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David Lane – Director

2020 will undoubtedly be recorded as one of the most tumultuous and eventful years in living history. In contributing to these newsletters, for the past year it has felt almost remiss not to begin each of these notes with adjectives such as 'unprecedented', 'massive', 'unparalleled' 'extremes' etc, while also recounting the tragic human and economic cost that has been associated with Covid-19. We also clearly cannot forget the terrible impact from the bushfires that preceded the virus impacts here in Australia.

The emergence of Covid-19 profoundly altered so many people's lives and its effect will be felt for years to come. The global pandemic and the subsequent response from governments, humanity and corporations across the globe has had such an immense impact on life across so many different levels. We have witnessed dramatic levels of change, with many disruptive themes accelerating markedly, especially those within the digital world.

The rate of change that we have experienced and witnessed over the last 12 months has been extraordinary, and has been further magnified by the speed of the global news flow. Not only has the political situation in the US been the most tumultuous experienced for decades – if not centuries – the world watched as the Capitol was stormed!

Investment market performance summary – 31 December 2020

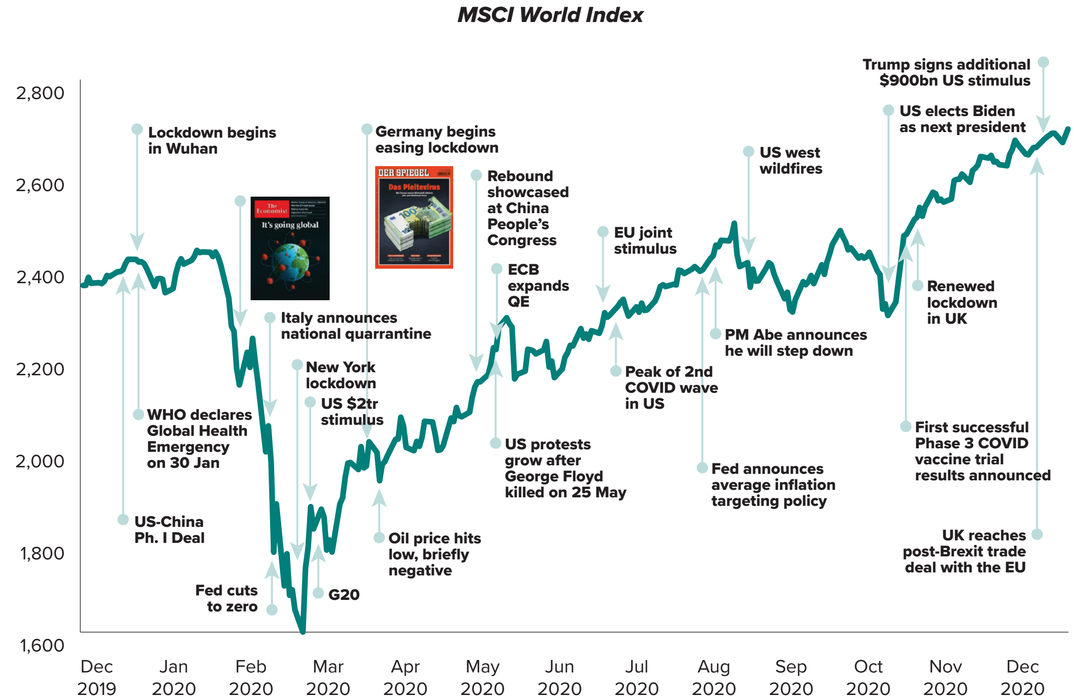
Indices	Current	3 months	1 year
ASX 200	6,587.1	13.3%	-1.5%
ASX 200 (Acc)	73,459.6	13.7%	1.4%
US S&P 500	3,756.1	11.7%	16.3%
Japan Nikkei	27,444.2	18.4%	16.0%
UK FTSE 100	6,460.5	10.1%	-14.3%
MSCI World	2,690.0	13.6%	14.1%
German Dax	13,718.8	7.5%	3.5%
French CAC	5,551.4	15.6%	-7.1%
HK Hang Seng	27,231.1	16.1%	-3.4%
Shanghai Comp	3,473.1	7.9%	13.9%
ASX 200 Prop (Acc)	55,293.9	13.3%	-4.6%
Global Prop	2,560.1	10.6%	-13.7%
Australian Bonds	10,699.0	-0.1%	4.5%
International Bonds	1,112.2	0.8%	5.1%
Commodities			
Gold (oz)	1,898.4	0.7%	25.1%
Oil (Barrel)	48.5	20.6%	-20.5%
Iron Ore (Tonne)	152.9	27.2%	77.9%
Aluminium	1,979.5	12.2%	9.4%
Copper	7,766.0	16.4%	25.8%
Lead	1,994.0	9.3%	3.5%
CRB Index	167.8	13.0%	-9.7%
Currency			
AUD/USD	0.7694	7.4%	9.6%
AUD/EUR	0.6298	3.1%	0.6%
AUD/GBP	0.5629	1.5%	6.4%
AUD/JPY	79.4690	5.2%	4.2%
AUD/RMB	5.0482	3.7%	3.2%

