

# Investment markets and economies: *In a relationship or just friends? It's complicated*

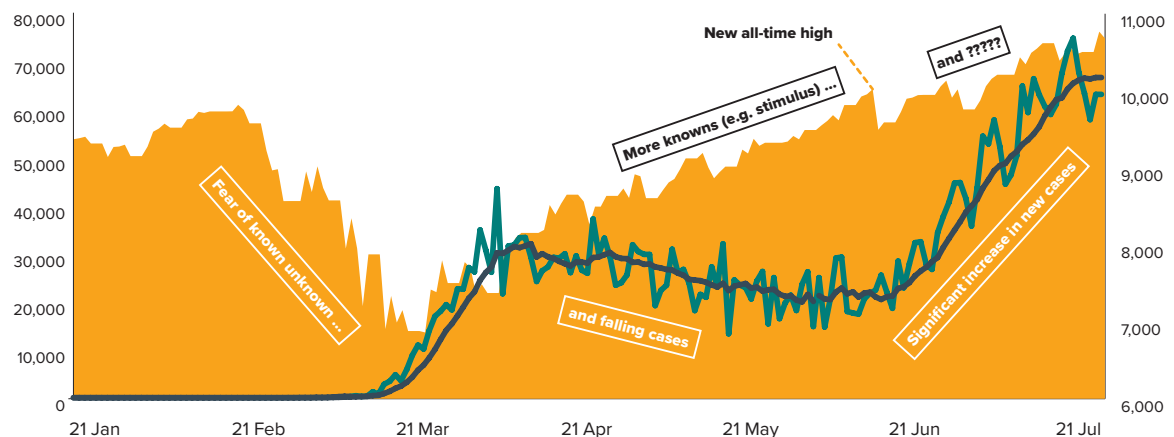
**Pitcher Partners Investment Services Pty Ltd**

## **Chris Gibson, CFA**

My wife tells me that Facebook references are passé. Be that as it may, Facebook, as the 'F' in the 'FAANG' stocks\* has proven itself to be hugely profitable for investors even if it's no longer at the vanguard of cool.

Many of us have been watching share markets around the world with incredulous fascination recently. How can the rosy outlook implied by the markets reconcile with daily records in new COVID-19 cases; multi-decade unemployment highs; and massive declines in consumer and business spending?

**Figure 1: NASDAQ Composite Index overlaid by US COVID-19 Daily Cases**



Source: NASDAQ, US Centre for Disease Control

The easy and fair refrain used in investments is that 'markets are forward-looking'. Over the longer-term current share prices and share market index levels should reflect their forecast future earnings capacity. But there's more to markets than this simple one-liner. The relationship between share markets and economies is a complicated one, and sometimes there's seemingly no relationship at all. In this note, we look at the difference in industry weightings between the economy and equity markets and the macroeconomic and geopolitical influences currently at play.

\* Facebook, Apple, Amazon, Netflix and Alphabet (Google)

