.
- On the monetary front, the Federal Reserve has made it clear that official interest rates will be kept low for an extended period.
- On the fiscal front, the House of Representatives passed President Biden's proposed new US$1.9 trillion aid package for the US economy; the third major spending program in the past year. The new scheme is worth nearly US$6,000 for every man, woman and child in the US. While the new stimulus package still requires approval by the Senate, some suggested it is unnecessarily large and will be inflationary.
- This was concerning, particularly since producer price inflation has already risen to its highest level in more than a decade.
- There has been a lot of concern about jobless numbers in America. But, at 6.3%, unemployment in the US is lower than in Australia. Average hourly earnings are up more than 5% over the past year and the latest stimulus plan includes an increase in the minimum wage. The latest retail sales data were also much stronger than anticipated, up over 5% in the month of January.
- All of these indicators suggest discretionary expenditure could rise quite strongly in the months ahead, and help explain why the market became so focused on the outlook for inflation.

- **Australia:** More than 29,000 jobs were created in Australia in January, which saw the official unemployment rate fall to 6.4%. The jobless rate has come down from 7.5% in mid-2020.
- Consumer confidence is close to its highest levels in a decade, buoyed by the relaxation of social distancing restrictions.
- This is being reflected in spending; retail sales have moderated a little from the very high levels seen in the September quarter of 2020, but remain comfortably above long-term averages.
- Auction clearance rates have also risen; another sign of higher confidence levels. This is translating to strong price growth. Median house prices in Australia grew 2.0% in February; the strongest monthly increase since 2003.
- **New Zealand:** S&P upgraded its credit rating on New Zealand government debt; the first upgrade to a sovereign issuer since the start of the Covid pandemic. This move reflected the country's containment of the virus and the strength of the subsequent economic recovery.
- Strong recent employment data suggest the Reserve Bank of New Zealand's official growth and interest rate forecasts from November will require significant upward revisions.
- Interest rate projections have moved significantly. Negative official interest rates were anticipated as recently as three months ago, yet consensus forecasts are now suggesting borrowing costs might need to be raised in early 2022.

- **Europe**: Conditions for European manufacturers are improving, according to the latest survey. Supply constraints and rising demand suggest prices might increase in the near-term.
- The services sector remains subdued, however, given continuing restrictions and closures in the region.
- The household savings rate has risen to nearly 18% in Germany. Spending is expected to pick up sharply in the remainder of 2021 as restrictions are eased, supporting above-trend GDP growth in Europe's largest economy.
- Lockdown restrictions remain in place in the UK, but the Prime Minister outlined a proposed 'roadmap' for the easing of restrictions. Retail, leisure, hospitality and travel will reopen in stages and the economy is expected to be fully operational by the end of June, in time for the summer holiday season.

- **Asia/EM:** Anecdotal evidence suggests consumer spending in China was quite solid through the lunar new year holiday period, with online sales maintaining their recent strength.
- Export demand also continues to gather pace, providing a strong tailwind for 2021 Chinese GDP growth forecasts.
- Numbers of Covid infections and vaccine rollouts were closely watched in Japan. It remains unclear whether the Tokyo Olympic Games will proceed in July and August this year, as planned.
- Consensus expectations indicate emerging economies grew at a combined annual pace of 2.6% in the December quarter.
- Export-oriented economies like Taiwan appear to have performed particularly well. In fact, Taiwanese officials have recently suggested exports in 2021 could be nearly 10% above 2020 levels, boosted by strong demand for semiconductors.

Australian dollar

- The Australian dollar was quite volatile in February, influenced by evolving interest rate and inflation expectations.
- The 'Aussie' briefly traded above 80 US cents – for the first time in more than three years – but lost momentum and closed at 77.4 US cents, an increase of 0.9% over the month.
- The Australian dollar fared better against other majors, appreciating by 2.6% against the Japanese yen, and by 2.4% against a trade-weighted basket of international currencies.