Source: Bloomberg.

As we look back at 2020 from an investment perspective, it seems surreal that the 12-month performance was good. Global equity markets produced some of the strongest returns for investors. After a steep decline across late February and March, extremely accommodative fiscal and monetary policy settings drove a sharp recovery led by the almost insatiable demand for stocks linked to new technology, disruption and innovation, especially those listed within the US and China. The technology-laden NASDAQ index was the best performer of 2020, with a gain of 43.6%. South Korea's KOSPI was the best of the country indices, up 30.7%. Towards the end of the year, optimism around the approval and rollout of vaccines led to a sharp rotation into more economically sensitive sectors including commodities and financials. European equities generally struggled due to weaker macro conditions amid a generally more mixed policy response, especially during 1H20.

A Look Back at Global Stock Markets in 2020

Investors look beyond pandemic and drive a rapid rally after a sharp downward correction in March



Source: LaSalle Investment Management

Thanks to a 13% gain in Q4, Australian equities edged into positive territory for the full year despite us being under-represented in some of the growth sectors that performed so well offshore, with banks rebounding sharply off mid-year lows.

Local and international fixed income asset classes produced yet another solid year of returns, as cash rates were cut and anchored at record lows across many countries that also prompted a number of major central banks, including the RBA, to embark on large QE programs. Credit spreads tightened substantially from March highs as funding channels opened up and easing macro and credit quality concerns continue to attract yield hungry investors.

The Australian dollar also gyrated wildly over the year, hitting a low of 56c against the USD in March before hitting 77c at the time of writing on improved risk sentiment, strong commodity prices and a weak USD.

In our newsletter this quarter, we provide a discussion on a selection of the key issues which we believe will help shape the performance of investment portfolios over the course of 2021, while we also look forward to communicating our updated asset allocation views with you in the coming weeks post our quarterly investment strategy committee review.

We trust that you all and your families had an enjoyable and restful festive period and as we maintain our Covid-normal environment, very much look forward to meeting and working for you all over the course of this year.

2021 Outlook – From resilience to recovery?

Duncan Niven – Director of Research

After the tumultuous year so many of us experienced in 2020 and the curtain having now closed on the Trump Presidency, we certainly look forward to 'turning the page' in 2021. Crystal ball gazing proved to be a profligate activity this time last year, with perhaps an exception for only the most extreme commentators.

In dusting ourselves off and recommitting to looking forward over the course of 2021, we believe it's likely to be a year of a multi-speed recovery, with many countries still experiencing high infection rates, but some are managing to contain the efforts and with multiple vaccines and a massive production and distribution effort, there is genuine cause for optimism in across many areas of the world, especially so in Australia.

We talk to a couple of the key issues facing local investors today, that in our view are likely to shape the direction and magnitude of financial asset performance over the course of the year.

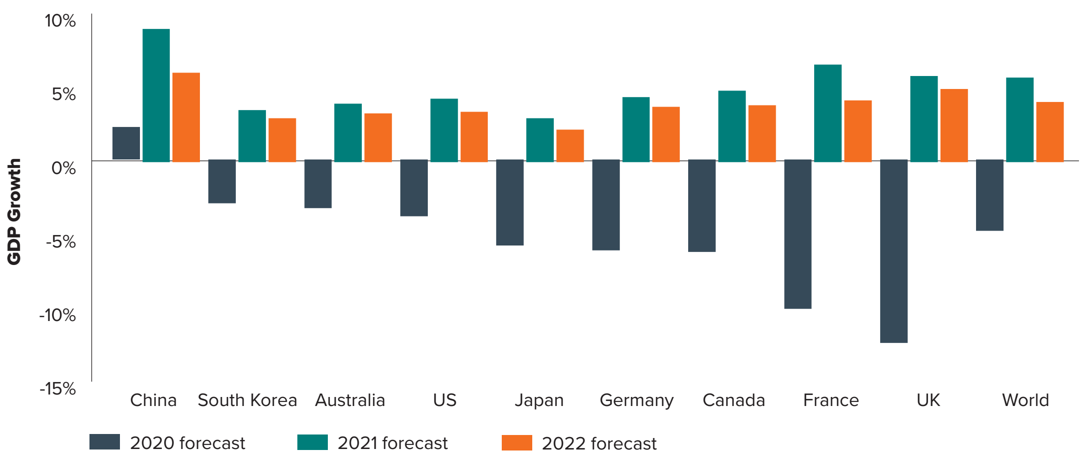
How quickly is the world's economy likely to recover?

