Monthly Economic & Investment Market Commentary

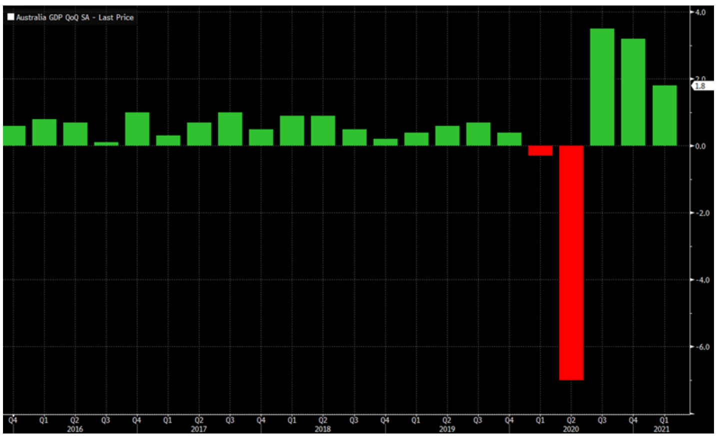
July 2021

In this month's commentary we will review some of the results that have been announced in the current company reporting season. They are generally quite strong, and many companies have confirmed a robust recovery in earnings for the financial year ended June 2021. This reflects the strong bounce in economic activity after the initial Covid-19 recession. The recovery in earnings and the better-than-expected economic outcome has in turn supported a restoration of dividends that were previously reduced. In some instances, there has also been a further return of capital to shareholders in the form of share buybacks.

Importantly, and as anticipated, this normalisation of earnings has also served to moderate what were temporarily extended valuations. As the Price to Earnings multiple includes less of the depressed earnings and more of the recovered earnings, the ratio of the two doesn't look as expensive.

These developments are unambiguously positive and have thus far supported the record highs that are regularly being set in the Australian share market. They are also part of history now.

As many will read this from the confines of our various states of lockdown, the obvious question is what does the future look like? Firstly, let's acknowledge that there will be a very real impact on economic activity in the first quarter of this new financial year. There will also be additional policy support from federal and state governments, and a reassessment of the monetary policy trajectory from our central bank. Perhaps more importantly though, we do still believe that this current episode of the protracted coronavirus saga is likely to be a short-term phenomenon. We do acknowledge though and share the frustrations of the last couple of months, and perhaps of the next couple ahead.



The magnitude of the contraction for the September Quarter is unknowable at this point, though the most recent estimates are that GDP will decline by 2% or more. For context, the initial impact of Covid-19 was felt in the March Quarter of 2020 with a -0.3% contraction, followed by the shuddering -7.0%. The recovery then started with +3.5%, +3.2% and +1.8% for the next three quarters, and the current estimate for GDP for the June 2021 Quarter is for expansion of +0.8%.

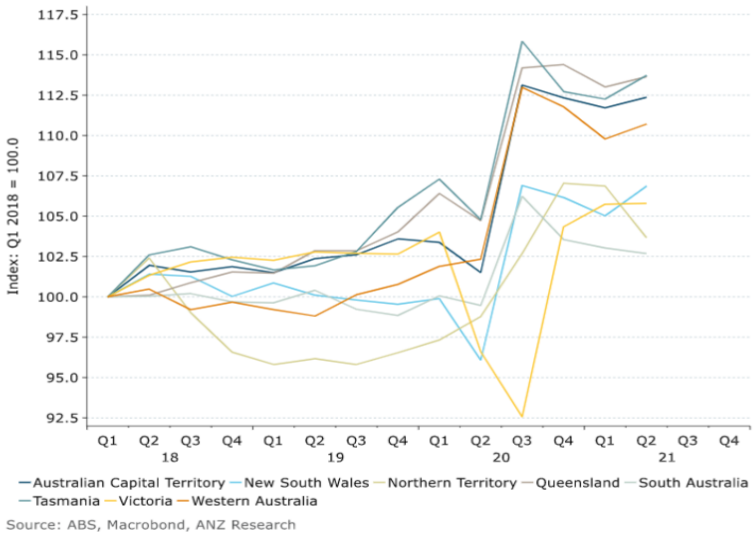
It does seem apparent that share markets are for now looking through the current Covid economic disruption, and importantly we think that remains the right approach. The reasons supporting this view are that the actual economic impact will be much less than last year, though there will be commensurately lower levels of policy support as well. Whilst frustration across the community is understandably very high, there is also much less panic and fewer known unknowns than in 2020. And most importantly, we now have multiple highly effective vaccines available and an accelerating acceptance of these will provide a path most of the way back to normality in coming months.

It is important to also remember that very often what financial markets pay attention to are the points of inflection. That is, the critical assessment is not so much whether today's circumstances are categorically good or bad, but whether things are getting better or worse. It will continue to be challenging to look ahead with any confidence for at least a few weeks, and probably a couple of months. We think that confirms again that a longer-term focus will continue to be the best timeframe in which to make portfolio management decisions.