Australian equities

- Most ASX-listed companies reported their financial results for the first half of the 2020/21 year during February. In general, the tone of the results was positive.
- Major banks achieved higher-than-expected margins, iron ore miners delivered strong cash flows and record dividends, and retailers experienced strong operating leverage.
- These drivers helped the S&P/ASX 100 Accumulation Index rise 1.5% over the month.
- The Materials sector (+7.6%) was the best performer. OZ Minerals (+20.1%), Rio Tinto (+15.3%), BHP Group (+12.8%) and Fortescue Metals Group (+10.6%) all delivered strong earnings updates, reflecting high copper and iron ore prices.
- Financials (+5.0%) also performed admirably as better-than-expected margins, growing capital reserves and rising loan volumes helped major and minor banks to outperform.
- The rise in longer-term bond yields affected the market in the latter stages of the month, and resulted in a factor rotation from ‘growth’ to ‘value’ stocks.
- The Information Technology sector (-10.2%) particularly suffered from the rotation. All constituents within the sector declined. Machine learning and artificial intelligence company Appen (-25.3%) experienced the greatest selling pressure, after its results missed expectations.
- The S&P/ASX Small Ordinaries Index also rose 1.5%, assisted by particularly strong performances from Zip Co, Virgin Money (+39.5%) and Starpharma (+38.7%). Continuing success in key markets, combined with growth in active customers and merchants saw Zip rally more than +90% by mid-February, before broader market weakness later in the month dragged the shares lower. The stock closed the month ‘just’ 43.1% higher.

Listed property

- Global property securities posted solid gains in February, with the FTSE EPRA/NAREIT Developed Index rising 2.9% in Australian dollar terms.
- The best performing regions included Hong Kong (+11.3%), Japan (+7.0%) and the US (+5.3%), while laggards included Germany (-3.4%), Singapore (-3.1%) and Switzerland (-3.0%).
- Real estate markets were generally underpinned by optimism regarding a strong economic recovery this year, on the back of a speedy vaccine rollout and continued government and central bank support.
- The resulting inflationary concerns can be perceived as negative for defensive, ‘bond proxy’ sectors like REITs. On the other hand, the income generated by property firms can provide an inherent inflation hedge, which could be appealing to investors in the current environment. This is achieved both directly, through inflation-linked escalators embedded within leases on properties, as well as indirectly, as the demand for tenancies typically increases during periods of economic expansion.
- Locally, A-REITs declined -2.6%, amidst the first-half reporting season. The best performers included shopping mall landlords Scentre Group (+8.2%) and Vicinity Centres (+6.8%).

Global equities

- The sharp increase in bond yields spooked equity markets towards month-end. Investors have become accustomed to extremely low interest rates, so suggestions that borrowing costs could start to rise appeared unsettling.
- Technology names, which have been among the strongest performers in the equity market rally over the past year or so, were among those most adversely affected. The tech-heavy NASDAQ declined by nearly 4% on the last trading day of February, eroding gains made earlier in the month.
- In February as a whole, the NASDAQ added 0.9%. The S&P 500 Index gained 2.8%, after hitting fresh all-time highs in mid-month.
- Elsewhere, the Spanish IBEX and French CAC 40 were among outperforming markets, lifted by hopes of a vaccine-driven recovery. These indices rose 6.0% and 5.6%, respectively, in local currency terms.
- In Asia, the Japanese Nikkei 225 and Hong Kong Hang Seng indices climbed 4.7% and 2.5%, respectively; again in local currency.
- Overall, developed markets outperformed those in emerging regions. The respective MSCI indices added 2.7% and 0.7%.

Global and Australian Fixed Income

- The potential for economic growth to gather pace and result in stronger inflationary pressure was reflected in government bond yields globally.
- In the US, 10-year Treasury yields rose 34 bps, to 1.40%.
- There were similar moves in Europe; yields on UK gilts and German Bunds rose 49 bps and 26 bps, respectively, both climbing to their highest levels in nearly a year.
- Japanese government bond yields rose too, by 11 bps to 0.15%. This was a particularly meaningful move, as Japanese yields have not traded higher for more than five years.
- The increase in yields was even more pronounced locally. Yields on 10-year Australian government bonds soared 78 bps, to 1.92%. This was the highest level since early 2019, long before the Covid pandemic started to influence financial markets.
- Yield curves steepened in all major regions. While longer-dated yields moved higher, yields on shorter-dated securities generally remained anchored at low levels. In most cases, central banks have made it clear that official interest rates will remain unchanged for the foreseeable future.
- All of this resulted in disappointing returns from fixed income, and prompted bond market investors to reassess future return projections for the asset class.

Global credit

- Concerns about rising inflation did not appear to affect sentiment towards corporate bonds as much as some other asset classes.
- Credit spreads continued to grind tighter, in both the investment grade and high yield sub-sectors. Spreads on US investment grade issuers have narrowed to their lowest level in three years.
- A gradual easing of Covid-related restrictions should be supportive of corporate earnings, and official interest rates are expected to remain low. These factors should enable borrowers to service their debt repayment obligations more comfortably, and help keep default rates low.