From a purely macroeconomic point of view, 2020 will go down as one of the strangest years ever. The Covid-19 crisis has resulted in the largest declines in GDP outside of periods of war or the Great Depression, the biggest economic revival ever and the most remarkable monetary and fiscal policy responses since the 1930s.

Despite a worrying start to the year for many countries, with mass vaccination programs planned or already underway, we believe that economic recovery will be a key theme throughout 2021, but the recovery will be multi-paced across the globe. Indeed, expectations are gradually building over a double dip recession across Western Europe as the second wave of infections take their toil across the region. Australia on the other hand, appears to be in a strong position to recover lost output by Q3/Q4, potentially sooner judging on recent strength in employment.

In the risk of oversimplifying events and glossing over a range of upside and downside risks, in our opinion it is highly likely that 2021 will see some of the strongest annual growth rates for GDP in the last forty or fifty years. The IMF has further upgraded estimates for global GDP to grow in excess of 5.5% in 2021, which would be comfortably the highest in the post-war period. Numerous downside scenario reports from economists and strategies that we have read still have the global economy recovering by over 3–4% over the course of 2021. The most upbeat scenarios are forecasting high single digits.

Consensus GDP growth forecasts



Source: LaSalle Investment Management

The bigger picture macro risks are still mostly the most obvious ones. A serious challenge either to vaccine distribution timelines, vaccine safety or efficacy would not only stall/stretch out an economic recovery, it would likely precipitate a correction across equity markets, especially the current rotation into cyclical/value stocks.

Longer term, the impulse from all the stimulus will eventually be unwound and economies will have to stand on their own two feet. We do see some challenges with respect to certain areas of credit markets and equities as that scenario unfolds, however the commitment to support and reinvigorate consumer and business confidence and activity in many countries remain strong, ensuring that economic recovery will hopefully be the dominant – and welcome – theme for the year ahead.

Virus Vs Vaccine

For the next few months, we are likely to see a battle of the “Vs”, the tug of war between virus and vaccine.

We are already seeing the positive news about vaccine development and roll out across various nations, whilst being offset by the ongoing waves of the Covid-19 virus with rising infections, hospitalisations, deaths and the attendant risks to economic activity. Currently, the US still has the highest level of case growth per capita globally, while Western Europe and Japan are now showing some signs of slowing rates of infection, although alarming shortages of hospital capacity are evident across many countries still. The recent announcement of new COVID quarantine centres being built in Northern China continues to emphasise that containing the spread of this virus, even for countries with perceived low infection rates, is an ongoing battle.

We should continue to highlight that a successful vaccine has been developed in record time, less than one year. The previous record for the fastest time to develop a vaccine occurred in the late 1960s when it took four years to develop a vaccine for the mumps. Pfizer/BioNTech, Moderna and AztraZeneca have all received various emergency regulatory approvals and whilst there have been some hiccups in terms of the distribution efforts in some countries so far (Pfizer has had to impose limits on some countries recently), people are getting vaccinated, with Governments setting very ambitious targets in a phased fashion, beginning with frontline healthcare and service workers and the most vunerable (Australia’s rollout strategy is outlined below).

Whilst these are great developments, we still don’t have all the answers yet – we don’t know if vaccination prevents someone from being contagious for instance, we also don’t know how long immunity from vaccination lasts for.

