ISSUE 94

Investment news

Pitcher Partners Investment Services Pty Ltd

Kellie Davidson – Partner

Improving growth and inflation expectations prompted a further rally in riskier assets over the March quarter, with many markets now reporting a quite staggering one year performance off their lows in late March 2020.

The global rollout of vaccines, the approval of the US$1.9tn fiscal stimulus package, improving economic momentum and the gradual relaxation of lockdown measures have all played their part in seeing quite an extraordinary recovery in the pricing of some assets which in a number of cases, are now well ahead of pre-pandemic levels.

It hasn't all been smooth sailing however. Many countries still remain subject to elevated virus outbreaks and related lockdown measures. We have witnessed disruptions in the supply and rollout of the vaccines in a number of regions and countries. There has also been reported challenges with the efficacy of vaccines (especially Astra Zeneca), which have prompted a few countries to hit the pause button on their vaccination programs.

In turning to the specific performance of financial assets over the quarter, Australian equities (+3.1%) performed strongly for the period, as our improving economy prompted a greater demand for more economically sensitive investments – benefitting our banks and resources companies especially. Global equities surged, as developed markets outperformed emerging and value stocks outstripped growth. Europe led the regional performance charts ahead of Japan and the US, despite the latter's further challenges around ongoing infection levels, lockdowns and delays to its vaccine rollout. The general strength in the $A over the period saw currency hedged investors outperform unhedged.

Investment market performance summary – 31 March 2021

Indices	Current	3 months	1 year
ASX 200	6,790.7	3.1%	33.76%
ASX 200 (Acc)	76,585.7	4.3%	37.47%
US S&P 500	3,972.9	5.8%	53.71%
Japan Nikkei	29,178.8	6.3%	54.25%
UK FTSE 100	6,713.6	3.9%	18.37%
MSCI World	2,811.7	4.5%	51.76%
German Dax	15,008.3	9.4%	51.05%
French CAC	6,067.2	9.3%	38.01%
HK Hang Seng	28,378.4	4.2%	20.23%
Shanghai Comp	3,441.9	-0.9%	25.15%
ASX 200 Prop (Acc)	55,034.8	-0.5%	44.66%
Global Prop	2,746.4	7.3%	29.66%
Australian Bonds	10,354.9	-3.2%	-1.81%
International Bonds	1,084.1	-2.5%	1.14%
Commodities			
Gold (oz)	1,707.7	-10.0%	8.28%
Oil (Barrel)	59.2	21.9%	188.87%
Iron Ore (Tonne)	154.2	0.9%	91.25%
Aluminium	2,212.0	11.7%	44.95%
Copper	8,785.5	13.1%	77.45%
Lead	1,974.5	-1.0%	13.38%
CRB Index	185.0	10.2%	51.87%
Currency			
AUD/USD	0.8	-1.2%	23.93%
AUD/EUR	0.6	2.8%	16.49%
AUD/GBP	0.6	-2.1%	11.61%
AUD/JPY	84.1	5.8%	27.53%
AUD/RMB	5.0	-1.2%	14.76%

Source: Bloomberg

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Expectations around rising inflation levels prompted a material sell off across many bond markets in Q1 (Australian bonds -3.2%, global bonds -2.5%), with curves steepening quite markedly as many central banks remained committed to their ultra-accommodative policy settings. Floating rate credit securities generally provided the greatest sources of relative performance for the period. Commodities were a major beneficiary of the 'reflationary' theme, with energy and industrial metals clearly outstripping precious metals such as silver and gold.

There was a wide distinction between the performance of local (-0.5%) and global listed property markets (7.3%) , which perhaps had as much to do with a catch up of prior underperformance from G-REITS rather than a specific pure reaction to rising bond yields.

Our articles this quarter talk specifically to the theme of recovery within Australia. We share some of our key observations on the sharp recovery year to date, as well as discussing a couple of challenges on the horizon. Our banks are well positioned to benefit from a broad based macro recovery and Alistair Francis in our research team provides a snapshot of some of the key improvements he has witnessed to date in the recovery of this sector.

On the path to recovery

Duncan Niven – Director of Research

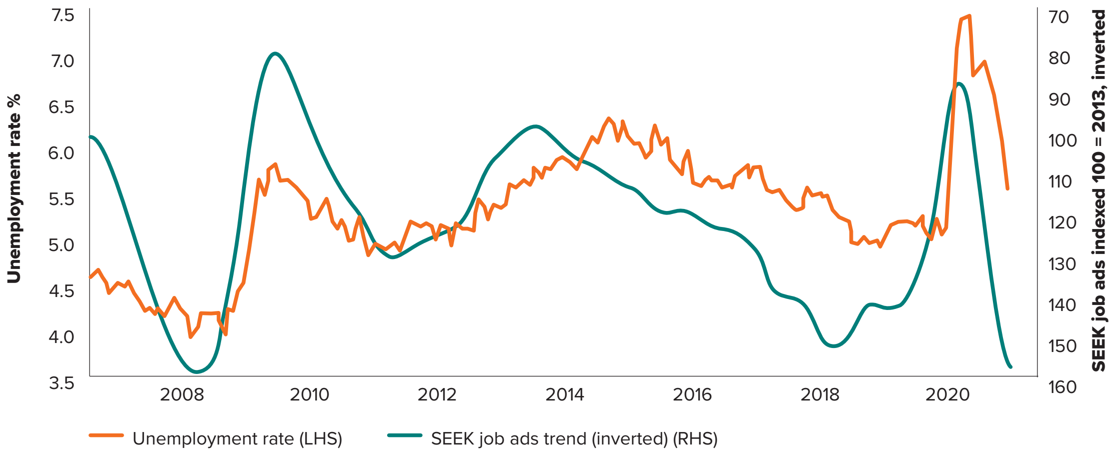
The Australian economy has recovered at a seemingly far swifter pace than what many already optimistic commentators were expecting since the turn of the year, with Australia's output potentially now close to or already running ahead of pre-pandemic highs reached in Q1 20.