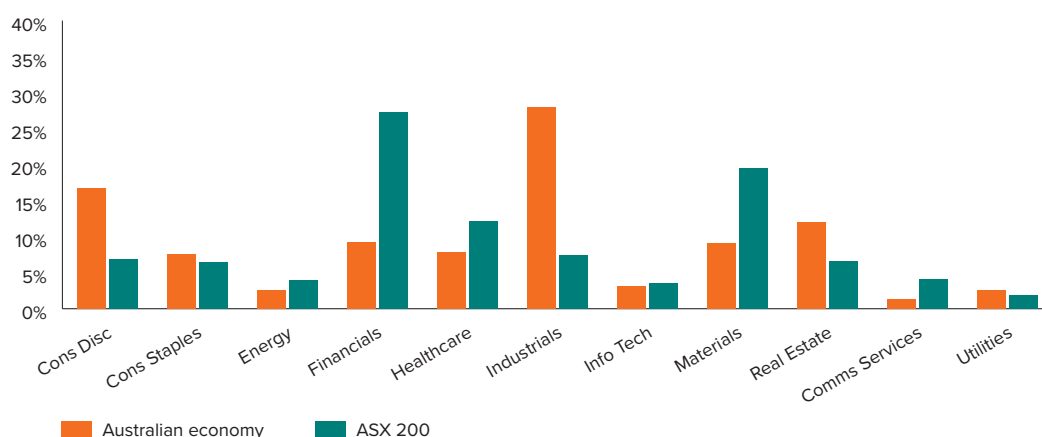
## Industry and market sector weights

We have reviewed the Australian Bureau of Statistics' (ABS) Industry Group data to reconcile the Australian economy to the ASX GICS (Australian Securities Exchange Global Investment Classification Standard) sectors – for example, consumer staples and energy – that make up the broader market indices we're familiar with, such as the ASX 200 Index.

By allocating this way, we can get an indication of the weight each sector contributes to the total economy in a manner that's comparable to the weights applied to sectors within the major market indices.

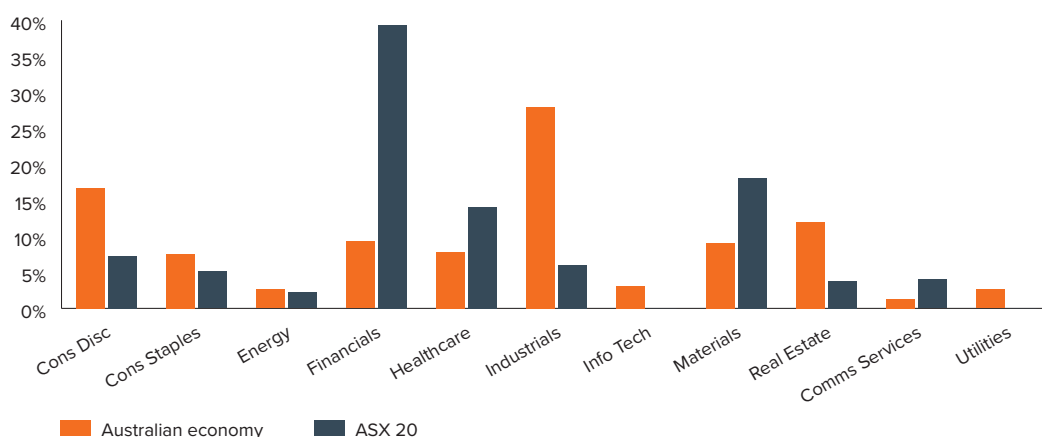
We compared these Australian economy 'sector weights' against the sector weights of the S&P/ASX 200 and the S&P/ASX 20.