Australia's COVID-19 vaccine roll-out strategy

Phase 1a– up to 1.4m doses (ongoing)

Quarantine and border workers	70,000
Frontline health care worker sub-groups for prioritisation	100,000
Aged care and disability care staff	318,000
Aged care and disability care residents	190,000
Total	**678,000**

Phase 1b – up to 14.8m doses

Elderly adults aged 80 years and over	1,045,000
Elderly adults aged 70–79 years	1,858,000
Other health care workers	953,000
Aboriginal and Torres Strait Islander people > 55	87,000
Younger adults with an underlying medical condition, including those with a disability	2,000,000
Critical and high risk workers including defence, police, fire, emergency services and meat processing	196,000
Total	**6,139,000**

Phase 2a– up to 15.8m doses

Adults aged 60–69 years	2,650,000
Adults aged 50–59 years	3,080,000
Aboriginal and Torres Strait Islander people 18–54	387,000
Other critical and high risk workers	453,000
Total	**6,570,000**

Phase 2b – up to 16m doses

Balance of adult population	6,643,000

Catch up any unvaccinated Australians from previous phases

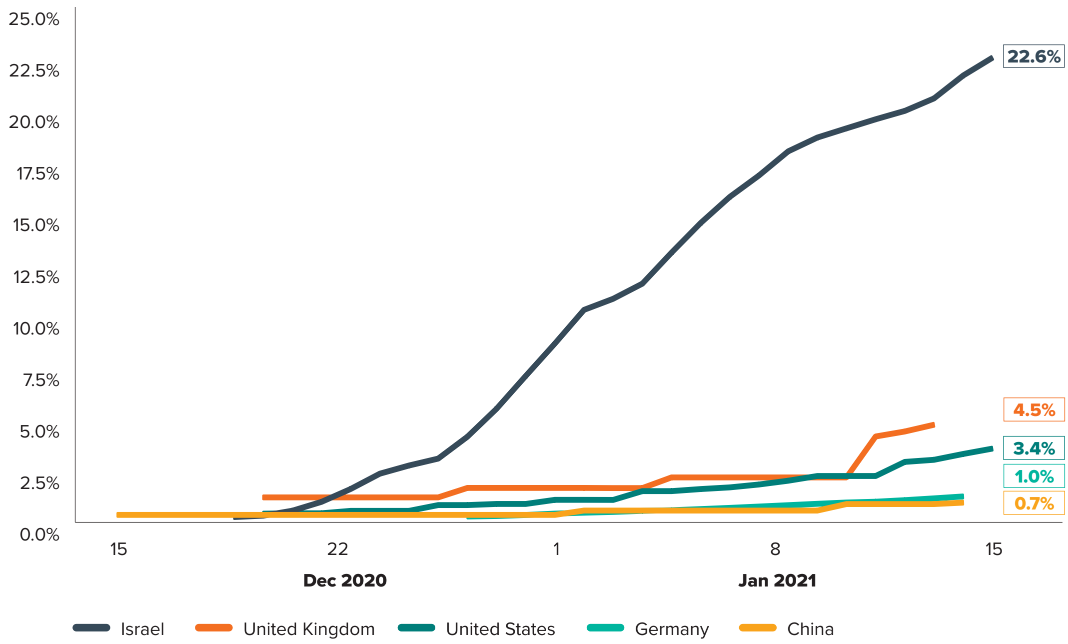
Phase 3 – up to 13.6m doses

<18 if recommended	5,670,000

Population numbers are current estimates for each category.

Close attention will be taken to Israel, which will be one of the first countries to embark on a widespread rollout of the vaccine. Early indications by Clalit, Israel's largest healthcare provider, show that based on 200,000 people aged over 60, it takes at least two weeks post the first of two injections, for infection rates to subside. It appears likely that we won't be in a position to declare 'herd immunity' in many countries until the second half of this year or beyond. In the meantime, expect this tug of war to continue.

