

Economic and Market Outlook

January 2021



International economy

Part 1: Overview

The cratering of the global economy in the first half of 2020 was the deepest since the Great Depression. Massive falls in Gross Domestic Product (GDP) brought on by sudden shutdowns of parts of the economy in response to the global pandemic were only arrested by unprecedented and timely government and central bank stimulus. Aggressive policy by governments and central banks have significantly boosted consumer sentiment and supported growth outcomes over the past two quarters. Recent news that several COVID-19 vaccines are highly effective and in the process of being rolled out has vindicated the views of those who believe the global economy is well on the way to a sustained recovery.

The Organisation for Economic Co-operation and Development (OECD) anticipates the global economy, after contracting by 4.2% in 2020, will rebound by 4.2% in 2021 and 3.7% in 2022. China is expected to do much of the heavy lifting. It is the only major economy expected to grow in 2020 and is forecast to contribute over one-third of world economic growth in 2021 (when it is expected to grow by 8%). Europe and North America, whilst growing, will underperform the Asian behemoth with growth rates of between 3% and 4%. The OECD attributes China's superior growth to the fact that it has been more successful in its handling of the pandemic, allowing its economy to reopen earlier than peers, as well as embarking on a massive stimulus program, most notably targeting infrastructure. At the 2020 National People's Congress, the Chinese Communist party announced over US\$1.4 trillion of new infrastructure projects as part of its latest 5-year plan. Projects targeted seven key areas; 5G networks, industrial internet, inter-city transportation and rail systems, data centres, artificial intelligence, ultra-high voltage power transmission, and new-energy vehicle charging stations. These projects are in addition to the Belt and Road initiatives already underway as well as energy projects, including the highly contentious hydroelectric dam project on the lower Yarlung Tsanpo river, that would be more than triple the capacity of the existing Three Gorges Dam.

The global economic recovery however is not without risks and could be prone to significant setbacks. Although the United States recorded growth of 33% (annualised) in the September quarter, a big slowdown is expected in the December quarter as the country grapples with a third wave of infections. Mixed messaging and woefully inadequate social distancing, face mask usage and contact tracing, has seen cases spike to over 200,000 per day. Renewed state induced lockdowns have resulted in job creation slowing sharply in November and retail sales have also fallen. Employment is still 9.8 million jobs below its pre-pandemic peak, and consumer expenditures on transport and recreation services is still almost 30% lower.

Given this outlook, it is clear that further fiscal stimulus is going to be required to support the US economy from plunging back into recession. After months of debate, the Republicans and Democrats have finally agreed on a US\$2.3 trillion aid package that includes a US\$600 stimulus cheque to millions of Americans, despite President Trump's preference for the cheques to be increased to US\$2,000. At best, the US recovery is now likely to be a slow 'u' shaped recovery than the 'v' that sharemarkets expect.

The situation in Europe and the UK, if anything, is even worse. After a sharp recovery in the September quarter, a second wave of infections threatens to overwhelm the hospital system once more, prompting further lockdowns. As a result, the economy has materially weakened and a double dip-recession now appears inevitable. Both the December and March quarters are now likely to record a contraction in activity.

The human toll of COVID-19 on many emerging market economies has been shocking. Those with limited healthcare systems and inadequate financial resources to provide transfer payments to furloughed workers have in the main fared much worse than those that do not. Nevertheless, the majority of emerging markets are now experiencing a recovery in conditions, driven by business re-openings and Chinese led demand. After contracting by around 2% in 2020, emerging market economies are expected to grow by around 6% to 7% in 2021.

Conclusion

Perhaps never before in history has there been such a disconnect between bullish financial markets and the real economy. Markets are forward looking and encouraging signs that effective vaccines will be rolled out throughout 2021 and 2022 provide hope that although, a difficult six months for the global economy may still lie ahead, the worst may almost be over. The massive stimulus packages released by governments and central banks worldwide have supported global economies and, for many, prevented worse outcomes by cushioning the economic contraction. Whether this positive sentiment continues is dependent upon the path of the virus and the timely rollout of vaccines to combat it, as well as continued favourable stimulus measures.