**Figure 2: Sector weights – S&P/ASX 200 vs Australian Economy**



Source: Standard & Poor's; ABS, PPIS Research Estimates

**Figure 3: S&P/ASX 20 vs Australian Economy**



Source: Standard & Poor's; ABS, PPIS Research Estimates

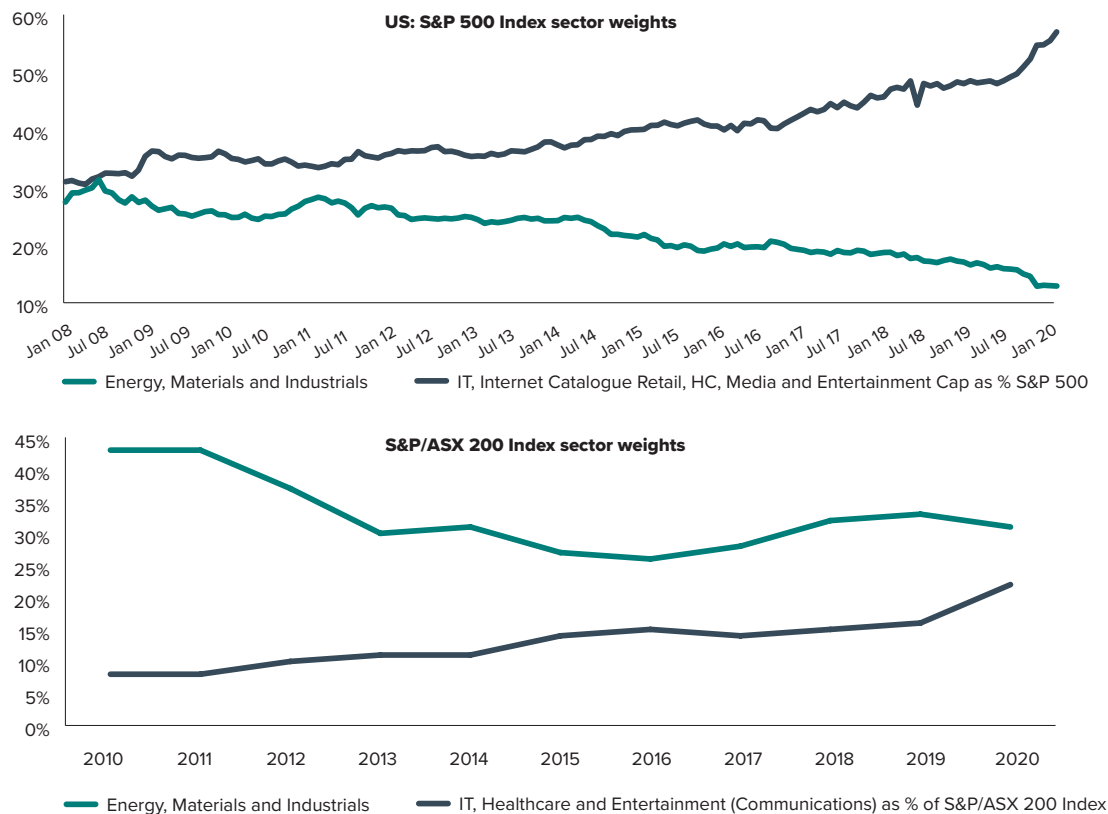
The makeup of share markets, while similar to the economies in which they are located, tend to differ in some key sectors. Figures 2 and 3 highlight the Australian share market's overweight exposure to financials, materials (mining) and health care. It also shows the large underweight exposure the market has towards consumer sectors and industrials (the real estate discrepancy is largely related to private homeownership).

These differing industry makeups between the share market and the economy highlights two key things. First, it's important to understand the difference between what's happening in the markets and what's happening in the economy. And, second, equity markets, as we've seen over the last few months don't always reflect the performance of the broader economy. The difference in industry capitalisations in the markets and the economy is one of a few reasons why the relationship between markets and the economy is a complicated one. Sometimes there's seemingly no relationship at all (more on that below).

In a pandemic that has shut down large swathes of the retail and industrial (manufacturing) sectors and increased demand for health care, medical research and life's staples, it could be expected that the share market might slightly outperform the broader economy.

Additionally, focussing in on the S&P/ASX 20 highlights a glaring underweight (i.e. 0%) to the domestic information technology sector. Microsoft and Apple hold the top two positions in the S&P 500 Index and represent over 10% of the Index's value. Three tech-driven companies hold spots three though to five: Amazon, Alphabet (Google) and Facebook. As discussed later, this is a key driver of the differing performance of US markets this year relative to most developed markets, including Australia.