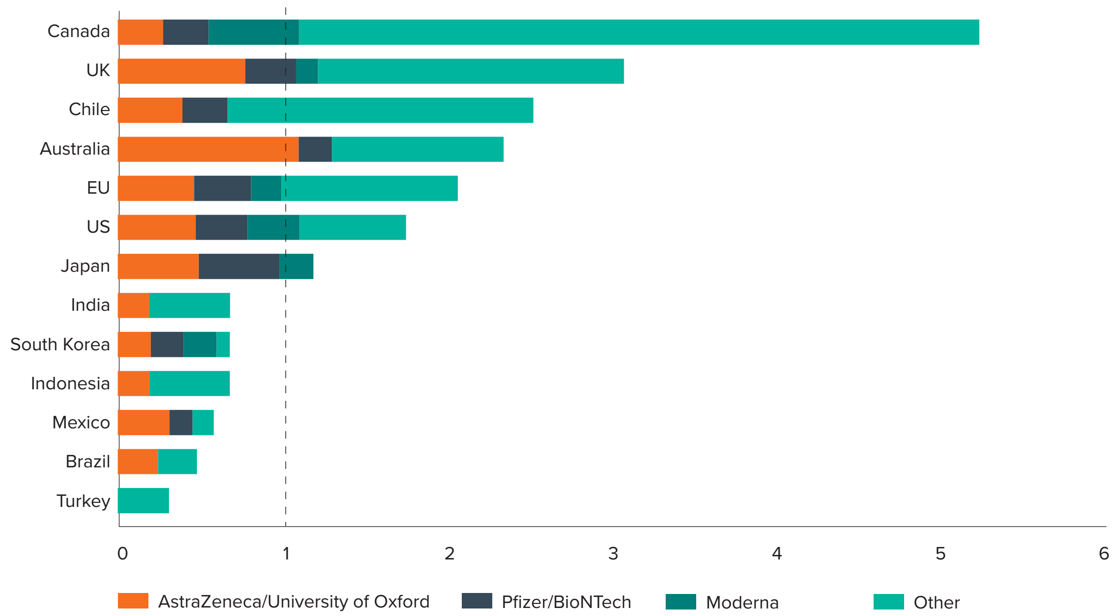
COVID-19 vaccine doses administered as a percentage of population*



* Full vcaccination may require more than one dose per person.
Source: National Australia Bank, National Sources, Macrobond

Confirmed orders for vaccinations per head of population

Vaccination courses per head of population



Source: Duke Global Health Innovation Center, World Bank, J.P. Morgan Assets Management. This chart shows the numbers of full vaccination courses for which a given country has confirmed orders. Data as of 18 January 2021.

Inflation – Reflation or reaction?

One of the major discussion points currently amongst strategists and economists is the outlook for inflation.

In Australia, we have had an almost 40 year super cycle of declining bond and inflation rates. Most major developed economies have also experienced similar trends, with inflation collapsing along with the decline in interest rates.

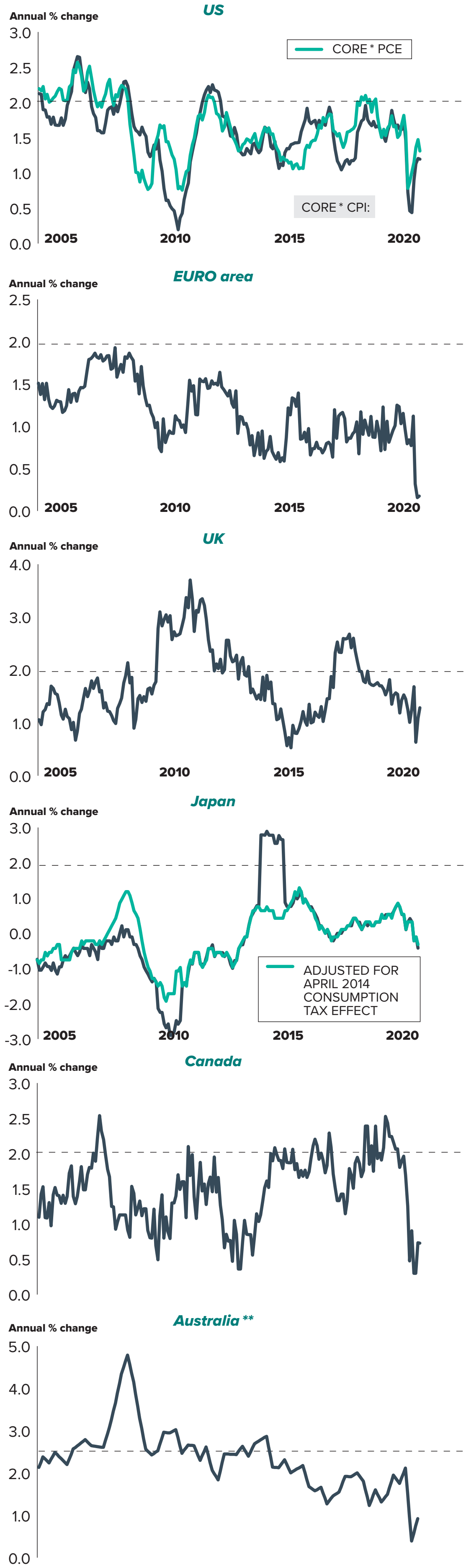
Current inflation rates across many economies are well below stated central bank target bands. Indeed, the RBA and Federal Reserve have both indicated they are waiting for a sustained breakthrough of inflation through these bands before looking to adjust policy settings.

