ARRIVE
WEALTH MANAGEMENT

ECONOMIC SNAPSHOT

DECEMBER 2020
YEAR IN REVIEW

SUMMARY

2020 began off the back of a big global equity rally, with a few geo-political concerns, but no inkling of the havoc that COVID-19 was about to wreak on the world. As the March quarter unfolded, with lockdowns following the virus from one country to another, risk assets such as equities and the A$ fell sharply as expectations of recession spiked. At the same time, a shortage of US$ liquidity pushed financial markets close to freezing up. Central banks and governments stepped in with massive liquidity and spending packages. Interest rates were cuts to historic lows.

Equity markets then began a rally that ran through to the end of the year, taking the US market to new highs. Tech stocks performed very strongly as economic activity switched from physical to virtual operations. Bricks and mortar companies hit by social distancing underperformed. These developments were part of a bigger picture underperformance of value stocks compared with growth stocks.

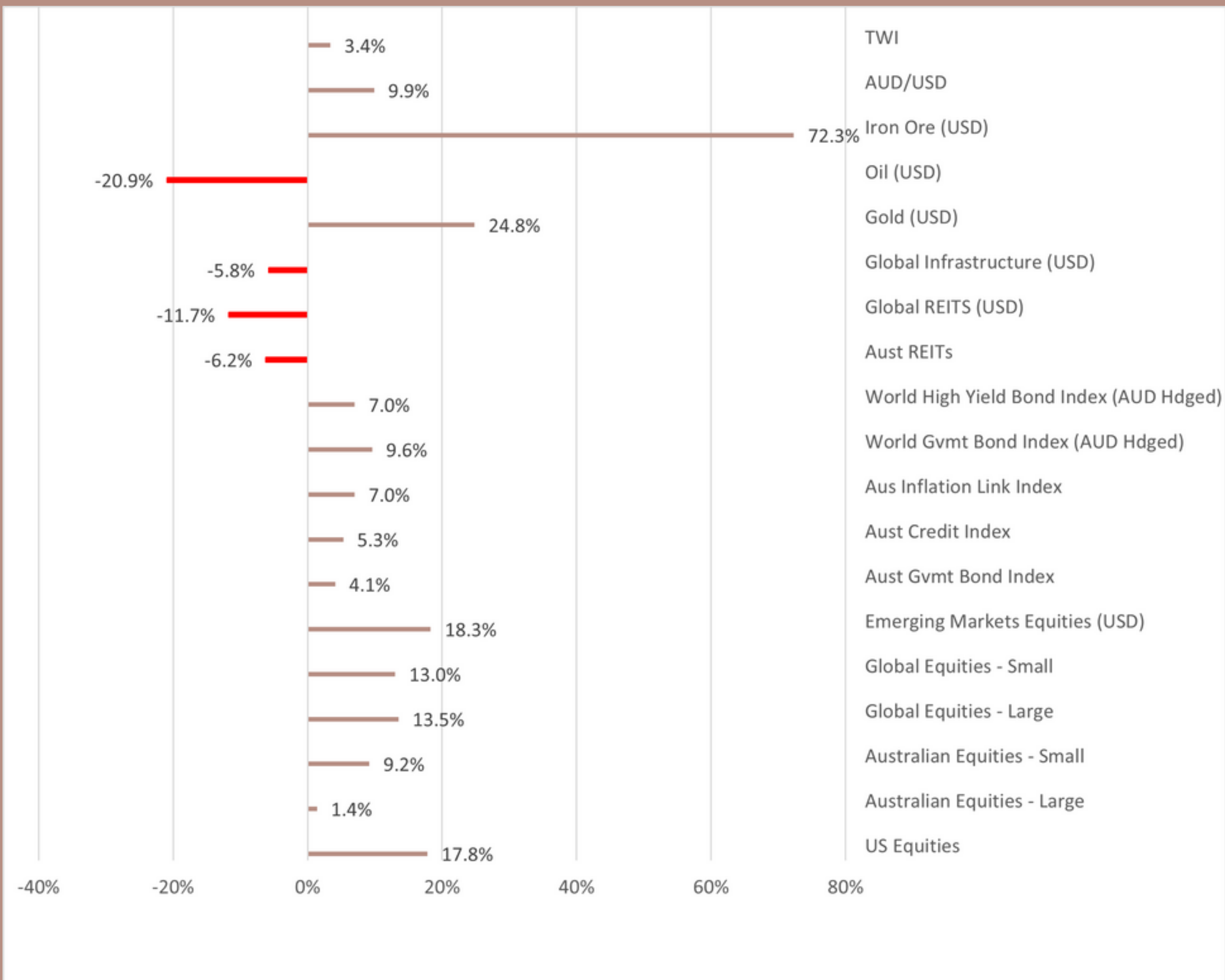
As the year progressed, the economic recovery proved faster than expected, but by the end of the year much remained to be done in returning unemployment to pre COVID-19 levels. Central banks vowed to keep interest rates at current levels for years if necessary.

