Market Watch

First Sentier Investors

Share markets power on, despite new Covid lockdowns in Australia

End-July 2021

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- The Covid situation took a turn for the worse, as spiralling infections saw new lockdowns introduced in Australia.
- The government has suggested all restrictions can be lifted once 70% of the adult population has been fully vaccinated. Until then, the outlook for economic activity levels has deteriorated.
- Despite these unwelcome developments, Australian shares started the FY22 year with solid gains. Bond yields fell sharply, resulting in favourable returns from fixed income markets too.
- It was a similar story offshore, with gains in both equity and fixed income markets supporting pleasing returns for most investors.

- **US:** US GDP grew at an annualised rate of 6.5% in the June quarter, which was substantially below consensus expectations. The shortfall appeared to be primarily attributable to lower government spending. Consumer spending – a more important indicator for policymakers – was stronger than anticipated. Indeed, economic growth appears to remain on track to meet the Federal Reserve's 7% target for the full calendar year.
- There was an ongoing focus on inflation. Consumer prices rose 5.4% in the year to 30 June; an acceleration from the May level and well above the official target. Nonetheless, officials continue to suggest the uptick will prove temporary, and that there is no need for policy settings to be tightened at this point.
- The latest data showed that 850,000 new jobs were created in America in June; well above consensus expectations. The numbers for May were also revised higher.
- Around half of US-listed firms released their earnings for the three months ending 30 June and the results were generally encouraging. Consensus forecasts suggest earnings per share among S&P 500 companies could increase by as much as 27% in the next 12 months as the economic recovery gathers pace. This is helping support sentiment towards US and global share markets.

- **Australia:** Printing at 0.5% for the June quarter and 1.6% on a rolling 12-month basis, core inflation in Australia was in line with consensus expectations. Unlike in some other countries, there was limited evidence of pricing pressures due to supply bottlenecks, leaving the inflation level well below the Reserve Bank of Australia's target range.
- With that in mind, the latest data are unlikely to have changed policymakers' thinking regarding interest rate settings. Investors continue to suggest that official borrowing costs are unlikely to be raised until 2024. Officials have reiterated that inflation will need to rise above 2% on a sustainable basis before policy settings are tightened.
- Australian unemployment fell to 4.9% in June, the lowest level in exactly 10 years – the last time the jobless rate was below 5% was in June 2011. Unfortunately with new lockdowns in place across much of the country, the unemployment rate seems likely to rise again over the next few months.

- **New Zealand:** The Reserve Bank of New Zealand surprised the market by halting its bond purchase program. Like similar 'quantitative easing' efforts in other countries, the program was designed to lower borrowing costs for households and businesses by injecting additional liquidity into financial markets.
- Officials have determined that economic conditions have improved sufficiently and that additional bond purchases are not required.
- The end of the program came around a year earlier than expected and had not been telegraphed in previous communications. In turn, investors speculated whether the Reserve Bank might consider raising interest rates. The decision will depend on the tone of economic data in the months ahead, but a rate hike before the end of 2021 now appears plausible.
- Inflation quickened to an annual rate of 3.3% in the June quarter and house prices are more than 22% above 2020 levels. These pricing pressures could be a concern for policymakers.

- **Europe:** The Eurozone economy grew at an annualised rate of 2.0% in the June quarter, which was above consensus forecasts. The beat was driven by stronger private and government spending. Industrial production has also rebounded strongly from 2020 lows.
- Germany – Europe's largest economy – suffered from some devastating floods in July. The economic impact is not expected to be too significant, perhaps 0.2%-0.3% of GDP, as the floods were mainly concentrated in areas with limited industrial density.
- The UK removed all remaining social distancing restrictions during the month, on 'Freedom Day'. With more than 90% of the population vaccinated, the hospitalisation rate is more than 3x lower and the mortality rate is more than 10x lower than in the previous wave of Covid infections. This suggests vaccines significantly weaken the link between cases, hospitalisations and deaths, and offers an encouraging roadmap for countries like Australia where vaccination rates are currently much lower.