After declining by 1.1% in 2020, consensus expectations for GDP growth in 2021 (~4%) and 2022 (~3%) are well above long run trend levels, driven by the tailwinds of the strong policy stimulus. In this note we talk through a couple of the key highlights of the recovery so far and the emergence of a potential couple of road bumps over the next 3–6 months.

Employment

No element of the recovery has been more evident than within our labour market. The March employment data highlighted that both full and part time jobs are back around pre-pandemic levels. The unemployment rate has contracted substantially to 5.8%, well ahead of the RBA forecast of 6% they had pencilled in at the end of this calendar year. Pleasingly, leading indicators are also looking positive, with employment hiring intention surveys at multi-year highs and also job advertisements, which at the end of Q1 are a whopping 26.8% higher than pre-pandemic levels and at multi-decade highs.

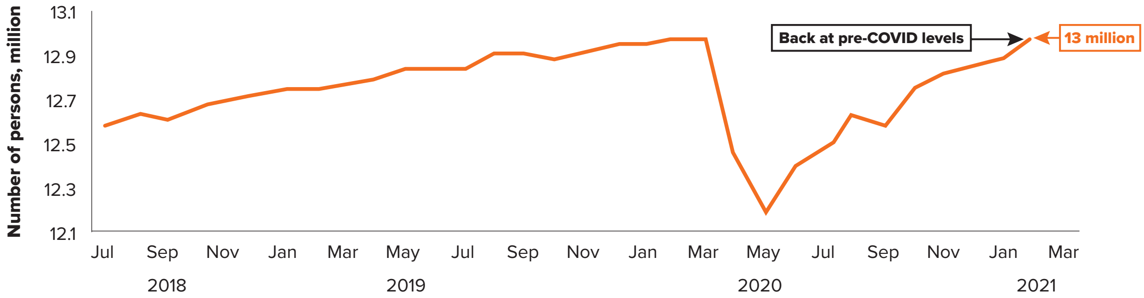
Job ads and the unemployment rate



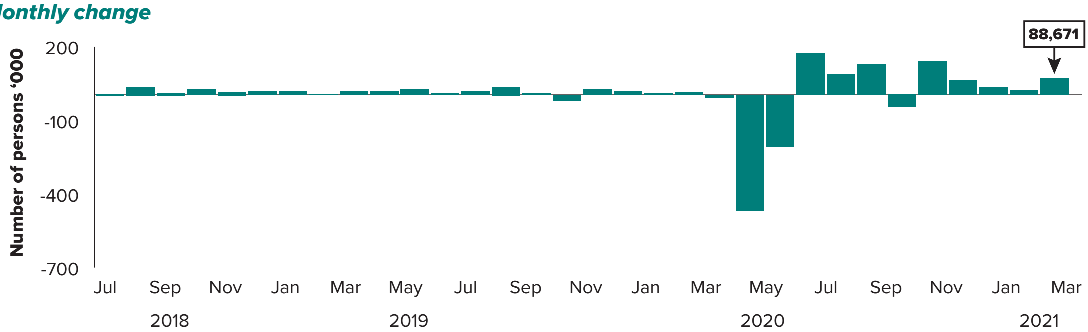
Source: SEEK, NAB, ABS

Australian employment

Level



Monthly change



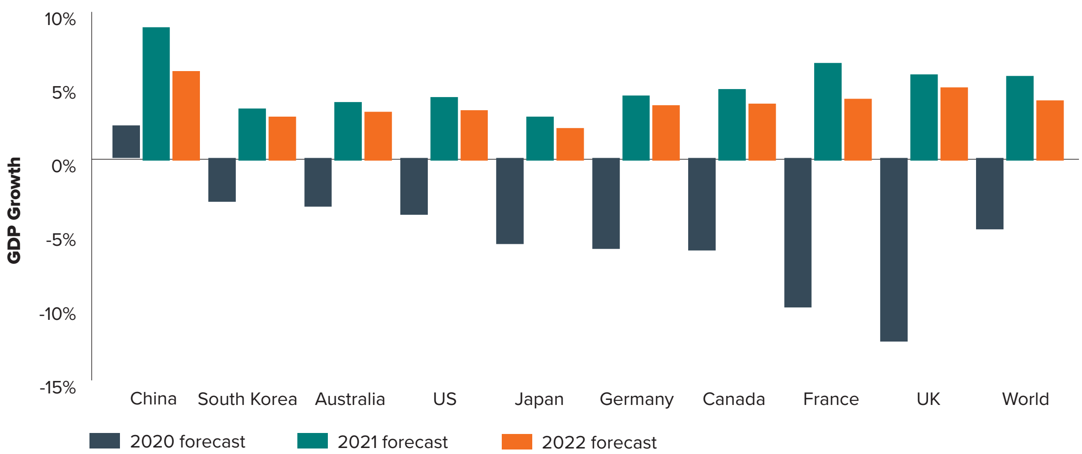
Source: NAB, ABS, Macrobond

Whilst this all looks very rosy, the end of March saw the end of the JobKeeper program. This program has been a clear success – despite perhaps the full benefits being not just confined to those who needed it the most – which was an unfortunate but accepted side effect of the rapid design and implementation of the policy. Without it however, we could well have seen a large majority of the ~1m people who claimed JobKeeper payments be part of a mid-teen unemployment rate, a level last seen since the great depression.