**Figure 4: 'New Economy' and 'Old Economy' Market Weights, US vs Australia**

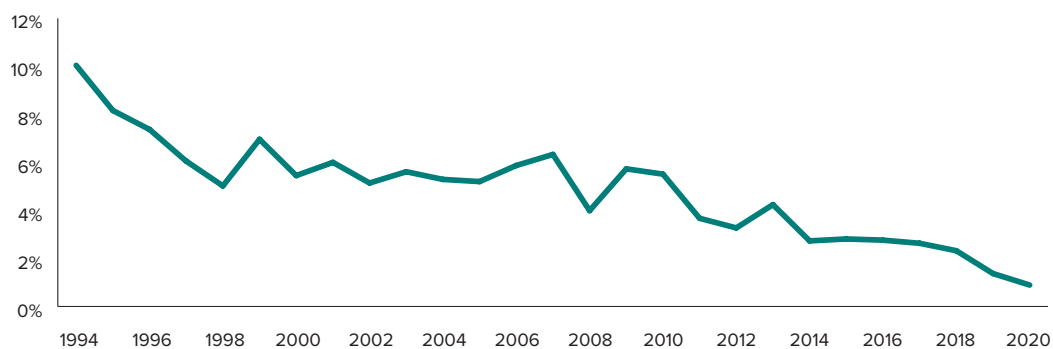


Source: Haver Analytics and Citi Research; Iress; Pitcher Partners Research estimates

## Interest rates

Falling interest rates are not new. Interest rates have been on a 30-year downward trend, punctuated by occasional steep changes following economic shocks. Interest rates act as both a barometer and benchmark for expected investment returns. Cooling interest rates suggests a lower growth outlook. Equally, lower interest rates reduces the 'required return' on other investment classes. If you can get a risk-free return on a government bond at 6% (remember those days?!), you would expect to get a notably higher return on a riskier asset like equities.

**Figure 5: 10-year Australian Government Bond Yield**



Source: Iress

As the returns available on low-risk assets falls – an Australian 10-year bond is currently yielding just 0.89% – this has the effect of lowering the ‘required return’ (the return investors are willing to accept) on other assets. This can be demonstrated by the Capital Asset Pricing Model (your adviser will be happy to explain this). If I need a 5% risk premium over bonds to invest in equities, then, all other things being equal, my required return has fallen from 11% to just 5.89%. On the face of it, I would be willing to pay almost twice what I would have historically for the same dollar of profit.

Central banks around the world have continued to reaffirm their expectations of lower for longer interest rate policies as part of their fight to stave off a large recession or depression in the face of COVID-19. This has encouraged equity investors to pay more for growth assets as the return on less risky assets is expected to remain low for an extended period.

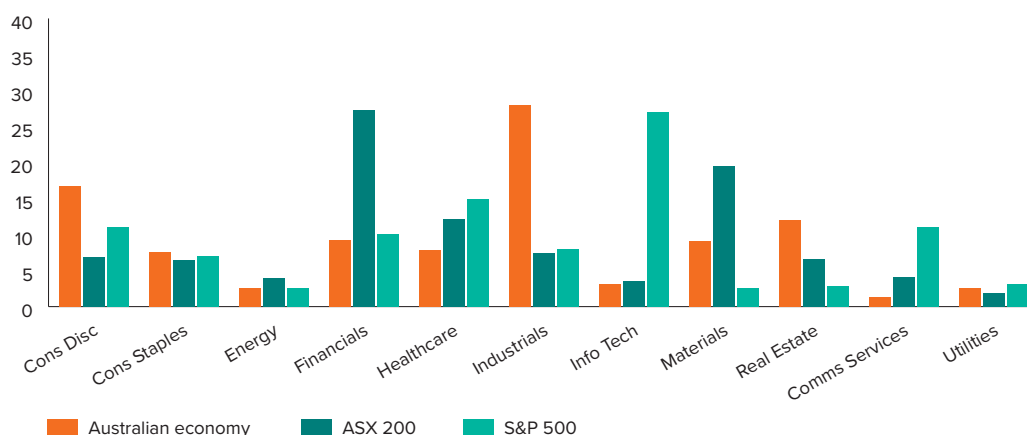
The Reserve Bank of Australia (RBA) and other central banks globally have continued, ramped up or started (in the RBA’s case) QE programs throughout the pandemic. As this liquidity reaches markets, equity prices continue climbing to all-time highs while economic data remains weak. If the last 12 years are any indication, central banks can’t simply print money to buy their way out of slowing economic growth. What was it that Einstein said about doing the same thing over and over again and expecting different results?

### Tech talk

Australia’s share market hasn’t rebounded as strongly as the key indices in the United States. Figures 6 and 7 show two key trends that have emerged from an Australian perspective since the pandemic began effecting markets.