- **Asia/EM:** At an annualised pace of 7.9%, GDP growth in China was slightly weaker than expected in the June quarter.
- The outlook for the second half of the year appears mixed, which prompted officials to reduce the amount of cash that banks must hold in reserves. Essentially this frees up more than A$200 billion of liquidity that can be lent, theoretically boosting lending and supporting economic activity levels.
- The Olympics got underway as planned in Japan, but the Games are not expected to move the dial economically. Inflation is running at just 0.2% in Japan, reflecting subdued activity levels.

Australian dollar

- The deteriorating outlook for growth in Australia weighed in the AUD. The 'Aussie' depreciated by 2.1% against the US dollar, falling to 73.4 US cents, and by 3.3% against a trade-weighted basket of international currencies.

Australian equities

- Australian equities were little changed in the first half of July as rising coronavirus cases and the return of lockdowns weighed on the market. However, improving earnings expectations following the release of generally positive financial results from US firms saw the S&P/ASX 100 Accumulation Index rally in the final week, to close July 1.2% higher – the 10th consecutive month of gains.
- Stronger iron ore and gold prices helped push the Materials sector 7.1% higher. The iron ore market has continued to benefit from rising demand for steel across several industrial sectors, particularly construction.
- Oil prices had fallen more than 6% in mid-July as OPEC members revealed plans to progressively remove production cuts by September 2022. Data also showed that factory activity in China, the world's second-largest oil consumer, had slipped. Although the oil price recovered into month end, these factors acted as a drag on the Energy sector (-2.5%).
- The IT sector (-6.9%) also declined, reflecting weakness in Afterpay (-18%), Computershare (-8%) and Altium (-8%). News that the global consumer electronics company Apple was preparing to enter the Buy-Now-Pay-Later market hampered Afterpay and other providers of consumer credit. Altium fell after US software company Autodesk confirmed it had withdrawn its takeover offer of A$40/share.
- Small caps underperformed, rising a more modest 0.7% as nearly half of index constituents lost ground.
- Meal delivery company Marley Spoon was the worst-performing small cap stock, declining 31% as its Q2 update revealed a sharp slowdown in sales growth.

Listed property

- Global property securities enjoyed solid gains in July, with the FTSE EPRA/NAREIT Developed Index rising 6.1% in AUD terms.
- The best performing regions included Sweden (+12.3%), Spain (+8.3%) and the UK (+7.8%). Underperformers included Hong Kong (-2.6%), Japan (-0.9%) and Australia (+0.3%).
- Global real estate markets remained affected by the evolving status of Covid-19. Concerns resurfaced in the UK and US over the newer delta strain, and more lockdowns were implemented throughout Asia. Markets seem to be looking through short-term volatility, however, towards a longer-term recovery.
- Self-storage investments continued to perform well, as did stocks in the residential and logistics sub-sectors.
- Locally, the A-REIT market returned 0.3%. The best performers included National Storage REIT (+7.6%) and Centuria Office REIT (+5.6%).

Global equities

- The performance of major share markets was mixed.
- In the US, the bellwether S&P 500 Index added a further 2.4%, rising to fresh all-time highs. The ongoing rollout of vaccines continues to support sentiment – more than 60% of American adults are now fully vaccinated, enabling restrictions to be lifted and paving the way for an improvement in company profitability.
- Further progress with vaccine rollouts supported risk appetite in Europe too, and helped most major share markets in the region make positive progress. The French, Swiss and Italian stock markets rose 1.6%, 1.5% and 1.0%, respectively.
- UK shares were little changed, despite the removal of all remaining virus-related restrictions in mid-July.
- Asian markets bucked the positive trend, performing very poorly. Hong Kong's Hang Seng dropped 9.9%, for example, while China's CSI 300 fell 7.9%. The weakness reflected the unexpected announcement of sweeping policy changes in the Chinese technology, education and property management sectors. These regulatory crackdowns prompted offshore investors to dump a wide range of shares listed in China and Hong Kong.
- Economic indicators in China have also deteriorated recently and there is growing concern about the extent of indebtedness among some Chinese firms. The share price of Evergrande – a conglomerate with interests in property development and various other industries – almost halved during the month, for example, reflecting concerns about liquidity and the company's ability to service its debt repayment obligations.
- Returns from almost all overseas shares were boosted quite significantly for Australian investors by weakness in the Australian dollar. A 1.7% increase in the MSCI World Index in local currency terms translated into a return of 4.0% in Australian dollar terms, for example.