Part 2: Key economic indicators

United States

Economic snapshot	Last reported result	Comments
Growth (GDP)¹	33.1% (annualised) Q3'20	The US economy rebounded strongly in the September quarter, after contracting by 31% in the June quarter, its worst ever contraction on record. The rebound was underpinned by a surge in business and residential investment, and a recovery in consumer activity.
Unemployment²	6.7% Nov'20	The unemployment rate edged down to 6.7% in November as job gains in transportation and warehousing, professional and business services offset employment declines in Government and retail trade.
Industrial Production³	0.4% m/m Nov'20 -5.5% y/y Nov'20	Industrial production was supported in November by manufacturing of motor vehicles and parts.
ISM Manufacturing⁴	57.5 Nov'20 56.0 Aug'20	The PMI reading of 57.5 was 1.8 percentage points lower than the October reading but continues to signal a manufacturing sector in expansion.
Retail sales⁵	-0.8% m/m Nov'20 7.1% y/y Nov'20	Retail sales fell in November as social distancing restrictions impacted the usually busy shopping season.
Credit growth³	2.1% y/y Oct'20	Credit increased by 2.1% year-on-year and stands at \$4.16 trillion.
Outlook	After suffering a record contraction in the second quarter, the US economy has rebounded strongly. This reflected the resumption of economic activity that had been impacted due to the pandemic. Growth outcomes over the next two quarters are likely to be subdued but we expect a stronger recovery over the second half of 2021 as a result of continued stimulus, and as the distribution of effective vaccines helps to fully reopen the economy.	

Part 2: Key economic indicators (cont.)

Eurozone

Economic snapshot	Last reported result	Comments
Growth (GDP)⁶	12.5% q/q Q3'20 -4.3% y/y Q3'20	The Eurozone economy recovered strongly in the third quarter as consumer spending rebounded. Investment spending and exports also supported economic growth over the quarter.
Unemployment⁶	8.4% Oct'20	The unemployment rate fell slightly in October as the number of unemployed people declined by 86,000.
Industrial Production⁶	2.1% m/m Oct'20 -3.8% y/y Oct'20	Industrial production rose again in October, underpinned by Germany as well as sales of capital goods.
Manufacturing PMI⁷	53.8 Nov'20 54.8 Aug'20	The IHS Markit Eurozone Manufacturing PMI confirmed the manufacturing sector expanded for the fifth successive month as consumer confidence continues to improve.
Retail sales⁶	1.5% m/m Oct'20 4.3% y/y Oct'20	Retail sales rose in October, supported by strong increases in non-food products as well as food/drinks/tobacco, offsetting a large decrease in sales of automotive fuel.
Credit growth⁸	8.8% y/y Oct'20	The annual growth rate of total credit to euro area residents increased to 8.8% in October from a rate of 8.4% in September. The annual growth rate of credit to general government stood at 20.3% in October, after increasing 18.9% in September, while the annual growth rate of credit to the private sector remained steady at 4.9% in October.
Outlook	The rebound in the Eurozone economy is likely to face resistance over the short term as many member nations close their borders and reimpose shutdowns as COVID-19 infections from the second wave rise sharply. However, the vaccine roll-out, coupled with increased stimulus from the European Central Bank (ECB), should lead to solid growth outcomes over the second half of 2021, underpinned by a rebound in the sectors battered by the pandemic, namely trade, travel and tourism.	

¹Source: Bureau of Economic Analysis

²Source: Bureau of Labour Statistics

³Source: United States Federal Reserve

⁴Source: Institute of Supply Management (ISM)