Progress with vaccines pushed equity markets higher again towards the end of the year and also triggered some rotation from growth stocks back into value stocks. The A$/US$ pushed towards US$0.77 on the back of a strong iron ore price and expectations of US$ weakness.

Looking into 2021, barring COVID-19 derailing things again and any major geopolitical shocks such as a China/Taiwan dispute, equity markets should be able to post reasonable gains in 2021. However, a higher A$ will make hedged equities more attractive than unhedged equities. The rotation into value stocks has scope to continue. A further sustained rally in gold depends on US inflation expectations rising further.

PERFORMANCE OF KEY FINANCIAL MARKETS IN 2020

Selected market returns 2020



Sources: Thomson Reuters, Bloomberg. Equity returns are total return.

LOOKING BACK. 2020 IN REVIEW

By the end of 2019 equity markets had staged a huge rally to new record highs and investors were becoming more confident of stronger growth in 2020. However, the new year started on a more troubling note with renewed hostilities between the US and Iran, the Democrat-controlled House of Representatives voting to impeach President Trump, and terrible bushfires in Australia. January also saw the first signs of the event that would go on to define 2020 – the emergence of COVID-19 in China.

Within weeks COVID-19 infections were spreading around the world and by March lockdowns were being imposed in many countries. One of the most important aspects of COVID-19 at this point was surprise and uncertainty. The last global pandemic had been 100 years ago, there was little information about the origin and nature of COVID-19, and the general view about a vaccine was that, while efforts would be made to find one, there had never been a successful COVID-19 vaccine.

Financial markets took these developments very seriously and immediately started to price in a major slowdown in economic activity caused by the lockdowns. Talk of global recession replaced the confident mood of the start of the year. Volatility exploded across markets with the prices of risk assets such as equities, oil and the A$ falling very sharply. By the end of March, equity markets were 20% - 30% below where they started the year. The US$ rocketed up on safe-haven demand for US cash and the A$ rate fell to US$0.557 on 19 March after starting the year at US$0.70. At one point in late April, the price of oil actually fell to negative US$37 per barrel as supply far outstripped demand.