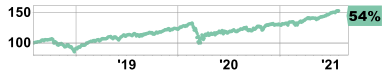
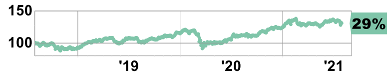
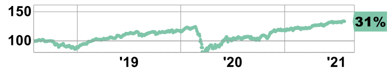
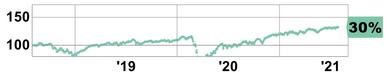
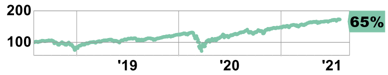
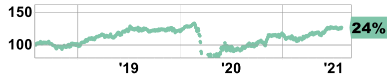
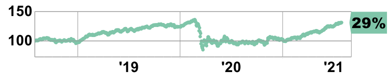
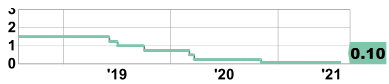
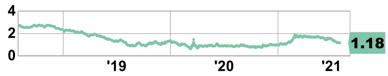
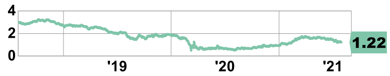
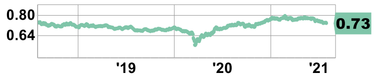
Global and Australian Fixed Income

- Government bond yields continued to fall, as central banks in the US and Europe hosed down suggestions that quantitative easing programs could be scaled back in the months ahead.
- The likely timing of interest rate hikes is also being pushed back again, suggesting recent increases in yields may have been a little premature.
- Ten-year yields closed the month 25 bps lower in the US and Germany, and 15 bps lower in the UK.
- The downward move was even more substantial domestically, with yields on 10-year Australian Commonwealth Government Bonds declining 35 bps over the month.
- These moves supported pleasing returns from major fixed income markets and helped bonds claw back more of their lost ground from earlier in the year.
- Bond market investors remain focused on employment data and associated statistics like wage growth and inflation. As ever, these indicators will have an important bearing on the outlook for official interest rates and, in turn, government bond yields.

Global credit

- Credit spreads – the additional yields on offer from corporate bonds over and above comparable government securities, to compensate investors for higher default risk – edged higher in July.
- The moves were not too significant among investment grade issues, but spreads on speculative grade issues widened slightly more as investors moderated their appetite for risk.
- Regionally, European issues fared a little better than those in the US and Asia.
- Overall, conditions remain favourable for corporate borrowers, with low interest rates and improving profitability. That said, increasing cases of the delta variant of coronavirus and the implementation of tighter restrictions in parts of the Asia Pacific have eroded confidence levels and could dampen the outlook if the pandemic worsens again in key regions.

MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
EQUITIES						
MSCI World (Gross of withholding tax, in AUD)	4,676.41	3.99%	10.25%	32.37%	15.52%	
MSCI Emerging Markets (AUD)	1,255.12	-4.68%	0.58%	18.06%	8.72%	
ASX 200	7,392.60	1.10%	5.80%	28.56%	9.48%	
ASX Small Ordinaries	3,406.30	0.68%	4.06%	32.30%	9.22%	
S&P 500 (USD)	4,395.26	2.38%	5.50%	36.45%	18.16%	
REITs						
ASX 200 A-REIT	1,558.30	0.28%	7.63%	32.75%	7.50%	
FTSE EPRA/NAREIT Developed (AUD)	3,789.91	6.09%	12.17%	32.86%	8.85%	
CASH and FIXED INCOME						
Official Cash Rate Australia	0.10%	0.00%	0.00%	-0.15%	-	
10-year yield Australia	1.18%	-0.35%	-0.57%	+0.37%	-	
10-year yield US	1.22%	-0.25%	-0.40%	+0.69%	-	
Foreign Exchange						
AUD/USD	0.7350	-2.09%	-4.84%	2.50%	-0.38%	

Source: Factset and Bloomberg, at 31 July 2021