⁵Source: United States Census Bureau

⁶Source: Eurostat

⁷Source: IHS Markit

⁸Source: European Central Bank

China

Economic snapshot	Last reported result	Comments
Growth (GDP)⁹	2.7% q/q Q3'20 4.9% y/y Q3'20	China's growth rate gathered momentum in the third quarter, supported by a rebound in exports and solid consumer spending.
Unemployment⁹	5.2% Nov'20	The urban surveyed unemployment rate fell for the fourth consecutive month in November.
Industrial Production⁹	7.0% y/y Nov'20 5.6% y/y Aug'20	Industrial production rose at its fastest rate this year during November, supported by a strong rise in exports.
Manufacturing PMI¹⁰	52.1 Nov'20 51.0 Aug'20	The latest reading of 52.1 was the highest since September 2017 and indicates the manufacturing sector remains in an expansion phase.
Retail sales⁹	5.0% y/y Nov'20 0.5% y/y Aug'20	Retail sales were strong in November, benefitting from "Singles Day" and strong e-commerce demand, which now accounts for 20% of total retail sales.
Fixed asset (urban) investment⁹	2.6% calendar y/y Nov'20	Fixed asset investment (FAI) rose strongly over the month and is now higher this calendar year than the first eleven months of calendar 2019.
Outlook	China's economy has picked up considerably since the height of the COVID-19 crisis. The growth rate is likely to continue to outperform peers, supported by domestic investment and consumption. This would allow Chinese authorities to finally normalise monetary and fiscal stimulus measures implemented to minimise the impact of the pandemic on the world's second largest economy.	

Japan

Economic snapshot	Last reported result	Comments
Growth (GDP)¹¹	22.9% (annualised) Q3'20 -29.2% (annualised) Q2'20	The Japanese economy rebounded from the sharp contraction suffered in the second quarter, expanding for the first time in four quarters.
Unemployment¹²	3.1% Oct'20	The unemployment rate rose to its highest level in three years in October.
Industrial Production¹³	3.8% m/m Oct'20 -3.2% y/y Oct'20	Industrial production increased for the fifth straight month, supported by a recovery in demand for machinery and autos.
Manufacturing PMI¹⁴	49.0 Nov'20 47.2 Aug'20	The latest reading of 49.0 marks the 19th consecutive month of contraction of the manufacturing sector.
Retail sales¹³	0.4% m/m Oct'20 6.4% y/y Oct'20	Retail sales rose strongly over the past year following implementation of a sales tax hike one year ago.
Outlook	A sharp rebound in export demand from key trading partners, including China, the United States and Europe, has helped drag the Japanese economy out of recession. We expect some of these tailwinds to fade over coming quarters as large swathes of the US and Europe head back into lockdown given the unchecked spread of the coronavirus. Nevertheless, the Japanese Cabinet office has recently upgraded 2021 growth expectations to 4%, based on a recently approved \$708 billion stimulus package, the rollout of the vaccine, and a continuation in strong demand from China.	

⁹Source: National Bureau of Statistics

¹⁰Source: China Federation of Logistics & Purchasing (CFLP) and the China Logistics Information Centre (CLIC). Based on data collected by the National Bureau of Statistics

¹¹Source: Cabinets Office

¹²Source: Statistics Bureau of Japan

¹³Source: Ministry of Economy, Trade and Industry

¹⁴Source: Jibun Bank and IHS Markit

Australian economy

Part 1: Overview

After suffering the worst downturn since the Great Depression in the first half of the year, the Australian economy has rebounded strongly. September quarter growth of 3.3% would have been much higher had it not been for the extended lockdown in Victoria. According to the Mid-Year Economic and Fiscal Outlook (MYEFO), released in December, real GDP is now expected to decline by just 2.5% in 2020, aided by strong export revenues as a result of the surging iron ore price, a lower-than-expected unemployment rate and a lower number of JobKeeper recipients.

This momentum is expected to continue into 2021, with GDP forecast to rebound by 4.5%. Growth is expected to be underpinned by a recovery in household consumption as consumer confidence gains traction, a vast pipeline of construction projects, as well as a gradual recovery in travel, education and tourism. Nevertheless, business investment is still expected to be broadly sluggish. Although the cost of money (interest rates) has never been cheaper, most businesses are still running well below capacity and will be reluctant to invest in new plant and equipment until this capacity begins to be absorbed. This will most likely require greater certainty in forward orders and activity returning to pre-COVID-19 levels. In recognition, both the Federal and State Governments have earmarked significant funds for infrastructure spending to offset otherwise weak private sector investment.