First, the Australian market has lagged both global and US markets (noting the US market represents a ~60% weight in the MSCI World Index). And second, the US has a much larger weighting to technology stocks and the communications sector, which captures a lot of entertainment companies, than our local market (and economy for that matter). In a work from home world, technology has had a genuine coming of age moment. This phenomena has to some extent been reflected in the US share market performance which has largely been driven by the FAANGs, along with the venerable Microsoft.

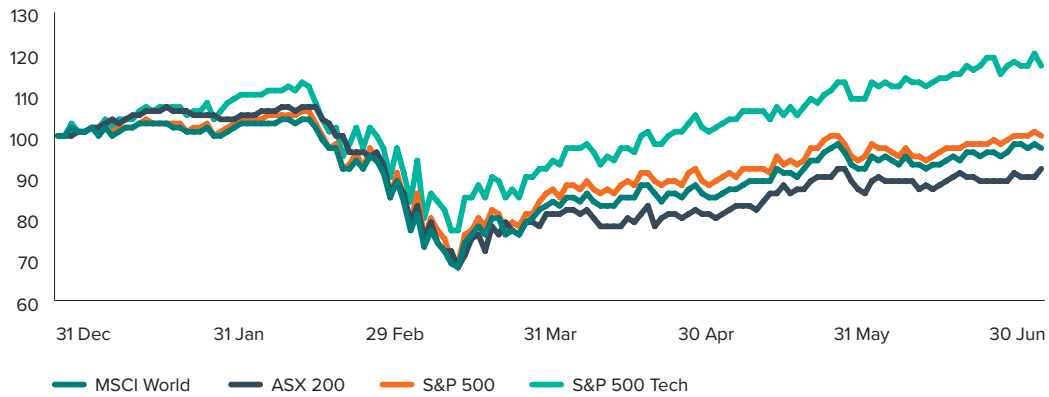
**Figure 6: S&P 500 Index weights vs Australian share market vs Australian economy**



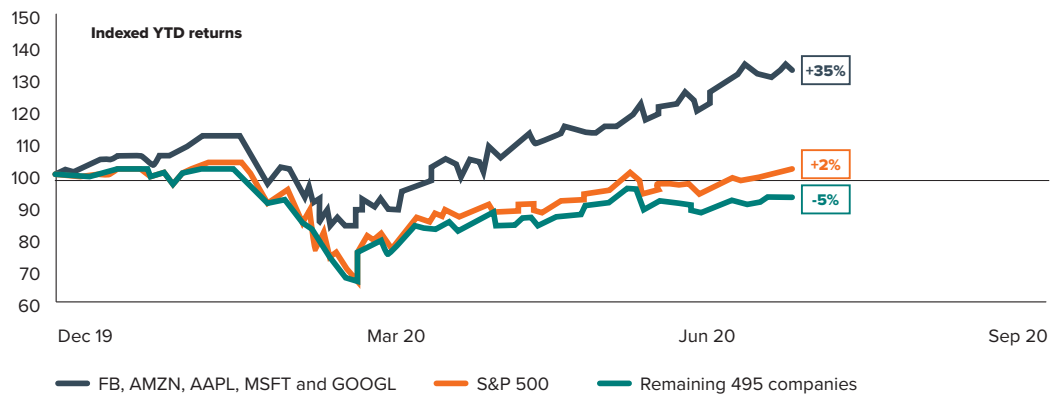
Source: Standard & Poor’s; ABS, PPIS Research Estimates