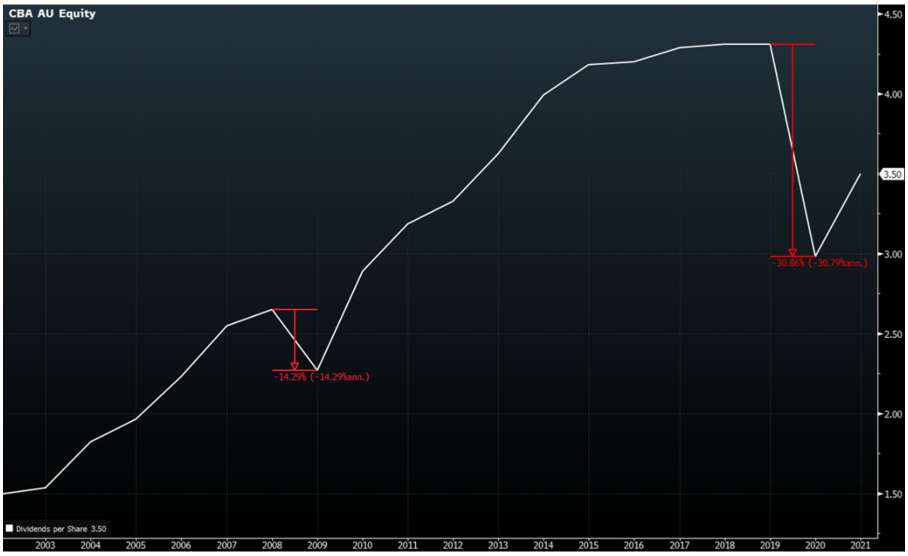
This chart will be familiar to many and shows two measures of sentiment in the business community. The top panel is Business Confidence, which for July re-entered negative territory. The bottom panel is the assessed state of current Business Conditions, the latest for which showed a marked decline, but was still positive. There is also a similar pattern with measures of Consumer Confidence, which show a retreat from recent peaks on the impact of extended lockdowns.

Here again though, we have the experience of the last year to provide context, along with the data that now continues to show that when restrictions are lifted that many categories of economic activity bounce back quickly.

This chart[1] tracks how retail sales have changed for each state, with a couple of years of pre-covid context, but the particular cause for optimism is the bounce shown for Victoria following their extended lockdown last year. The expectation is that this will also occur when current restrictions are eased.

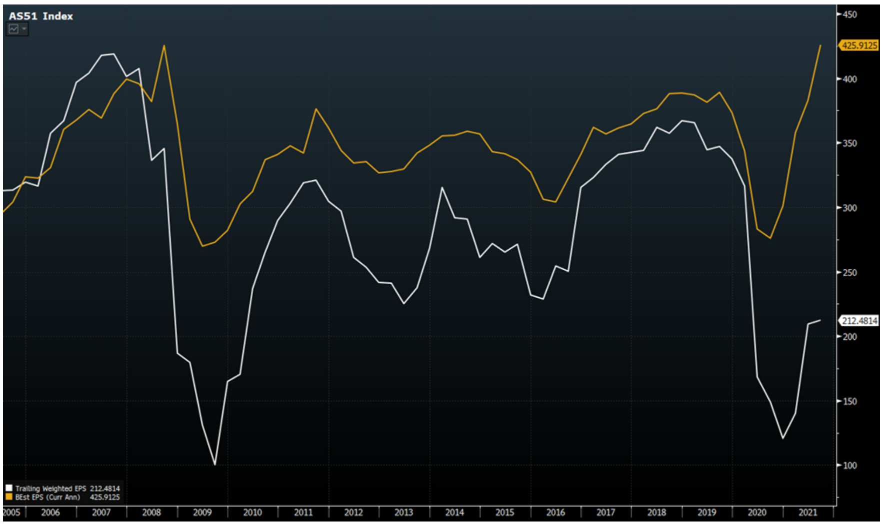


Returning now to the latest updates being provided by the companies in your portfolio, we'll focus on some specific details for the Commonwealth Bank of Australia, the largest listed company in Australia, and a large exposure within the Australian Equities asset class in your portfolio.



This chart shows the Dividends per Share (DPS) for the bank, going back about 20 years. You can see when dividends were reduced during the GFC of 2008/09, but also how they recovered quite quickly. You can also see how much more significant an impact the Covid induced recession last year had, but again that the recovery in dividends has begun.

Now we switch to the next element of our long-term forecasts and consider the earnings recovery, and here we revert to the benchmark S&P/ASX200 index. The white line shows both the cyclicality of earnings over time and of course the steep decline last year, that has again been partially recovered. The additional gold line is the collective view of analysts who forecast the next 12 months of earnings for the all the companies in the index.



Two points are noteworthy here, the first being that those analysts are just about always too optimistic. More importantly though, there is a relationship between the two lines, and whilst we should not expect the white line to catch up all the way to the gold one, it is reasonable to expect that there is still a significant earnings recovery to play out for Australian Equities.