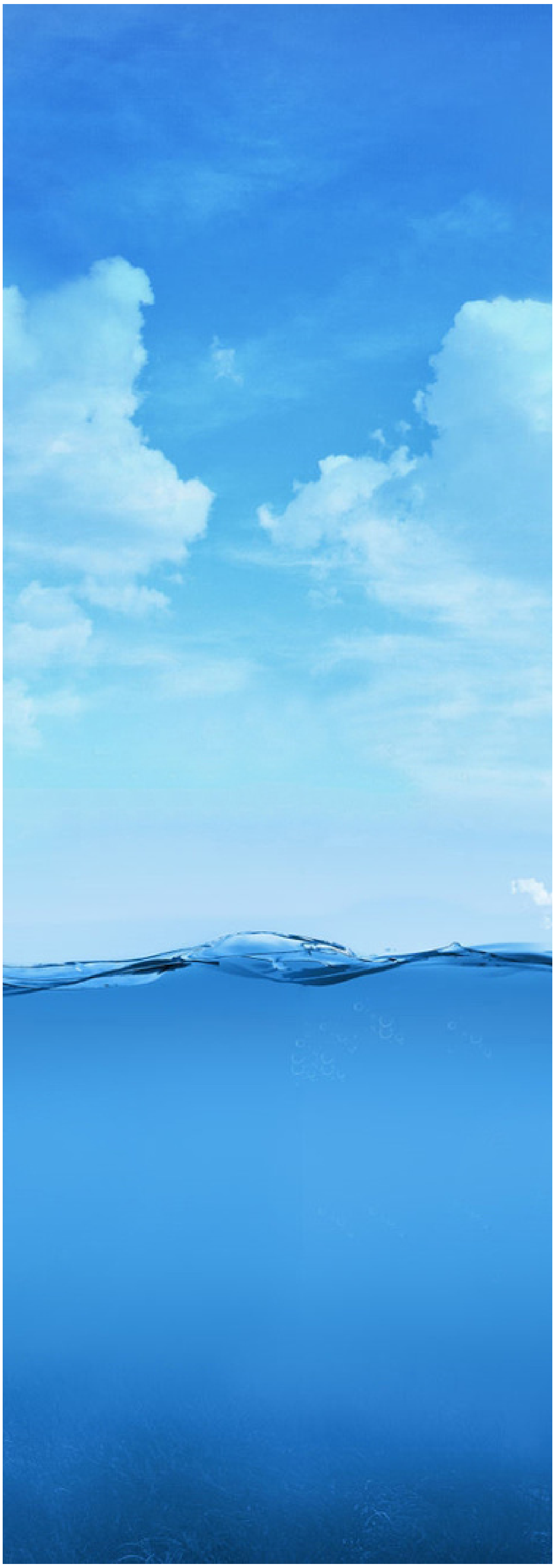
These developments reflected more than just a sudden and dramatic downward revision to global growth expectations. They were also a sign of imminent market failure, reviving memories of how global financial markets froze up in the wake of the Lehman Brothers collapse in late 2008. Policy makers were faced with two problems: keeping financial markets working and providing support for economies to offset the hit to private sector growth caused by the lockdowns.

Central banks responded by cutting cash rates to historic lows and injecting massive amounts of liquidity into the global financial system. The US Federal Reserve cut the cash rate to 0.05% and dramatically expanded its QE program. The Reserve Bank of Australia cut the cash rate to 0.25%, though by the end of the year this had been reduced to 0.10% and the RBA had started a QE program like other central banks. At the same time, governments around the world announced massive increases in fiscal spending primarily aimed at supporting household incomes through job preservation/wage subsidy schemes.

The combined degree of stimulus between both fiscal and monetary policies far exceeded what was done in the GFC.

Financial markets reacted swiftly and started to discount the surging virus figures, higher unemployment and weaker growth, in favour of a better 2021 led by the stimulus programs. As the year went on, increasing confidence about a vaccine also supported this more optimistic view.

Equity markets rose sharply, as did the price of oil, and the A$ moved back towards US$0.70.