**Figures 7 and 8: Relative Index moves since first confirmed COVID-19 case in the US**



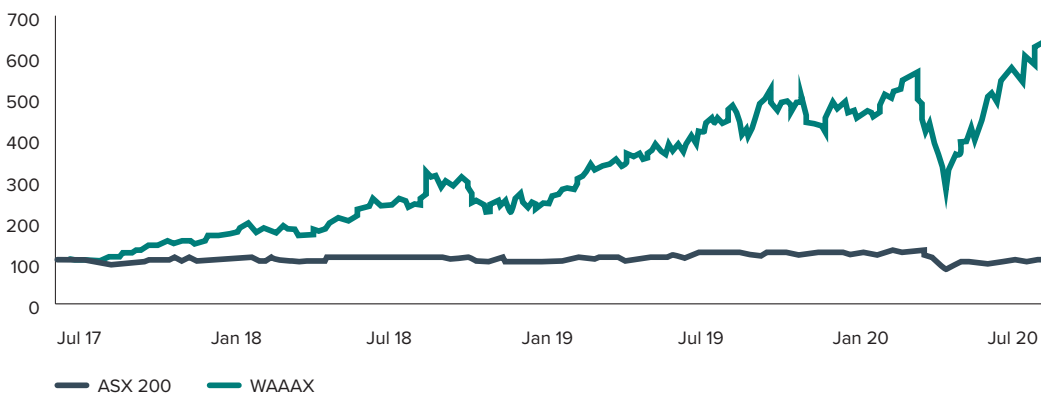
Source: Standard & Poor's, ABS, PPIS Research Estimates



Source: FactSet, Goldman Sachs Global Investment Research

Australia's equivalent of FAANGs is WAAAX, which includes WiseTech, AfterPay, Appen, Altium and Xero. AfterPay is knocking on the door of the S&P/ASX 20 and may soon be allowed in. These companies have also been on a stellar run. Their relative size, however, means the impact on our indices is less noticeable.

**Figure 9: WAAAX On – Share Price Performance of the WAAAX shares vs S&P/ASX 200**



Source: Morgan Stanley Wealth Management; Factset

Australia's contribution to global tech is perhaps underrepresented as many Australian success stories led by Atlassian have moved to tech's Mecca, Silicon Valley in the US. Finding a way to encourage local companies such as Canva to stay at home would be great for the Australian economy and for Australian investors.

### **The not-so invisible hand of the government**

Eighteenth century economist Adam Smith viewed the tendency of self-interest as the invisible hand that ultimately leads to the advancement of the species – the baker sells you bread not out of benevolence but to meet his own goals.

Nearly 250 years later, governments across the globe have been more forthright in their intent and actions in the face of the pandemic.

On one hand, government restrictions have made running a business near impossible in a range of industries.

And on the other, they have splashed unprecedented levels of cash support throughout the economy, bringing about the largest peacetime deficits on record. Promises by governments that they will continue to splash the cash have comforted investors that their investments are supported and/or backstopped by public funds. How the massive debt pile being created is to be repaid is not yet being factored into market assumptions.

On the domestic front, the Federal Government is focused on moving ahead with supply-side reform to drive Australia's economic recovery.

"Not everyone is a Keynesian and thinking about income support. It is important to go to the supply side. Thatcher, Reagan, that's an inspiration," said Treasurer Josh Frydenberg to the National Press Club in his July address.

The Government will announce further policies to support the country's economic recovery in its October 6 budget which we expect to include industrial relations reform, tax incentives and deregulation.

In a world increasingly reliant on deficits to keep the wheels of the markets and the economy turning, it's promising to see that the economic recovery here will likely be one that's focused on empowering businesses and individuals with the environment they need to grow their wealth through offering something of service to the world. It's not always a palatable message to some, but it's one that's much-needed today.

### **Can't be ignored – capital markets provide capital to companies that need it**

Listed markets draw in business types that need vast amounts of capital, either for:

- **Undertaking huge upfront infrastructure developments.** These were initially projects like the Suez Canal and railroads across continents. In modern times they have moved to metropolitan tollways and airports; or
- **To fund large footprints that can generate scale benefits** (like banks, supermarkets, technology platforms and health care).

These factors will also have some influence in the types of companies and sectors that will be represented in share markets.