We'll finish with this quote and commend the source to you[2]: "Vaccinated people will eventually inhale the virus but need not become severely ill as a result. Some will have nasty symptoms but recover. Many will be blissfully unaware of their encounters. 'There will be a time in the future when life is like it was two years ago: You run up to someone, give them a hug, get an infection, go through half a box of tissues, and move on with your life… That's where we're headed, but we're not there yet.' "

Kind regards,
Asset Allocation & Investment Committee

Asset Class Tipping Points

The recent fall in bond yields is reflected in the lower threshold at which Overpriced starts, which now stands at 1.3%. This in turn has the flow on effect of adjusting the other valuation bands, so that Cheap begins when long-term forecasts are better than 6.3%.

Asset Class Tipping Points - July 2021

Australian Equities

All Ords	10 Year Forecast	Valuation	31-Jul
10,500	0.8%	Overpriced	
10,200	1.2%	Overpriced	
9,900	1.6%	Fully Priced	
9,600	2.0%	Fully Priced	
9,300	2.4%	Fully Priced	
9,000	2.8%	Fully Priced	
8,700	3.3%	Fully Priced	
8,400	3.8%	Fully Priced	
8,100	4.3%	Fair Value	
7,800	4.8%	Fair Value	
7,500	5.3%	Fair Value	Aust 5.0%
7,200	5.9%	Fair Value	
6,900	6.5%	Cheap	
6,600	7.2%	Cheap	Fin'l 6.8%
6,300	7.9%	Cheap	
6,000	8.6%	Cheap	
5,700	9.5%	Cheap	

Income	4.3%	p.a.
Earnings	2.5%	p.a.
Valuation	-1.8%	p.a.
Forecast	**5.0%**	**p.a.**

International Equities - Developed

World ExAust	10 Year Forecast	Valuation	31-Jul
3,700	0.9%	Overpriced	
3,600	1.2%	Overpriced	
3,500	1.5%	Fully Priced	
3,400	1.9%	Fully Priced	
3,300	2.2%	Fully Priced	
3,200	2.6%	Fully Priced	Dev 2.7%
3,100	2.9%	Fully Priced	
3,000	3.3%	Fully Priced	
2,900	3.7%	Fully Priced	
2,800	4.1%	Fair Value	
2,700	4.5%	Fair Value	
2,600	5.0%	Fair Value	
2,500	5.5%	Fair Value	
2,400	6.0%	Fair Value	EU 6.2%
2,300	6.5%	Cheap	UK 6.6%
2,200	7.0%	Cheap	Japan 7.0%
2,100	7.6%	Cheap	

Income*	2.1%	p.a.
Earnings	2.2%	p.a.
Valuation	-1.5%	p.a.
Forecast	**2.7%**	**p.a.**

International Equities - Emerging

Emerging Markets	10 Year Forecast	Valuation	31-Jul
1,850	0.9%	Overpriced	
1,800	1.2%	Overpriced	
1,750	1.6%	Fully Priced	
1,700	1.9%	Fully Priced	
1,650	2.2%	Fully Priced	
1,600	2.6%	Fully Priced	
1,550	3.0%	Fully Priced	
1,500	3.3%	Fully Priced	
1,450	3.7%	Fully Priced	
1,400	4.1%	Fair Value	
1,350	4.6%	Fair Value	
1,300	5.0%	Fair Value	EM 5.2%
1,250	5.5%	Fair Value	
1,200	6.0%	Fair Value	Asia-P 5.8%
1,150	6.6%	Cheap	
1,100	7.1%	Cheap	
1,050	7.7%	Cheap	

Income*	-0.7%	p.a.
Earnings	5.5%	p.a.
Valuation	0.5%	p.a.
Forecast	**5.2%**	**p.a.**

Listed Property

ASX200 Property	10 Year Forecast	Valuation	31-Jul
2,250	0.9%	Overpriced	
2,200	1.2%	Overpriced	
2,150	1.5%	Fully Priced	
2,100	1.8%	Fully Priced	
2,050	2.1%	Fully Priced	
2,000	2.4%	Fully Priced	
1,950	2.8%	Fully Priced	
1,900	3.1%	Fully Priced	
1,850	3.5%	Fully Priced	
1,800	3.8%	Fair Value	
1,750	4.2%	Fair Value	
1,700	4.6%	Fair Value	
1,650	5.0%	Fair Value	
1,600	5.4%	Fair Value	
1,550	5.9%	Fair Value	A-REITs 5.8%
1,500	6.3%	Cheap	
1,450	6.8%	Cheap	

Income	4.0%	p.a.
Dist Grwth	1.4%	p.a.
Valuation	0.4%	p.a.
Forecast	**5.8%**	**p.a.**

** Income for International Equities includes dividends and forecast currency impact.*

Sources

1. *A Timbrell, "Resilient Retail" – ANZ Economics. 6-Aug-21.*
2. *E Yong, "How the pandemic Now Ends" – The Atlantic. 12-Aug-21.*

NOTE: *It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time, or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio, please contact your Adviser.*