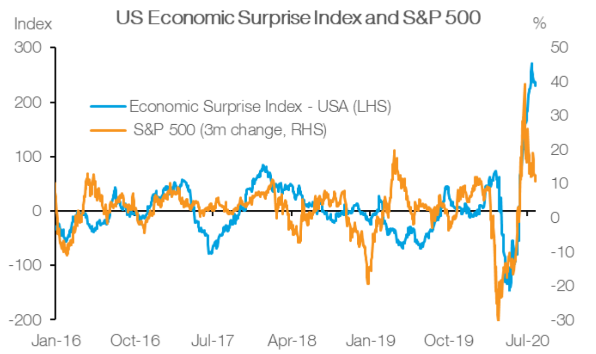
Research
Macquarie Wealth Management

Quick Comment

Catalysts are getting stale, but the trend remains intact

After a sharp v-shaped recovery through April-June, the pace of equity market gains have slowed substantially throughout the past month as fears that upside catalysts are getting stale, particularly in light rising downside risks.

Economic surprises starting to roll over



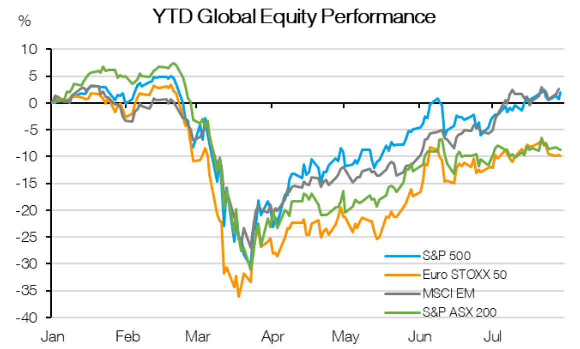
Source: Factset, MWM Research, July 2020

While the near-term risk-reward is less appealing than when markets were 40% lower, we don't think the trend is at risk of being broken. We remain positive on equities and think the more likely (near term) path is for a range of trading environments to develop as the market reassesses the outlook in light of a moderation in economic data, rising political tensions and the extreme valuation dispersion that has opened up.

We don't think this picture is unusual or that there is anything new that either changes the story in terms of the market direction (still gradually higher) or market internals (a slow transition towards cyclicals as economic growth becomes more certain). Momentum behind the equity market rally was always going to fade as expectations re-set higher (economic and earnings) and this is clear to see in where economic data surprises now sit. However, we see no less commitment by central banks (the Fed in particular) in continuing to provide the backstop for growth and to a lesser extent risk assets over the near term.

In fact, while overnight commentary by the Fed provided limited "new" news, we think the message was crystal clear. If the path of the US economy is dependent on the virus, then the path of future monetary policy will also be dependent on these developments. We do not think the Fed will be dissuaded by politics (US election) or where asset markets sit (the bubble risk) from doing more if necessary.

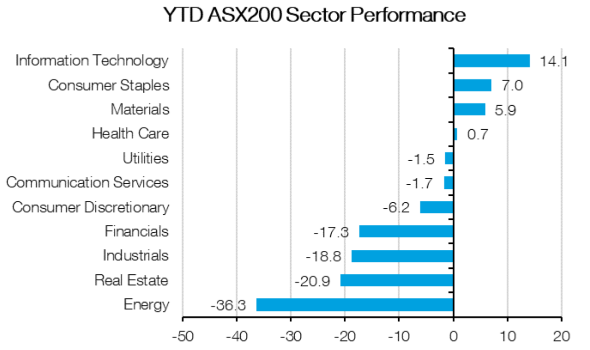
Equity performance has flattened out in recent weeks



Source: Factset, MWM Research, July 2020

In addition - and what appears a hard hurdle for many investors to get over - the forward guidance by the Fed and other central banks (like the RBA) is indicating their commitment to a new ultra-low rates regime and this is how we can justify some unusually high, and extremely uncomfortable, valuations.

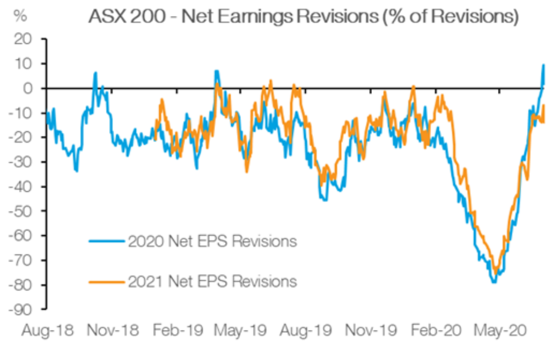
Australian equity performance has been dispersed



Source: Factset, MWM Research, July 2020

This is a constant and likely to be an underlying tailwind for some time to come. It might not be enough to avoid periods of weakness or rising volatility, but it should be enough to ensure that the trend towards further growth improvement is not permanently interrupted.

Revisions nearly back into Net Upgrade Territory



Source: Factset, MWM Research, July 2020

From a markets perspective this implies several things.

- **PE's are high, but the fair value of equities is higher:** PE valuations are stretched, but lower bond yields put the fair value of Australian equities above the early year high by ~5%. This is hard to grasp given the earnings decline and the weak outlook, but if earnings recover and bond yields remain anchored (as the RBA has indicated), then equities can trade higher. However, we think the PE expansion phase of the recovery is largely played out.

- **Own a barbell of COVID-19 winners and some cyclicals:** It remains too early to align portfolios towards cyclicals. We think a barbell including both COVID-19 winners - A2 Milk (A2M), Afterpay (APT), Domino Pizza (DMP), Fisher & Paykel (FPH), Goodman Group (GMG) - and early cyclical recovery plays - Aristocrat (ALL), James Hardie (JHX), Incitec Pivot (IPL), Nick Scali (NCK), Stockland (SGP), Transurban (TCL) - is how best to position until uncertainties around the growth outlook / reopening up of the economy becomes clearer. However, if the PE expansion phase is over and the next phase is driven by an earnings recovery, then it will be cyclicals that lead this..

- **Operating leverage will be the focus as growth certainty improves:** Investors are fearful of cyclicals and value stocks, but this is where the operating leverage will emerge into 2021. We think the most important area to focus on in the upcoming reporting season is COSTS and how aggressively these have been cut in response to falling demand. This is where operating leverage will come from as activity begins to rise and why we can see corporates being re-rated even in a below trend GDP backdrop. This has the potential to be the key driver of stock performance going into 2021.

- **Deflation and not inflation is the world we live in:** Prior to the pandemic, the global economy was already struggling with structural disinflationary pressures despite numerous rounds of QE. These pressures have now been joined by an even greater deflationary influence – the output gap created by the rapid escalation of unemployment all around the world. As Brett Lewthwaite highlighted in our Expert Panel Roundtable discussion, while inflation could emerge in pockets and differing countries, investors should be more attuned to the risk of deflationary pressures. On this basis, while some hedging for inflation might be appropriate, we don't think portfolios should be aligned with this outcome.

Jason and the Investment Strategy Team

The report was finalised on 30 July 2020

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return