In the absence of record government spending and monetary stimulus, there is little doubt that millions more would be out of work and the economy would be in the midst of a depression. The fact that unemployment is now projected to fall below 6% (the point where the Treasurer has said the Government would turn its attention to budget repair) a year earlier than originally forecast, is a stellar achievement. The stimulus that has made this possible though has come at an enormous cost. The budget deficit is now expected to peak at \$197.7 billion in FY21 (equating to 9.9% of GDP), before reducing to \$66.0 billion (3.0% of GDP) in 2023-24. However, it is highly likely that it will remain in deficit over the entire decade. Treasury expects government debt to peak at around 55% of GDP later this decade, but these assumptions could easily prove optimistic. Admittedly, while interest rates are so low, the taxpayer funded sum required to service this debt is not overly onerous. If however, inflationary pressures unexpectedly rise, and interest rates revert to longer term averages, then much higher debt servicing costs will impose a significant drag on the government's ability to fund future services and commitments, thereby constraining future growth outcomes.

While the explosion of debt imposes medium to longer term risks, perhaps the biggest challenge Australia now faces is the escalation of tensions with China. If banning Huawei from the 5G network was the spark that lit the fuse, then Australia's push for an inquiry into the origins of COVID-19 certainly ignited it. China's attempt to punish Australia economically by either restricting or imposing tariffs on an ever-growing range of Australian products, including timber, barley, lobsters, wine, red meat and cotton, will damage a number of our key export industries. The recent unofficial ban on coal, our second largest export industry in 2018/19, worth almost \$10 billion a year, will have far reaching effects as suppliers will now be forced to find other buyers or curtail operations. Similarly, education services - our fourth largest export industry as of 2018/19 - is also likely to suffer with reports that Chinese students are being actively discouraged to return to study in Australia.

At this stage it is unlikely the ban will extend to Australia's biggest export, iron ore. Australia supplies over one half of the world's ore, which contributes around \$85 billion annually to GDP. Surging steel demand in China coupled with supply constraints in Brazil has seen the price soar. Banning Australian iron ore would only see the price rise even further, potentially crippling Chinese steel mills. Nevertheless, if China could source enough supply elsewhere, they probably would pursue this course of action. The combined revenue generated from these exports has made a significant contribution to national income for many years and is part of the reason why we enjoy such a high standard of living. Losing access to the lucrative Chinese market is clearly not in Australia's economic interests and so the importance of negotiating a diplomatic resolution to this impasse cannot be overstated.

At the onset of the pandemic there was concern that much higher unemployment could lead to mass mortgage defaults and a collapse in housing prices that would have damaging flow on effects for bank bad debts and the broader economy. Instead, a moratorium on repayments, stimulus measures including those targeting residential construction (such as HomeBuilder), along with record low interest rates, have seen a near-doubling in housing credit over the past year that has helped prices stabilise. As the outlook for the Australian economy continues to improve, prices may well rise even higher. Yet risks have only risen. Servicing large debts may be affordable when interest rates are low, but households will be particularly vulnerable should rates rise more rapidly than expected.

Conclusion

The Australian economy has rebounded strongly from the depths of the pandemic but the real challenge will come when the fiscal support that has helped underpin the recovery (JobKeeper and JobSeeker) is withdrawn. Many small businesses are still struggling, particularly those that rely on CBD foot track as well as travel, tourism and education providers. Challenges clearly still lie ahead but overall we remain confident that the economy will grow by around 4% to 5% in 2021, absent any further lockdowns or abrupt withdrawal of stimulus measures.