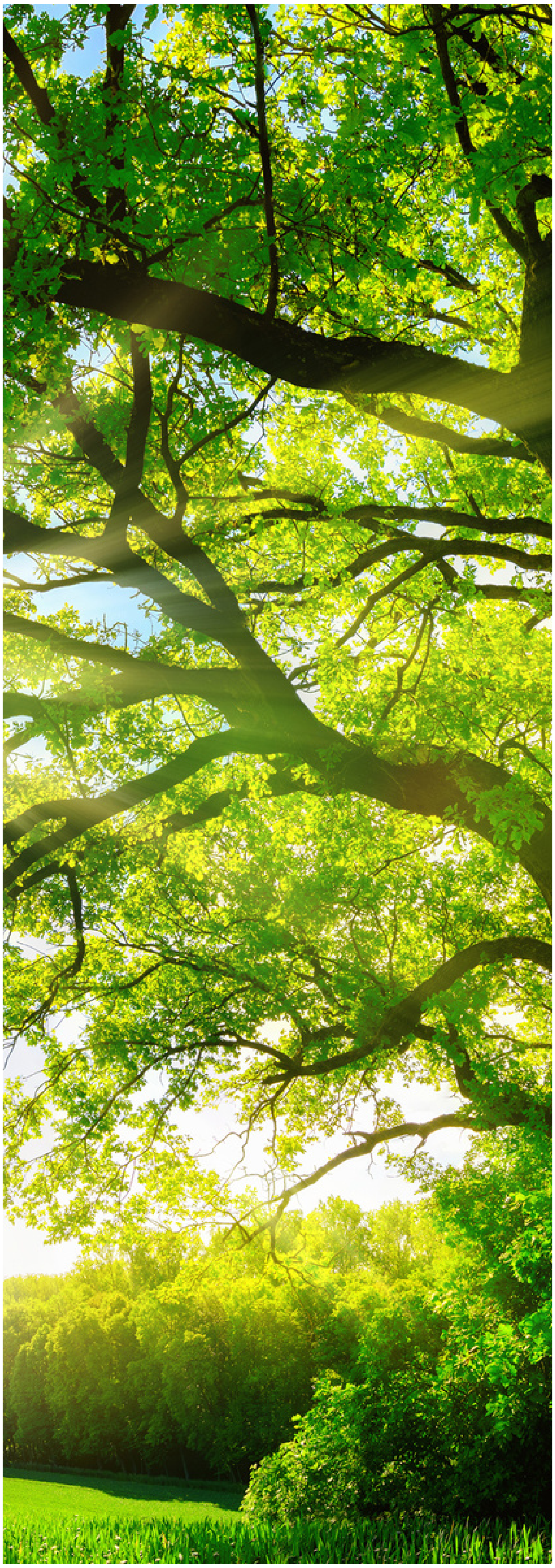


The price of gold enjoyed a sustained rally taking it to new highs over US$2,000. The rise in the gold price was partly due to safe-haven demand on the surging COVID cases in the US and partly on fears of inflation caused by the massive expansion of the money supply caused by the central banks.

The big rally in equities masked some interesting developments between sectors within equity markets as investors assessed the relative prospects of stocks impacted by COVID-19. For example, online retail companies did better than shopping centres. Selected pharmaceutical stocks also did well on expectations about vaccines. Banks struggled in the low interest rate environment amid concerns about the level of bad debts. At the same time, low interest rates and bond yields helped growth stocks, including tech, relative to the more cyclical value stocks. Added to this, the rise of online stock trading platforms brought a new wave of retail investors to global equity markets. These investors proved more interested in momentum and speculation than in traditional valuation metrics.

While all this was happening in equity markets, bond yields remained very low as central bank QE operations aimed to suppress any upward drift in nominal bond yields. One result of this was that as US inflation expectations rose, bond market traders were less able to price those expectations into nominal yields and resorted to pushing the yields on inflation protected bonds (TIPS) down. (Recall that nominal yields minus inflation protected yields equals bond market inflation expectations). As markets revised up their inflation expectations towards 2%, so the yield on TIPS fell to -1%. The TIPS yield is a key driver of the price of gold, which rose as the TIPS yield fell.

Another important development on the commodity front was the sharp rise in the price of iron ore, especially towards the end of the year as China's economy recovered, which helped drive the A$ up towards US$0.77.



The Reserve Bank expressed concerns about the A$ rising too far, potentially hurting exports and growth. This was a key reason the RBA introduced its QE program late in the year.

As the chart on page 3 shows, by the end of 2020, equity markets were higher than a year earlier, though the Australian markets lagged the rest of the world. REITs and infrastructure indices underperformed, while bond markets posted some good positive returns.

As if 2020 was not already dramatic enough, there were also important developments on the geopolitical front. The tensions between the US and Iran at the start of the year evaporated quickly as COVID-19 expanded, but tensions between China and the rest of the world increased. China's treatment of Hong Kong, its behaviour in the South China Sea, and renewed rhetoric about reclaiming Taiwan, have all been sources of concern about China's attitude and intentions. Their verbal attacks on Australia and attempts to punish us economically have also not gone unnoticed on the broader global stage.

In the US, after a somewhat inept primary season, the Democrats finally settled on Joe Biden as their Presidential candidate. As COVID-19 rolled through the US and Donald Trump's performance became increasingly bizarre, so the tide of electoral sentiment started shifting to the Democrats. But the Democrats did not do as well as expected, losing seats in the House of Representatives and not securing a clear majority in the Senate (pending the Georgia run-off elections).

In the UK, Boris Johnson squeaked a Brexit deal through at the last moment. Implementing the deal will of course take time and have major implications. Not surprisingly, the Scottish Nationals have started talking about independence again.