So what is likely to happen now to our labour market now that this program has been wound back? Perhaps it won't be as bad as first thought. The Australian Treasury recently completed a survey, which was further corroborated by separate analysis by the economists at NAB and Westpac, highlighted that 'only' 100–150k of the ~1m on the subsidies are likely to be displaced – that is, be unable to find immediate paid work. As you might expect, a number of these are within the accommodation, recreation and hospitality industries in areas such as the Sydney and Melbourne CBD, as well as the tourist areas of Cairns and the Gold Coast.

Ending JobKeeper and employment

COVID hit then recovery



Source: CoreLogic, Westpac Economics

We believe these losses are unlikely to occur precisely in one hit, but will be spread over a number of months as firms assess the economics of their labour force and the viability of their business. In addition, they will also be net against the strong job growth in areas of the economy. For instance, Westpac economists believe we will see a further 111k jobs created in the June quarter which could absorb this impact (in an absolute sense) in one go.

We do also note that there has been a strong increase in job advertisements within the industries most affected by COVID as well. This is coupled with the potential for more industry specific fiscal support programs to be announced at the 11 May Federal budget.

So in aggregate, in the very near term, we could well see a stabilisation or small upward tick in the unemployment rate back toward 6%, however we expect the ongoing momentum in job ads to result in tighter labour markets going forward, this year especially. Longer term however, there is still substantial progress to be made in order to reach the RBA's desired full employment objective, an unemployment rate in the 4% range.

House prices

A clear beneficiary of the low interest rate environment has been the local housing market. House prices moved at their fastest monthly rate in March this year since October 1988, a period where the housing boom was just starting to peak. Whilst it is unlikely we will see annual price growth in the high 30% range that we saw that year, economists are still forecasting double digit price growth for the next two years, underpinned by policy support, stronger consumer confidence and balance sheets, as well as relatively easy and cheap access to credit.

The surge in February building approvals, which admittedly is a volatile segment month to month, was driven principally through private detached house approvals, giving us a glimpse that the Federal Homebuilder scheme is clearly providing a boost to the residential construction sector.

CoreLogic home value index – March 2021

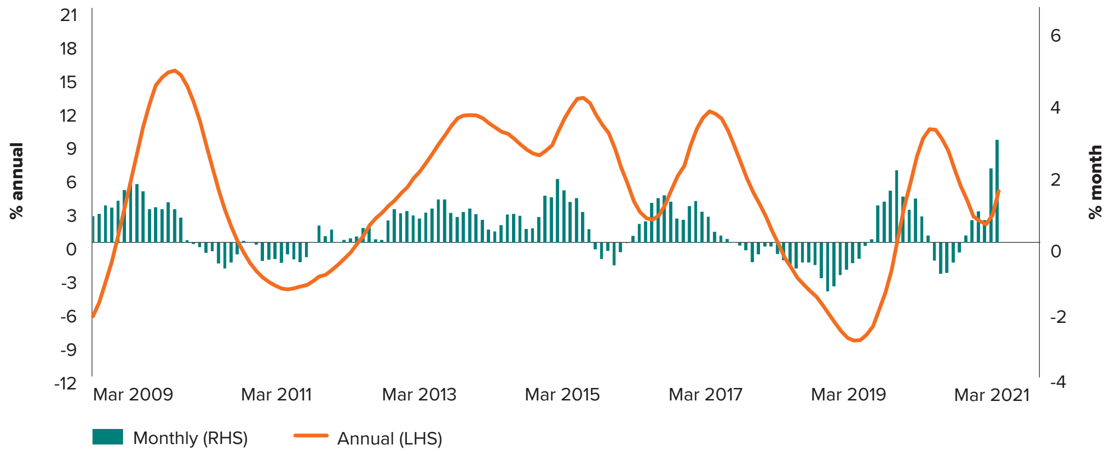
	% month				% annual			
	Dec	Jan	Feb	Mar	Dec	Jan	Feb	Mar
Australia*	**0.9**	**0.7**	**2.0**	**2.8**	**2.0**	**1.7**	**2.6**	**4.8**
– houses	1.1	0.9	2.3	3.1	2.6	2.4	3.6	6.0
– units	0.2	0.1	1.1	1.9	0.2	-0.1	-0.1	1.1
Major capital cities								
Sydney	0.7	0.4	2.5	3.7	2.7	2.0	2.8	5.4
Melbourne	1.0	0.4	2.1	2.4	-1.3	-2.1	-1.3	0.7
Brisbane	1.1	0.9	1.5	2.4	3.6	4.0	5.0	6.8
Adelaide	1.1	0.9	0.8	1.5	5.9	6.5	7.3	8.6
Perth	1.1	1.6	1.5	1.8	1.9	3.4	4.6	6.0
	3 month %				**% annual**			
	Dec	**Jan**	**Feb**	**Mar**	**Dec**	**Jan**	**Feb**	**Mar**
Turnover	**22.8**	**17.2**	**5.5**	**-7.9**	**27.6**	**27.2**	**20.7**	**20.7**

* Combined capital cities.