Part 2: Key economic indicators

Economic snapshot	Last reported result	Comments
Growth (GDP)¹⁵	3.3% q/q Q3'20 -3.8% y/y Q3'20	Australia has technically emerged from its first recession in three decades but contracted over the past year.
	12 month Outlook	The economy should grow on a yearly view by mid-2021 but the recovery is likely to be uneven.
Retail trade¹⁵	1.4% m/m Oct'20	Retail trade increased in October, underpinned by the reopening of physical stores in Victoria.
	12 month Outlook	Retail sales are likely to rise in line with an increase in consumer sentiment as economic conditions improve.
Manufacturing PMI¹⁶	52.1 Nov'20 49.3 Aug'20	The Performance of Manufacturing Index (PMI) declined by 4.2 points over the month as the easing of restrictions in Victoria saw the state's manufacturing industry return to expansion.
	12 month Outlook	We continue to expect a gradual improvement in manufacturing conditions nationally as the Victorian economy continues to improve.
Business investment (private new capital expenditure)¹⁵	-3.0% q/q Q3'20 -13.8% y/y Q3'20	Private new capital expenditure decreased over the quarter, impacted by sharp declines in capex on buildings and structures.
	12 month Outlook	Business investment is likely to be supported by the solid pipeline of infrastructure projects.
Unemployment¹⁵	7.0% Oct'20 7.5% Jul'20	The unemployment rate decreased slightly in October as employment increased 178,000 - most of these positions were gained in Victoria.
	12 month Outlook	The unemployment level is likely to stabilise around pre-COVID-19 levels, as many positions become redundant as Government support measures are further wound back.
Inflation and interest rates¹⁷	Inflation: 1.6% q/q Q3'20 0.7% y/y Q3'20	The Consumer Price Index (CPI) rebounded strongly in the September quarter as the period of free day-care ended in all states except Victoria.
	Interest rate: 0.10% Cash Rate Dec'20	The RBA left the cash interest rate unchanged in December at a record low of 0.10%.
	12 month Outlook	The RBA has reached its lower bound for the cash rate of 0.10% and is unlikely to lower this rate further.
Australian dollar	AU\$1 = US \$0.77	The Australian Dollar rose solidly over the September quarter as risk appetite continued to improve on positive progress on the vaccine front.
	12 month Outlook	The AUD is likely to remain well supported while demand for key mineral commodities remain elevated and global growth continues to gain traction.

¹⁵Source: Australian Bureau of Statistics

¹⁶Source: Australian Industry Group

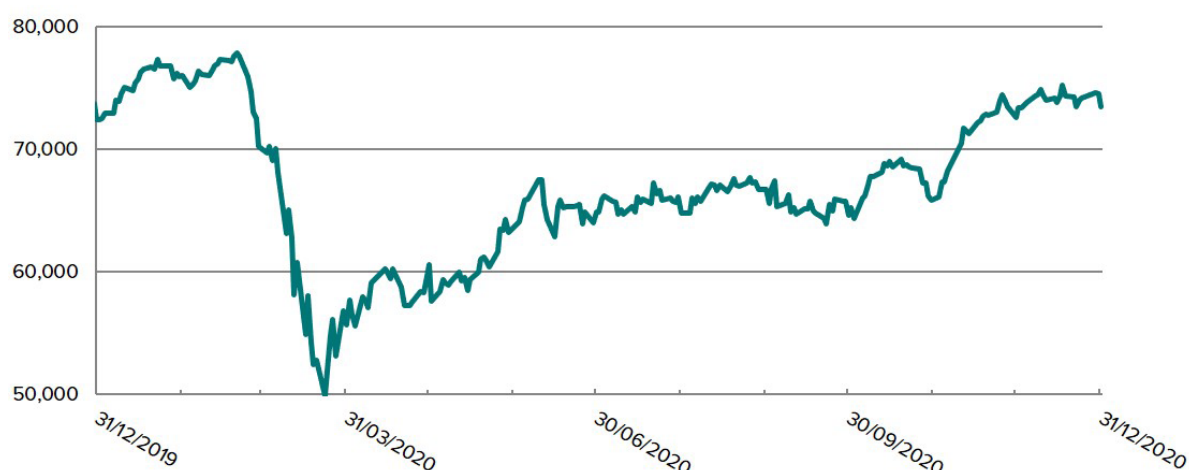
¹⁷Source: Reserve Bank of Australia

Australian equities

Overview

The S&P/ASX 200 Total Return Index returned 13.7% over the three months and 1.4% over the twelve months to 31 December 2020.

S&P ASX200 Accumulation Index



Source: S&P

Outlook

Our outlook for some of the major sectors of the S&P/ASX 200 is as follows:

Banks

The COVID-19 pandemic has rattled many parts of the economy and the banking sector has not escaped unscathed. Many of the headwinds facing the sector that have been building over a number of years – rising doubtful debt charges, increasing competition and regulation, slowing credit growth and falling margins, to name a few – have only been exacerbated by the pandemic.