While there have been some structural long term forces at play that have depressed inflation (globalisation, increasing disruption and innovation), in recent times the massive levels of stimulus, rising commodity prices, some near term global supply chain issues and pent up consumer demand point to some building pressures into many economies.

On the flip side, many consumer goods and service prices haven't moved due to higher levels of unemployment, increased household savings (although this is now starting to trend lower) and until recently, lockdown restrictions on consumers.

Inflation was actually negative in Q2 20 across many economies and due to the quirk of numbers, we are likely to see higher inflation reported mid-year as economies recover and compound off this lower base – however the question will be how sustainable the increase is, beyond the lower bound of central bank target ranges. This is what will drive change in monetary policy.

Wage growth is very low in Australia and given there is still ample labour capacity (starting to tighten but a long way to go), the RBA have indicated they don't expect to see inflation sustainably in its target range for the next 3 years. The Federal Reserve have not quantified a time period other than 'for quite some time', as it seeks to achieve strong progress toward its goals of maximum employment and average 2% inflation target.



Source: BCA Research

* Excluding food and energy for the US, Canada and Japan;
Excluding food, energy, alcohol and tobacco for the Euor area and the UK;
Excluding volatile items (fresh fruit, vegetables and automotive fuel).

** Dashed horizontal line denotes midpoint of 2%–3% target range.

Note: Dashed horizontal line denotes Central Bank inflation target.

We have seen yield curves steepen over recent weeks as very depressed pricing expectations on inflation rates have moderated. However we now question whether the market already has priced any near term bounce in inflation and whether the current optimism will be sufficiently matched by the economic outcomes generated in Q1.

We do believe that higher inflation will occur at some point, but it may be choppy and varied given the multi-speed global recovery and supply chains that are still being rebuilt or redirected. Any sustained period or breakout of inflation will potentially require material changes to investment portfolios in the future, however it is too early to tell until we at least enter the second half of this year to try get and a clearer sense of how economies, consumers and labour markets are recovering from the enormity of events over the past 12 months.

What might the economic consequences be from a further deterioration in Australia's bilateral relationship with China?

Aside from stricter COVID induced lockdowns, one of the primary downside risks to Australia's macro outlook are escalating/ongoing political and trade tensions with China. Over the course of 2020, China has placed a range of tariffs and non-tariff measures on a range of goods including wine, barley, coal, sugar, copper, ore, timber and lobsters.

The impact to date at a national level has been minimal according to Goldman Sachs, who estimate the value of these exports to be ~$6bn annually (0.3% GDP). This may also be overstating the impact if many of these goods have been redirected to other markets, but potentially at lower prices.