^ Rolling 3 month total, seasonally adjusted by Westpac.

Source: CoreLogic, Westpac Economics

Australian dwelling prices



Source: CoreLogic, Westpac Economics

The price boom is clearly strengthening, but there are some signs that the complexion looks to be changing. Movements within segments of the Sydney market for instance are particularly headline grabbing and suggest some areas will soon see significant affordability issues emerge. That may start to cap 'owner occupier' demand and taking some of the heat out of price gains. Credit growth and demand from 'investors' though has been a lot more mundane and suggests this could perhaps provide a next leg of demand as the year unfolds.

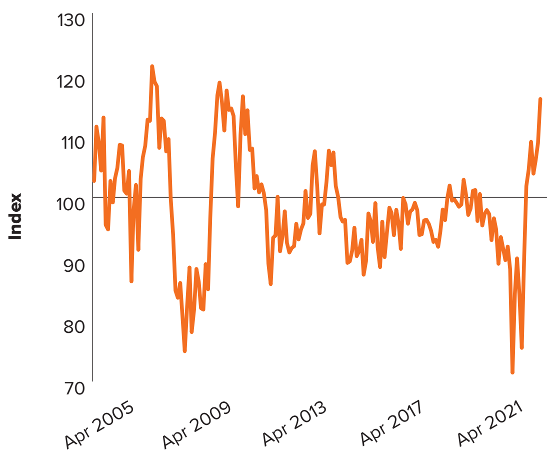
The price movements have raised concerns about the possibility of the re-introduction of macro-prudential control to protect against any related financial stability risks emanating from this sector. Recent comments by APRA and the RBA have cooled these concerns, as they suggested house price dynamics are not yet overly concerning, that house prices are not the responsibility of either body and that lending standards are not deteriorating – they are more focussed on the risks here as opposed to achieving set goals.

Importantly, as things stand today, investor lending and interest only lending remains well below the levels that previously drove macro-prudential changes in 2014. A recent tick up in higher Loan to Value Ratio (LVR) loans is being attributed to higher LVR first home buyers being drawn into the market due to government incentives. Any such pull-forward is likely to reverse once the incentives end. But we expect that the regulators will keep watching to ensure lending standards are well maintained.

Consumer

With consumer sentiment recently hitting an 11yr high, consumption is likely to be the key driver of above-trend growth in 2021.

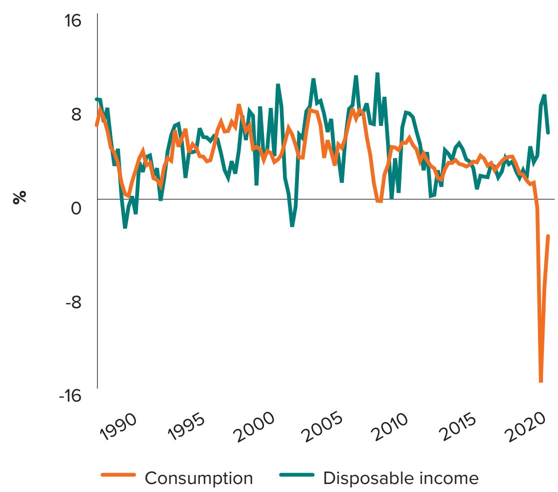
Consumer sentiment index



Source: Westpac Economics, Melbourne Institute

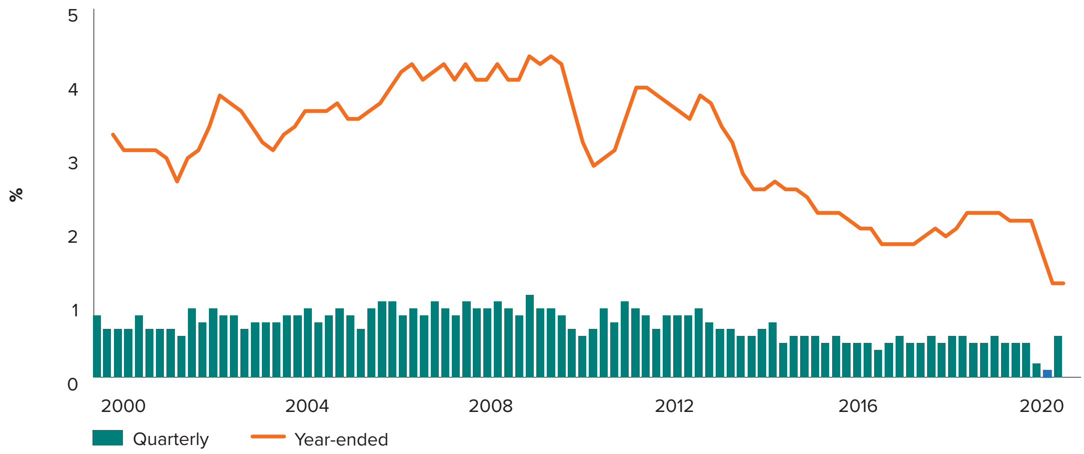
Household income and consumption*

Real, year-ended growth



Source: National Australia Bank, ABS, RBA, Macrobond

Saving ratio



* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; saving ratio is net of depreciation.