The government has been proactive in supporting the economy during the pandemic. These measures have helped businesses and individuals navigate the most challenging economic environment for many decades. The road to recovery, however, is not-so straightforward – it is likely to be rocky and uneven. Stimulus measures will eventually be withdrawn – albeit gradually – and the banks, being a proxy for the overall economy, will have to contend with this. A direct consequence of this stimulus removal is that many businesses and individuals may well default on their repayments and banks face the prospect of a steep rise in losses in both retail and business divisions.

Mitigating the headwinds in the banking sector is the fact that capital positions have remained robust over recent years as banks have built large capital buffers. This is evidenced by the recent banking reporting season, which has been highlighted by the cancellation or reduction of dividends in line with APRA's requirement for bank capital levels to be "unquestionably strong". A further positive is that the housing market appears headed for a soft landing, with house prices rising across the nation – with the exception of Melbourne – in recent months. The gains in banking shares since late October are unlikely to continue until the market has a firmer reading as to the magnitude of bad debt charges across the sector.

Australian equities (cont.)

Resources

The resources sector continues to benefit from the global economic recovery, positive developments on the vaccine front and continued stimulus from governments and central banks the world over. China, in particular, has renewed their infrastructure spending in an effort to mitigate the sharp decline in global demand due to COVID-19, which in turn has underpinned strong commodity prices, notably iron-ore and copper. By 2035 China plans to double the size of its high-speed rail network and integrate this into the One Belt One Road initiative. This, among many other large-scale projects, is likely to support elevated demand for resources for many years to come.

Not all resources, however, have a similar attractive demand profile. Oil, for example, absent any significant production cuts from OPEC+ nations, is likely to recover more slowly. Global consumption is expected to reach pre-pandemic levels only towards the middle of this decade as changes in consumer and employment behaviour lead to lower demand for jet fuel and gasoline over (at least) the short term, and energy use continues to shift away from fossil fuels in favour of renewables.

Continued diplomatic tensions between Australia and China remains a significant risk to commodity prices over the short term. However, we note that Australia is a significant producer of several commodities (notably in iron ore) and so any action in regard to tariffs on such commodities would appear to be futile as China would have difficulty sourcing significant quantities elsewhere.

Retail

The retail sector has borne the brunt of the fallout from COVID-19, as weak consumer demand (and confidence) and rising unemployment levels impacted retail sales. At the peak of the crisis earlier this year, retail spending collapsed at its fastest rate in two decades. Unprecedented stimulus packages from the Federal Government such as JobKeeper and JobSeeker helped provide the sector, and the economy as a whole, with a lifeline as many recipients have spent these payments.

Structural change in the retail sector has been a phenomenon for the best part of the past decade. The pandemic has only accelerated the willingness for consumers to engage in e-commerce. Notwithstanding the easing and eventual removal of social distancing measures, many brick and mortar operations lacking a significant online presence are likely to continue to struggle as consumers continue to gravitate towards digital channel transactions due to their efficiency and price competitiveness. The ABS estimate that up to 20% of non-food sales are generated via online channels. Many retailers will be forced to restructure in order to survive, while others will likely be forced to shut their doors permanently.

Within the retail industry, consumer staples such

as supermarkets, food and liquor are expected to see robust sales. However, department store sales are expected to continue to struggle. In the short term, the greatest risk to retail spending involves the winding back of temporary relief packages at the end of December and March, which could lead to an overall decrease in consumer spending as overall disposable incomes fall and unemployment rises, and a corresponding increase in staff costs as JobKeeper subsidies expire.

Australian Real Estate Investment Trusts (AREITs)

The AREIT sector bore the brunt of a brutal COVID-19 induced sell-off in the first half of the year. Investors fretted as lockdowns saw foot traffic capitulate in CBD's, causing many retailers to shutter operations and landlords forced to offer rental relief to tenants. Further, offices in the CBD saw a large drop-off in workers frequenting their workplace, casting a pall over long-term demand for office space as the working-from-home phenomenon becomes entrenched in many workplaces.