LOOKING AHEAD. ISSUES FOR 2021

So where does all this leave us at the end of 2020 and what does it mean for 2021?

The current virus situation varies greatly between countries. Some countries, including Australia and New Zealand, have infections well under control. Others, notably the US never had it under control, while others, including Europe and the UK, have lost control of it. Progress in developing multiple vaccines has been extraordinary and the race is on to distribute them as quickly as possible. Although markets have largely chosen to ignore the virus in recent months, it is likely that at times it will cause bouts of volatility in markets. Similarly, if the vaccine rollout does not go as smoothly as markets hope, then that too would upset markets.

Economies are recovering, but still have a way to go. In particular, it will take some time to get inflation and unemployment back to where the central banks want them. There are some signs of over-confidence in markets and households about these variables. The data suggests that by end 2021 inflation will still be lower, and unemployment higher, than the central banks want. This means that we can take literally the central bank statements about no interest rate rises for the coming year. With interest rates at rock bottom levels, bond and credit markets are likely to deliver only modest positive returns.

Equity markets should be the best performing asset class in 2021, though not as spectacularly as some of 2020's performance. Continued economic recovery should underpin profit growth, while central bank liquidity and interest rate settings will help keep P/E ratios elevated. Within equity markets, the rotation from growth to value stocks has scope to continue. Underperforming sectors like REITs and infrastructure can also outperform, as long as the virus does not disrupt the gradual normalisation of economic activity.

The Australian dollar may rise further to around US$0.80, so that hedged international equity exposures will do better than unhedged exposures. If the US$ depreciates as much as the markets seem to expect, then the A$ could go higher than this and emerging market equities could outperform.

If we are right about inflation not being as big a threat in the coming year as the markets currently think, then the price of gold may have little upside from here.

Key risks to the outlook, apart from COVID-19 derailing things again, include the Democrats getting control of the Senate and enacting a much more aggressive program of reform and fiscal expansion. China deciding to try its luck with taking over Taiwan would be a major shock to global financial markets. If we are wrong about inflation and it does in fact go up much more than we expect then rising interest rate expectations could well hurt equity markets. However, gold could rally as TIPS yields would fall further.

MAJOR MARKET INDICATORS

	31-Dec-20	Changes over periods shown:*			
		1 Month	3 Months	6 Months	12 Months
Cash rates					
Australia	0.10%	0.0%	-0.2%	-0.2%	-0.7%
USA	0.08%	0.0%	0.0%	0.0%	-1.5%
Japan	-0.10%	0.0%	0.0%	0.0%	0.0%
Europe	0.00%	0.0%	0.0%	0.0%	0.0%
10 Government bond yields					
Australia	0.97%	0.1%	0.1%	0.1%	-0.4%
USA	0.91%	0.1%	0.2%	0.3%	-1.0%
Japan	0.02%	0.0%	0.0%	0.0%	0.0%
Europe	-0.58%	0.0%	-0.1%	-0.1%	-0.4%
Equity markets					
ASX200	73460	1.2%	13.7%	13.2%	1.4%
AREITs	3323	-1.4%	12.3%	18.3%	-9.4%
S$P500	6836	3.8%	12.0%	21.9%	17.8%
Topix	1805	2.8%	11.0%	15.8%	4.8%
EuroStoxx	3553	1.7%	11.2%	9.9%	-5.1%
MSCI Emerging Markets	624	7.4%	19.7%	31.1%	18.3%
VIX volatility index	22.41	10.6%	-14.0%	-25.2%	64.9%
Currency markets					
Aud/Usd	0.7702	4.2%	8.4%	12.2%	9.9%
Aud TWI	63.40	3.1%	4.4%	5.7%	5.1%
Usd/Y en	103.25	-1.0%	-2.2%	-4.3%	-5.0%
Euro/Usd	1.22	2.3%	4.3%	8.9%	9.0%
Commodity markets					
Gold	1897.8	7.0%	-0.1%	6.4%	24.8%
Oil	48.4	7.0%	20.7%	23.1%	-20.9%
Iron Ore	158.5	21.5%	32.1%	56.2%	72.3%
Coal	62.7	0.0%	20.6%	16.7%	-5.8%

*For cash rates and bonds the changes are % differences. For the rest of the table, % changes are used.

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