Source: National Australia Bank, ABS, RBA, Macrobond

The most recent sentiment index data release was taken in the week following the unwinding of JobKeeper – any initial fears this and any associated job losses would undermine confidence appears to be clearly unfounded at this point in time.

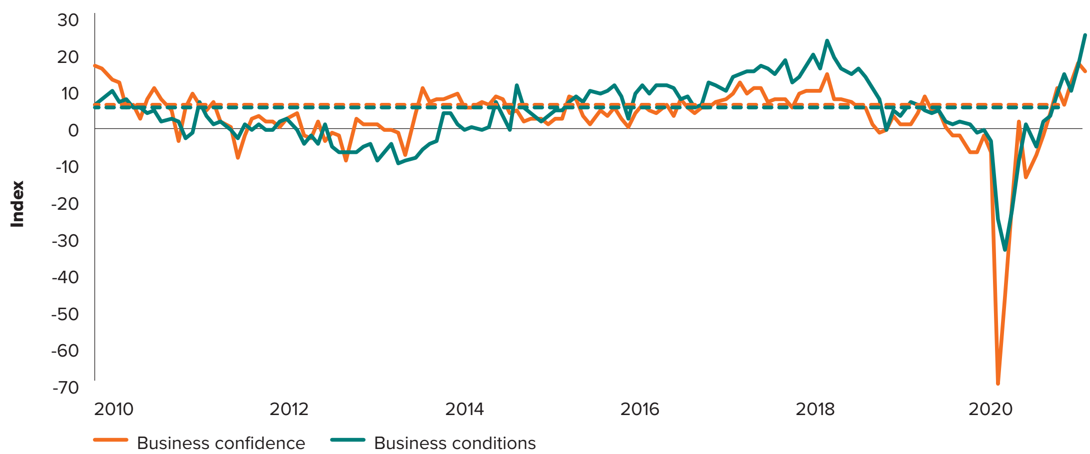
In aggregate, household balance sheets strengthened materially over the course of 2020 and whilst some of these savings are now making their way into the economy, there is plenty of capacity to spend further. We believe that if employment maintains its level of momentum and that businesses continue to reinvest, there is plenty of upside risk for consumption growth through this year.

Business conditions

A major drag on pre-pandemic growth was the steadfast decline in business investment. Supported by an array of Government and various funding support mechanisms, both business conditions and confidence have risen markedly. The latest NAB business survey saw conditions rise to a record high driven by strong increases in all subcomponents (trading, profitability and employment). Even better was the fact this was evident across all states and industries, showcasing improved activity and capacity utilisation. Unsurprisingly, recreation and personal service companies still continue to operate at pre-COVID levels given pandemic related restrictions.

A really encouraging uplift was in forward orders – which also rose to record levels. A large pipeline of work supports ongoing strength in activity and all the positive flow on effects from that wealth creation. Taking this all into account, the strength in conditions point to an economy that is continuing to grow at a relatively healthy rate.

Conditions reach a record high



* Dotted lines are long-run average since March 1997.

Inflation

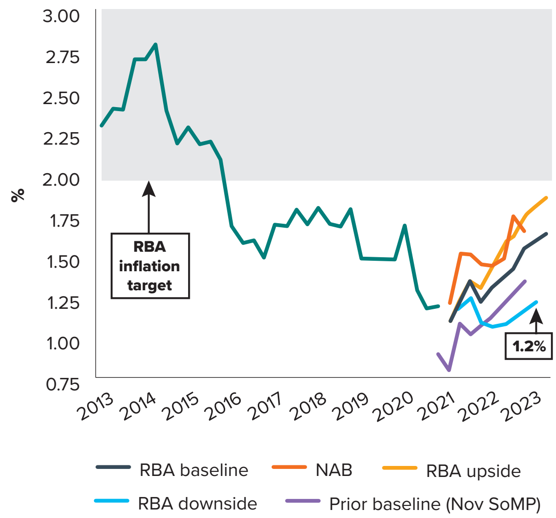
A major theme over Q1 has been the resetting of inflationary expectations, evidenced through a material steepening of local and offshore yield curves. There is no doubt that inflation will accelerate through the middle half of this year as free childcare benefits have ended, energy costs have risen and a rebound in housing component costs will result in a sharp uplift on the base effects of the fall in CPI in Q2 20. NAB are forecasting a headline annual inflation rate of 4% year on year.

In narrowing focus to the RBA's preferred inflation measure, core inflation (trimmed mean) which seeks to avoid the more volatile components of the CPI basket, NAB are estimating an uplift to 1.2% year on year, a touch higher than the RBA's forecasts at the start of the year, but still well below its long run target band of 2–3%.

Given the strong rebound in activity to date, there could well be some upside pressure to inflation numbers over 1H21 in particular, however it will be important to isolate between what are transitory pressures and what are more structural in nature. Wage growth is a key driver of inflation, but it still remains pretty anaemic despite the recovering labour market and a material uplift here is required for the RBA to adjust its extremely accommodative policy settings, which we believe are likely to remain in play for the next 12–18 months as things stand today.