Conditions in the retail sub-sector have ameliorated during the second half of the year as consumer sentiment has improved significantly and the positive news in regard to the COVID-19 vaccine has boosted confidence. Government and RBA stimulus has supported individuals and businesses, leading to a lower unemployment rate than would otherwise have been the case. The net effect has been an uplift in retail sales. Whether this behaviour continues once stimulus is withdrawn remains to be seen. A ban on foreign tourists entering Australia is impacting retail sales. However, the Australian economy is projected to grow solidly in 2021, which would imply that retail sales should continue to be well supported. This would auger well for the retail sub-sector.

The office sub-sector continues to feel the effect of low numbers of workers frequenting their workplaces. Whilst workplace numbers have increased over the past three months, many tenants will seek to renegotiate their leases on better terms as they come up for renewal (notably reducing their footprint as flexible working arrangements become the new normal). This would indicate that the challenging conditions in the office sub-sector are likely to continue into the medium term.

The residential sub-sector has rebounded solidly as evidenced by the strong rise in mortgage pre-approvals. Mortgage defaults (and by extension, bad debt charges) are likely to increase from historic lows as a result of a rise in unemployment but are likely to be well-contained as the unemployment rate is expected to be far lower than what was predicted at the height of the crisis. Notwithstanding record low interest rates, a continued ban on immigration (with the exception of a few travel bubbles) is likely to cap any significant rise in house prices.

The industrial sub-sector remains the outperformer in the AREIT sector. It was the only sub-sector than benefitted from the crisis as the gravitation towards e-commerce accelerated during the pandemic, underpinning the strong demand for industrial properties. The disruption to supply chains has proved to be less of an issue than anticipated. Growth in online sales could prove to be more than a transitory phenomenon as consumers become accustomed to purchasing goods through these channels.

We maintain our neutral recommendation on the AREIT sector. The moderate gearing levels of companies across the sector continue to provide support amid an uncertain outlook.

Conclusion

Domestic equities have suffered a tumultuous 2020 as an improving global growth outlook at the start of the year rapidly morphed into a pandemic-driven sell-off in late February through to the end of March. Equity prices have since rebounded strongly as investor confidence was restored by a combination of stimulus measures that reduced the severity of the economic shock, including very low interest rates that made other asset classes relatively unattractive, business re-openings and vaccine optimism. Nevertheless, markets appear to have rapidly priced in the economic recovery even though the path to recovery is likely to be uneven and fraught with risks.

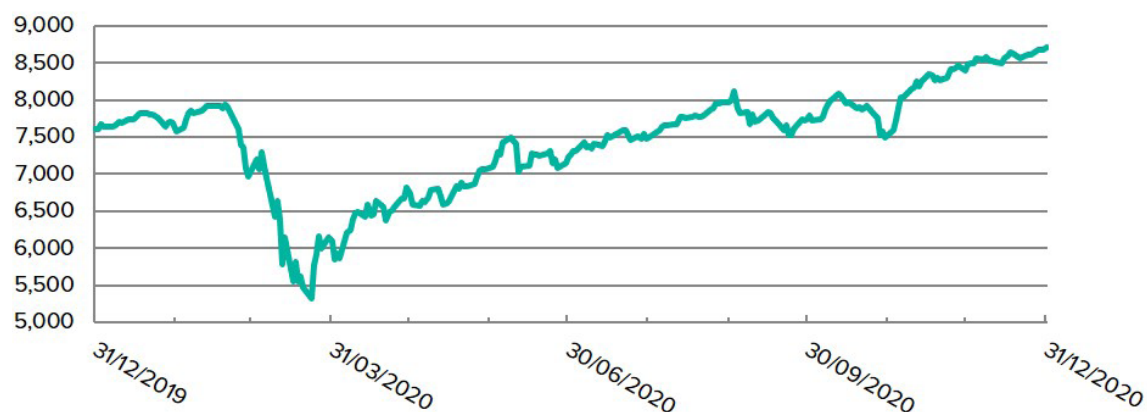


International equities

Overview

The MSCI World (ex-Australia) Accumulation Index (local currency) returned 12.4% over the three months and 14.4% over the twelve months to 31 December 2020.