Goods category	Exports to China (FY20; A$bn)	% of 2019 GDP	Share of China-bound exports	China share of category	Australia's largest ex-China market
1. Iron ores and concentrates	84.7	4.2%	55.9%	82%	Japan (A$7.0bn) Republic of Korea (A$6.2bn)
2. Natural gas	15.8	1.0%	10.4%	33%	Japan (A$19.3bn) Republic of Korea (A$4.6bn)
3. Coal	13.7	0.7%	9.0%	25%	Japan (A$14.4bn) India (A$6.2bn)
4. Confidential items of trade	5.4	0.3%	3.6%	NA	Singapore (A$3.6bn) Japan (A$1.8bn)
5. Beef, f.c.f.	2.8	0.1%	1.9%	25%	Japan (A$2.4bn) US (A$2.3bn)
6. Copper ores and concentrates	2.4	0.1%	1.6%	37%	Japan (A$2.1bn) Republic of Korea (A$0.5bn)
7. Other ores and concentrates	2.0	0.1%	1.3%	55%	Republic of Korea (A$0.7bn) Japan (A$0.3bn)
8. Wool and other animal hair (inc. tops)	1.9	0.1%	1.3%	77%	Italy (A$0.1bn) India (A$0.1bn)
9. Aluminium ores and concetrates (incl. alumina)	1.6	0.3%	1.1%	18%	South Africa (A$0.6bn) Mozambique (A$0.5bn)
10. Edible products and preparations, nes	1.5	0.1%	1.0%	55%	New Zealand (A$0.3bn) Vietnam (A$0.1bn)
11. Medicaments (incl. veterinary)	1.4	0.1%	0.9%	47%	New Zealand (A$0.3bn) US (A$0.2bn)
12. Copper	1.3	0.1%	0.9%	39%	Malaysia (A$0.7bn) Taiwan (A$0.4bn)
13. Meat (excl. beef), f.c.f.	1.3	0.1%	0.9%	24%	US (A$1.1bn) Japan (A$0.4bn)
14. Alcoholic beverages	1.1	0.1%	0.7%	34%	US (A$0.5bn) UK (A$0.4bn)
15. Crude minerals, nes	1.1	0.1%	0.7%	88%	Belgium (A$0.1bn) Republic of Korea (A$0.0bn)
16. Fruit and nuts	1.0	0.0%	0.7%	40%	Japan (A$0.2bn) Vietnam (A$0.1bn)
17. Crude petroleum	0.9	0.2%	0.6%	11%	Singapore (A$1.3bn) Malaysia (A$1.0bn)
18. Gold	0.8	0.6%	0.5%	3%	Hong Kong (SAR of China) (A$3.3bn) UK (A$12.7bn)
19. Wood in chips or particles	0.7	0.0%	0.5%	57%	Japan (A$0.5bn) Taiwan (A$0.0bn)

Goods category	Exports to China (FY20; A$bn)	% of 2019 GDP	Share of China-bound exports	China share of category	Australia's largest ex-China market
20. Cotton	0.6	0.0%	0.4%	63%	Indonesia (A$0.1bn) Vietnam (A$0.1bn)
21. Crustaceans. f.c.f.	0.6	0.0%	0.4%	76%	Hong Kong (SAR of China) (A$0.1bn) Japan (A$0.0bn)
22. Pharmaceutical products (excl. medicaments)	0.6	0.1%	0.4%	16%	US (A$1.8bn) Germany (A$0.7bn)
23. Wheat	0.6	0.0%	0.4%	15%	Republic of Korea (A$0.4bn) Phillipines (A$0.3bn)
24. Wood, rough	0.6	0.0%	0.4%	95%	Malaysia (A$0.0bn) Vietnam (A$0.0bn)
25. Barley	0.6	0.0%	0.4%	54%	Thailand (A$0.2bn) Japan (A$0.2bn)
Total	**145.1**	**8.5%**	**95.8%**		

Goods category	Exports to China (FY20; A$bn)	% of 2019 GDP	Share of China-bound exports	China share of category	Australia's largest ex-China market
1. Education	12.7	0.6%	72.4%	31	India (A$6.4bn) Nepal (A$3.0bn)
2. Tourism	4.5	0.2%	25.6%	20	New Zealand (A$2.3bn) UK (A$2.1bn)
3. Business	0.3	0.0%	1.9%	12	US (A$0.3bn) India (A$0.3bn)
Total	**17.5**	**0.9%**			

Source: Goldman Sachs Investment Research

* Shading denoes categories affected by recent Australia-China trade disputes.

** f.c.f. = fresh, chilled, frozen.

The key sensitive areas for Australia's economy remain iron ore and educational services, which are very large export markets for Australia with also very limited ability to diversify this trade away from China in the near term.

Australia currently exports ~780mt p.a of iron ore to China. China is extremely reliant on Australian imports, with its estimated annual import requirement totally ~1170mt, which is well above the ~660mt non-Australian seaborne supply. Should China decide in an extreme environment to cease Australian imports, Goldman Sachs estimates ~50% of iron ore could be diverted to other nations, leaving a ~2% hit to national GDP and big $3bn dent in the royalties due to the W.A Government. In reality, we feel this event is extremely unlikely given China's high dependence to date on our better quality iron ore.

In turning attention to education services, pre-pandemic, ~250k student enrolments contributed 0.6% to GDP growth over the last 5 years. Australia has already begun actively switching focus to market our education services to countries such India and ASEAN nations, given their growing populations and relatively close proximity to Australia.

So whilst some of the smaller industries within Australia may well continue to feel the pinch while political tensions remain at play, including around areas such as tourism, a major economic shock from a further deterioration in the relationship with China is unlikely at this stage.

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