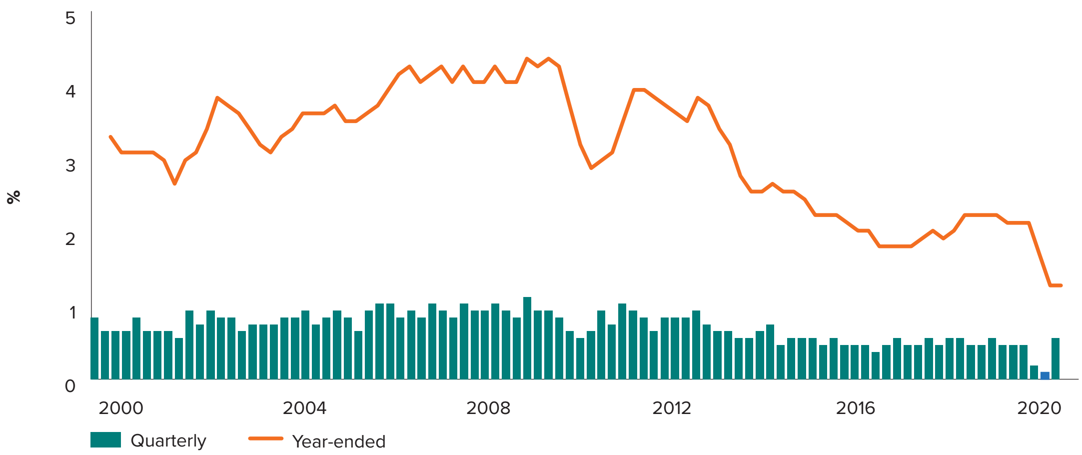
RBA is forecasting inflation below the band

Australian trimmed mean inflation



Source: NAB, ABS, RBA, Macrobond

Wage price index growth*



* Total pay excluding bonuses.

Source: ABS

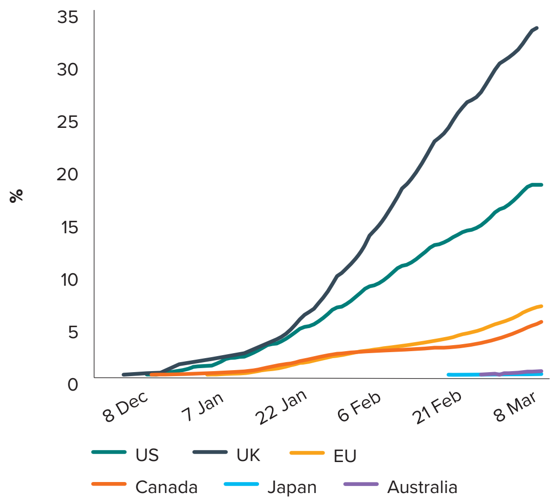
Virus and vaccines

Of course everything is still contingent on the virus. Certainly the various State Governments have a better understanding of the virus and how to manage any outbreaks – testing and tracing regimes have improved significantly. Flash lockdowns are now generally being unwound in a reasonably swift period of time – however this still remains a key influence on consumer and business confidence – for instance, have you or how many people do you know that have deferred all overseas travel plans until at least the end of the year?

The opening of the travel bubble will hopefully begin a potentially arduous/protracted process for the gradual opening up of international travel, however, the recent challenges with the vaccine rollout have thrown a spanner into the works.

The start of Australia's vaccine roll-out has been slower than expected, due to disruptions to global vaccine supplies and a relative lack of urgency given very low levels of virus transmission and mobility restrictions. So far only c.2.5% of Australia's population has received one vaccine dose – a comparably low share to many global peers.

Developed markets: Percentage of population receiving the first dose



Source: CoreLogic, Westpac Economics

Following evidence that ~4 people in each million vaccinated with the Astra Zeneca (AZN) vaccine had experienced a blood clot (with a ~25% fatality rate), the Australian Government announced that the Pfizer vaccine is now preferred over the AZN vaccine for Australians less than 50 years of age. Despite being framed as a recommendation and not as a directive – this is likely to delay the national roll-out further.

The Government guided that phases 1a and 1b of the vaccine roll-out will be minimally impacted by the decision (as these phases target older Australians and/or utilize the Pfizer vaccine), but signaled delays to the 2a/2b phases of the roll-out which commence mid-year. Australia's prior heavy reliance on the AZN vaccine suggests there will be material delays to the prior guidance that all Australians who want a vaccine will have received one by October 2021.

As it stands today, the Government currently expects 20m doses of the Pfizer vaccine to be delivered this year, with supply of the Novavax vaccine coming online in Q3 21. A further swing factor may be in how nations such as the U.S and U.K manage/distribute any excess vaccine supplies that build up between now and the end of the year.

We do need to be mindful that until we do receive a widespread level of vaccination, we will be susceptible to the risk of another outbreak, especially given we are heading into the colder winter months where the virus is generally more transmissible. Despite this, we caution against overstating the aggregate economic impact if there are further delays in the vaccine roll-out, reflecting;

- Economic activity in Australia has largely already normalised and has good momentum, mobility restrictions are generally pretty modest and there is a very negligible level of infection currently in the local population.
- The closure of international borders continues to boost growth via the on-shoring of tourism spending, which NAB has estimated could contribute 1.5% to GDP alone.
- Over time, it is possible that vaccinated international students could return ahead of the local population being fully vaccinated, proving another potential kicker to growth.