MSCI World ex-Australia Accumulation (Gross) Index (Local Currency)



Source: MSCI

Outlook

Most equity markets around the world have soared over the last nine months, since the lows of late March. The US (8% higher than it was at the pre-COVID-19 peak in February) and China are up far more than most European markets where lockdowns have been longer and harsher. With global industrial production in advanced economies still well below pre-COVID-19 levels (about 5% lower as the end of September), it is clear that corporate earnings are going to be on average, materially lower than those experienced in 2019. This means that either investors are betting on a robust recovery in earnings expectations in 2021 and beyond, or they believe that stock valuations should be materially higher due to the low interest rate settings.

Valuations

In the United States, operating earnings for S&P 500 companies are currently expected to fall by 15% in 2020 and grow by 22% in 2021 and 17% in 2022 respectively. Using these forecasts and conventional long-term multiples, we estimate that the US sharemarket is overvalued by between 5% and 33%.

2020 Calendar year forecast	EPS earnings estimates	S&P 500 Fair Value estimate	Upside/(downside) S&P 500 = 3,756
<i>Consensus</i>	\$138	2,277	(39)%
<i>If 10% below</i>	\$124	2,049	(45)%
<i>If 10% above</i>	\$152	2,505	(33)%
2021 Calendar year forecasts	EPS earnings estimates	S&P 500 Fair Value estimate	Upside/(downside) S&P 500 = 3,756
<i>Consensus</i>	\$169	2,789	(26)%
<i>If 10% below</i>	\$152	2,510	(33)%
<i>If 10% above</i>	\$186	3,067	(18)%
2022 Calendar year forecasts	EPS earnings estimates	S&P 500 Fair Value estimate	Upside/(downside) S&P 500 = 3,756
<i>Consensus</i>	\$197	3,251	(13)%
<i>If 10% below</i>	\$177	2,925	(22)%
<i>If 10% above</i>	\$217	3,576	(5)%

Source: S&P, Bloomberg, Refinitiv

In an attempt to justify elevated valuations, investors are increasingly subscribing to the theory that low interest rates support higher market valuations. Intuitively we know this to be true over the short run because low interest rates reduce interest repayment expense, increasing earnings. Further, a lower cost of debt reduces a firm's weighted average cost of capital (debt + equity). The Weighted Average Cost of Capital (WACC) is used to discount the future value of a company's earnings to present day values. A lower WACC produces a higher valuation. By extrapolation, the same approach can be used to gauge value for the sharemarket as a whole.

In the example below, you will note that the higher the WACC, the lower the present value of the future income stream (in this case, the estimated value of the S&P500). The long-term growth rate assumption for earnings equates to the long-run economic growth rate of about 3% p.a. (different companies will obviously grow at a faster or slower rate than the broader economy but it is the average that we are concerned with here).

WACC (discount rate)	10%	9%	8%	7%
<i>2021 S&P 500 EPS</i>	\$169	\$169	\$169	\$169
<i>2022 S&P 500 EPS</i>	\$197	\$197	\$197	\$197
<i>Long term growth (p.a)</i>	3%	3%	3%	3%
<i>S&P 500 Valuation (estimate)</i>	2,712	3,167	3,804	4,760
<i>Upside/downside</i>	-28%	-16%	+1%	+27%

Conclusion

As COVID-19 spreads out of control across many parts of the world, including Europe and the United States, the likelihood of further lockdowns curtailing earnings growth in the short run is high. Nevertheless, as vaccines begin to get rolled out, optimism remains high that the broader impacts will be temporary in nature, paving the way for a sustained recovery over the second half of 2021 and beyond. In the meantime, massive central bank and government stimulus in most developed economies remains supportive of equities relative to cash and bonds. As valuations, however, are already expensive based on conventional metrics, especially in the tech sector, markets are starting to exhibit signs of irrational exuberance. Nevertheless, we expect that investors will be prepared to accept higher valuations in this low interest rate environment, at least until inflation starts to rise once more.

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