August 2020 — Over the Horizon Market Commentary by David Offer

AN IMPORTANT ANNOUNCEMENT REGARDING YOUR WESTPAC BANK ACCOUNT LINKED TO YOUR INVESTMENT PORTFOLIO.

Westpac have advised that due to being unable to meet their ongoing compliance obligations, they will be closing their institutional banking service as offered by DDH Graham effective 14 March 2021. As a result, we will be obligated to change the bank account linked to your portfolio prior to this date.

Given the ever diminishing levels of service offered by the major banks it is necessary to continue to use an intermediary and, to that end, we will continue our relationship with DDH Graham. DDH Graham have recommended Bank of Queensland (BOQ) and, given the Federal Government underwrites all bank deposits up to a value of $250,000, we are comfortable with this change. BOQ pay an interest rate that is 0.25% above the official RBA rate (current 0.25%). While 0.5% is meagre in a historical context, during this period of unusually low interest rates, BOQ rates highly when compared too other 'at call' banking facilities.

Our experience in switching from Macquarie to Westpac several years ago highlighted that changing bank accounts can be quite involved and drawn out. With a hard closure date, we need to progress alternative banking arrangements well in advance. In that regard, preparations are already underway with your new BOQ bank account already established pro forma. It is our intention to activate your new BOQ account and switch over from WBC to BOQ from October, with subsequent months spent ensuring all investment income is redirected to your new BOQ account.

We do not require you to do anything with respect to this upcoming change of portfolio bank account. Should your cash account balance be over $250,000, our office will be in touch in due course to discuss whether additional banking facilities should be established so as to ensure all monies held in cash are covered by the Federal Government bank guarantee. If you have any queries regarding this upcoming change, please contact our office and we will assist.

AUGUST PORTFOLIO REPORTS

The Australian share market returned 3.1% for August with the All Ordinaries Index up 187 points too close at 6,245 points. This was largely off the back of a better than expected reporting season as companies tended to be more resilient to Covid-19 than previously thought. While normal is a long way off for many sectors including the banks, listed property trusts, travel and gaming, a sign of optimism is that over 50% of companies that reported forecast earnings are expected to return to more normalised (2019 earnings) in 2021.

The relative resilience of the Australian economy and global economies in general in the face of Covid-19 has been largely due to a level of government stimulus that, with the exception of World War II, is unprecedented in the last 100 years. This has been evidenced by the Australian Government generating enough stimulus to increase the budget deficit to around 9% of GDP, Europe collectively 9.5% of GDP and the US whacking another $US4 trillion on it's credit card to generate stimulus equivalent to almost 20% of US GDP. With such significant amount of money being injected into the world economy, a financial

crisis has been avoided … at least for now. The topic of repaying such immense sums of debt will be one for another day, and arguably by another (younger) generation of taxpayers.

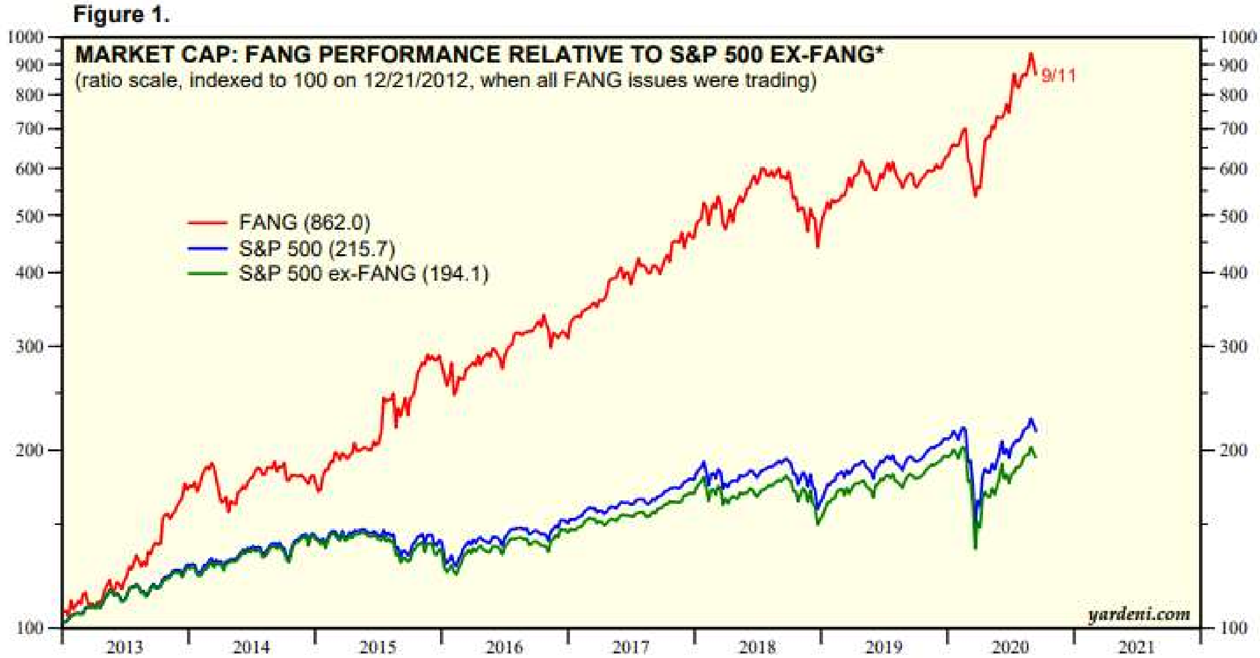
As an example of government spending closer to home, the WA State Government has recently announced a range of stimulus packages to boost the State Economy post Covid-19. This has included a $252 million stimulus package for the South West of Western Australia. Details regarding this package can be found at https://www.wa.gov.au/organisation/department-of-the-premier-and-cabinet/wa-recovery-plan-initiatives#plan-for-the-south-west. Of note is the bringing forward of the commencement of work for the Bunbury Outer Ring Road by three months with construction now expected to commence January 2021. These initiatives are part of $5.5 billion in total State Government stimulus packages that have been annouced since the coronavirus pandemic began. Ironically, it would appear that Covid-19 may be the catalyst for an economic recovery that has been many years overdue in Western Australia.