So all in all, plenty to still be positive about as we look forward to the rest of 2021.

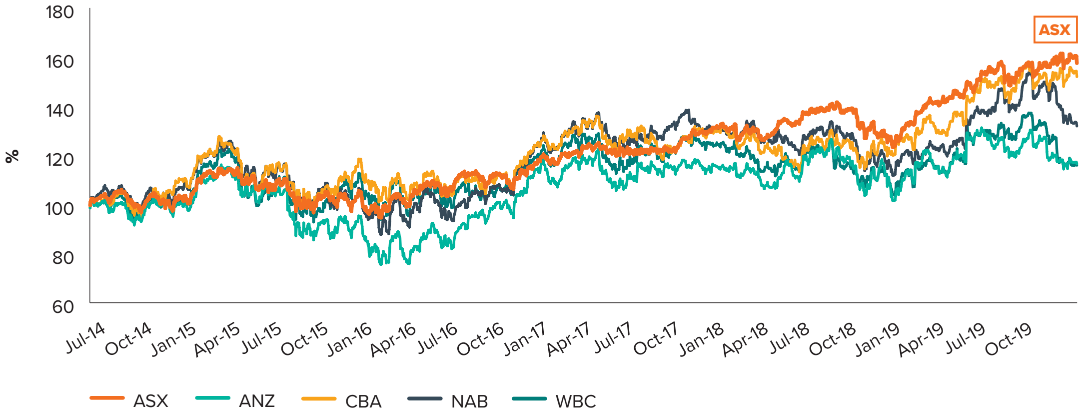
The great Bank turn-around

Alistair Francis – Senior Investment Analyst

The Australian banks since the mid 1990's experienced what many believe was a "super cycle" driven by the uninterrupted economic growth, rising household leverage along with the major banks enjoying oligopoly pricing power. However, for the 5–6 years pre COVID-19, the majors faced more onerous capital requirements, slowing loan growth, falling interest rates, higher investment requirements along with greater regulatory and political scrutiny.

Four Banks vs ASX 200 TR

Date Range 1 July 2014 to 31 December 2019

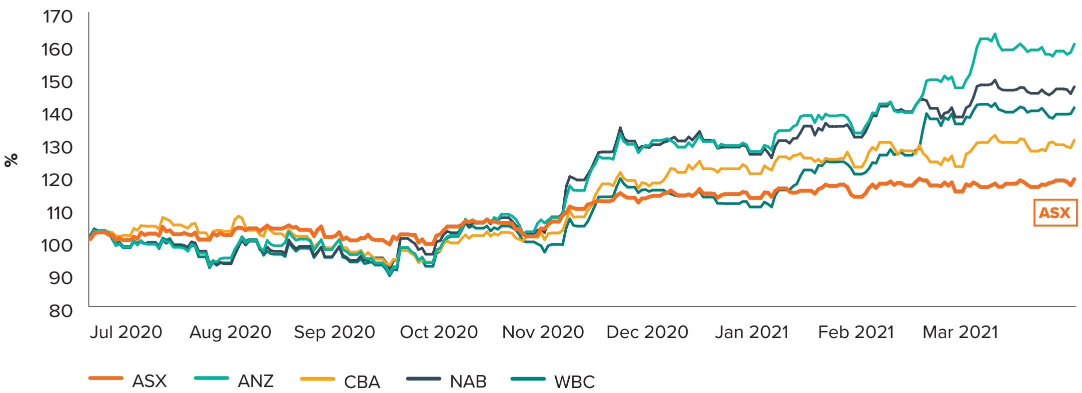


The fallout from the 2018 Hayne Royal Commission in particular hit the banks hard as the remediation process, civil penalties, and the re-writing of risk management systems had a material impact on the sector's performance.

As it transpired, 2020 proved to be another remarkable year for the Australian banks. The first half was dominated by concerns over the impact of the pandemic, provision build-up and interest rate cuts. In the middle of the year, investors wrestled with the shape of the economic recovery – we had a "V", "L", "U", "W" and the Nike "tick" recovery profile to consider. However, due to the combination of a wide-ranging fiscal and monetary policy response and a better-than-expected COVID outcome, the Australian banks experienced a remarkable turn-around.

Four Banks vs ASX 200 TR

Date Range 1 July 2020 to 31 March 2021



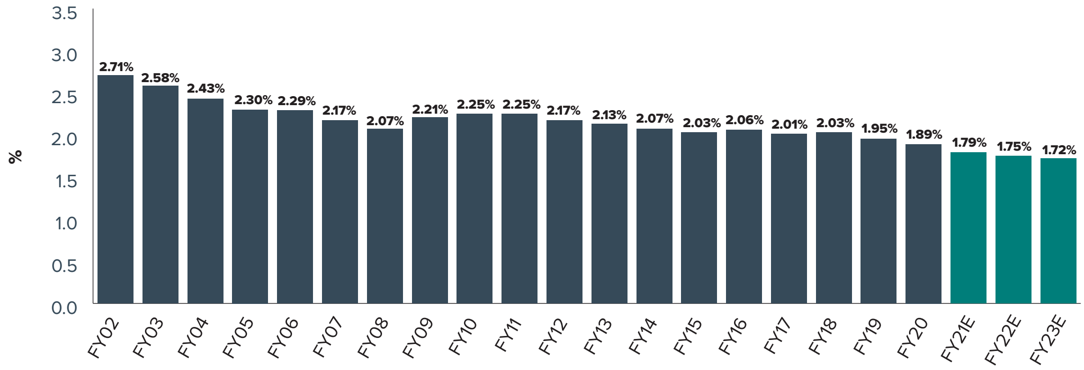
Bank margins

A key concern for the banks since the RBA began lowering the cash rate last year has been the long-term impact of ultra-low rates to banking sector margins. As spread businesses, banks are more profitable when rates are higher, and they can produce income on both assets and liabilities.