### **Diversification remains a key – share markets are more than a reflection of the local economy**

Economies remain a very important factor in determining the likely performance of investment markets. In the shorter-term, sentiment around the economic outlook, government and central bank actions will weigh heavily on share markets. However, over the medium to longer-term there are many more influences that will affect share market performance and the relative performance of individual share markets among their peers.



## We're here to help

Economies and markets aren't in a clearly defined relationship, but we would argue they're more than just friends – it's complicated. We expect the near-term economic data will remain weak and the upcoming reporting season will give us a strong indication of its impact on local shares. The dispersion of research analyst's earnings forecasts as demonstrated in Figure 10 below is an indication of the uncertainty faced by investors.

**Figure 10: Dispersion of consensus estimates**

Our latest Quarterly Newsletter (#91) outlines how key industries have been performing throughout the



Source: IBES, FactSet, Morgan Stanley Research. Data as at 29 May 2020

pandemic, and the importance of high-frequency data to see how people and businesses are reacting in real time. We're always available to discuss our view of the markets, and will be in touch, as always, with our regular quarterly updates, along with other time-sensitive updates as needed.

Like so many things this year (and particularly as a Victorian), I suspect it'll be 2021 before we can sit back and reflect on what has been and what's to come. It was, however, nice to take a moment listening to Ross and John on 3AW as John Burns signed off last week, heading into retirement after almost 20 years with 3AW.

In the interim, we look forward to continuing to provide bespoke advice and investment guidance to all of you – our valued clients.

*Stay safe and take care.*

**Kellie Davidson**

Partner

**p.** +61 3 8610 5334**e.** [kellie.davidson@pitcher.com.au](mailto:kellie.davidson@pitcher.com.au)**Sue Dahn**

Partner

**p.** +61 3 8610 5124**e.** [sue.dahn@pitcher.com.au](mailto:sue.dahn@pitcher.com.au)**David Bedford**

Partner

**p.** +61 3 8610 5200**e.** [david.bedford@pitcher.com.au](mailto:david.bedford@pitcher.com.au)**Adam Stanley**

Partner

**p.** +61 3 8610 5517**e.** [adam.stanley@pitcher.com.au](mailto:adam.stanley@pitcher.com.au)**Duncan Niven**

Director of Research

**p.** +61 3 8612 9541**e.** [duncan.niven@pitcher.com.au](mailto:duncan.niven@pitcher.com.au)**Disclaimer**

This document has been prepared for the exclusive use and benefit of Pitcher Partners Investment Services Pty Ltd, our clients and our Authorised Subscribers. It must not be used or relied on by any other person, without our prior written consent. Information is sourced from third parties and Pitcher Partners believes it to be reliable at the date of publication, although we cannot guarantee accuracy and reliability, nor do we accept responsibility for errors and omissions. The information, including opinions, estimates and forecasts contained herein are as of the date of publication and are subject to change without notice. Pitcher Partners is under no obligation to correct any inaccuracy or update the information. Any financial product advice contained in this document is general advice only and does not take into account your objectives, financial situations or needs. If you wish to acquire a financial product, we recommend you seek advice from a Pitcher Partners Investment Services' representative, and where applicable, consider the relevant offer document prior to making any financial decision. Before acting on anything contained in this document, you should speak to your Pitcher Partners Investment Services' representative and consider the appropriateness of the information or general advice having regard to your objectives, financial situation, or needs. If you act on anything contained in this document without seeking personal advice you do so at your own risk. To the maximum extent permitted by law, neither we, nor any of our representatives, will be liable for any loss, damage, liability, or claim whatsoever suffered or incurred by you or any other person arising directly or indirectly out of the use or reliance on this information, or any changes made to this document without our prior written consent.



Pitcher Partners Investment Services Pty. Ltd. ABN 24 052 941 036 AFS LICENCE NO. 229887

Pitcher Partners is an association of independent firms. Liability limited by a scheme approved under Professional Standards Legislation. Pitcher Partners is a member of the global network of Baker Tilly International Limited, the members of which are separate and independent legal entities.

**[pitcher.com.au](http://pitcher.com.au)**