Despite increased mortgage competition, banks have been able to offset some of the squeeze by lower wholesale funding costs, cuts to deposit rates and enjoying the benefits of the RBA term funding facility (TFF) with rates currently at 10bpts.

More recently, even though the RBA has stated that it expects it will not increase the cash rate until 2024 at the earliest, there has been a significant rise in long bond yields as investors have become more optimistic on the outlook with inflation expectations beginning to rise.

Major banks: Net interest margins



Source: Company data, E = Morgan Stanley Research estimates

Bank capital

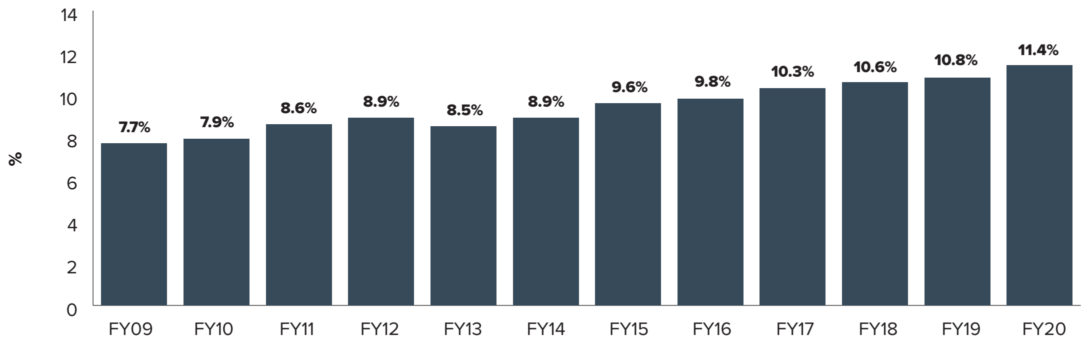
The Australian major banks have steadily increased their average dividend payout ratios over the past 25 years as lending growth has slowed (and therefore capital to support growth), and investors have sought higher and higher franked dividends. Following the GFC, bank share prices have been driven significantly by the “yield trade”. At one stage, the major banks were able to grow their dividends faster than their cash earnings due to lower lending growth, significant RWA * optimization, and healthy DRP participation.

However with the pandemic shock, the major banks' dividends were cut by an average of ~60% in FY20 as APRA (Australian Prudential Regulation Authority) initially required them to "seriously consider deferring decisions on the appropriate level of dividends until the outlook is clearer" and then required them to "retain at least half of their earnings”.

Whilst APRA is set to remain cautious given the on-going global uncertainty, excess capital is set to build across the major banks as loan growth is low and non-core assets are sold. The major banks' capital positions are currently healthy, with an average pro forma CET1 ** ratio of ~11.4%. This means the probability of further capital raisings in 2021 is unlikely.

The pathway to achieve this position has varied across the major banks but the common goal is to meet APRA's new capital framework which should increase their flexibility through the cycle, finalise its response to the Financial System Inquiry (2014) and ensure compliance with the global Basel III accord.

Major banks: Average CET1 ratio



* Risk-weighted assets are used to determine the minimum amount of capital that must be held by banks and other financial institutions to reduce the risk of insolvency. The capital requirement is based on a risk assessment for each type of bank asset.

** Common Equity Tier 1 compares a bank's capital against its risk-weighted assets to determine its ability to withstand financial distress. The core capital of a bank includes equity capital and disclosed reserves such as retained earnings.

Source: Company data

Bank costs

Prior to the Royal Commission, the bank cost base was not a high priority but given todays low growth environment along with the threat from increased competition, the focus has changed. Accordingly, bank management teams regularly talk about the need to be more efficient and to lower the absolute cost base, but it has proven a challenge with increased technology and compliance costs.

Beyond some temporary expenses falling away, a step change in costs is unlikely unless banks are prepared to significantly reduce staff levels along with their property costs.

Conclusion

Having endured a torrid 2020, the banks entered 2021 with cause for more optimism. With on-going government and central bank policy support directly aimed at stimulating the housing market and SME employment, the underlying drivers of the bank's profitability have improved. Further supporting the economic recovery is the vaccine rollout which is gaining momentum. While non-recurrence of provision top-ups suggest a positive short-term earnings outlook, the medium term remains challenging, with competitive forces driving net interest margin pressure and ongoing threat of market share loss.

That said, the recovery is expected to be uneven, and will take time. Corporates will also have to deal with reduced levels of government support, particularly post 31-March.

We will be watching the upcoming bank reporting season with interest, which we believe will deliver key milestones for their on-going re-rating, with the upside risk being provision write-backs and capital returns if the domestic economy recovery is maintained. This would drive upgrades to earnings and dividends, as well as a more positive outlook for a sustainable ROE.

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