Covid-19 has accentuated some notable trends in 2020. This has included;

<u>The rise and rise of the US technology giants.</u>

Collectively known as the FANG shares, the share prices of Facebook, Amazon, Apple, Netflix and Alphabet (formerly known as Google) have enjoyed the Covid-19 period, having doubled from their March lows. These companies still have a staggering combined value of $5.5 trillion and now represent 26% of the value of the US share market, up from 8% in 2013. This is despite generating just 0.5% of total revenue of US listed shares. Trading on heady valuations, the average Price Earnings Ratio of these 5 companies is presently 59 times. The out-performance of these 5 companies when compared to the broader US share market is highlighted by the chart below;

Figure 1.



* FANG stocks include Facebook, Amazon, Netflix, and Google (Alphabet).
Market cap includes both classes of Alphabet.
Source: Standard & Poor's and Yardeni Research Inc.

Investors who simply invested passively in index funds have been able to capture the upside of these companies as their market capitalisation has steadily grown relative to other companies. However, history has shown that the winners of today are unlikely to remain the winners of tomorrow, so huge caution is warranted; particularly as these companies trade at levels that makes them highly susceptible to a material share price pull back. Recent US share market weakness has been attributed to a correction in technology companies and there is scope for much more downside to occur. This is not a trend we are comfortable participating in.

The rise of Australian iron ore miners

As recently discussed by journalist Robert Gottliebsen from The Australian, China was able to contain the effects of Covid-19 more effectively than any other developed nation. To restart its economy China subsequently embarked on a major program of infrastructure and property investment, thus increasing the demand for steel and iron ore. China's second largest supplier, Brazil, could not respond to the higher demand because its main producer, Vale, became a victim of COVID-19 infection. In contrast, Australian iron ore mines did not become infected with Covid-19 and lifted output marginally. The result is that iron ore has increased from $US80 a tonne to $US126 a tonne now.

This is another area to be cautious. China-Australia relations are at a record low and China is taking proactive steps to lessen dependence on Australian iron ore. This includes increasing local Chinese production, which is profitable at prices above $US90 a tonne. Likewise, encouraging Brazil to open new mines and new deep water ports to enable Chinese supercarriers to take Brazilian ore to China at reportedly a comparible cost to shipping ore from Australia. Finally, opening new mines in different locations such as the massive Simandou iron ore mine in Guinea, which is in partnership with Rio Tinto. Equally important, China is likely to reduce captial spending next year with Chinese consumers expected to fill the gap. After so many years of infrastructure investment within China, there is the risk that current capital investment is much more marginal in nature; as was the case at the end of the Japanese capital investment boom.

Against this backdrop, the cyclical nature of the iron ore price will likely remain with the expectation that at some point the iron ore price will track materially lower. If so, the share prices of our iron ore miners would also be expected to fall.

The underperformance of cyclical companies, versus the outperformance of (non tech) companies that have benefited from Covid-19.

Covid-19 has tended to impact companies exposed to the day to day economy harshest as Australians were (and in the case of Victoria still are) forced to curtail normal day to day activities. However, as the national economy stabilises and starts to recover, largely due to massive government spending programs mentioned above, it is these cyclical companies that stand to recover most strongly. This is particularly given many of these companies have been forced to cut costs substantially this year, increasing their leverage to an economic recovery. Any successful release of a Covid-19 treatment or vaccine will further expedite this trend. This is a preferred exposure to the share market and includes companies like Cimic, Link, Suncorp Metway, Crown, United Malt, Challenger, Scentre and Woodside. (Our other preferred exposure are companies that have had share prices marked down despite being relatively immune from the impacts of Covid-19. Examples here include Amcor, Brambles, Tassal, Worley and, post recent share price weakness, Medibank Private.)

Just as there is the expectation that cyclical companies will recover as the adverse impact of Covid-19 diminishes, there is the risk that companies that benefited through the Covid-19 period will encounter a less favourable operating period going forward as operating conditions normalise. Examples here include Wesfarmers (Bunnings), Woolworths, Coles, JB Hi-Fi and Harvey Norman.

Overall, we remain cautiously optimistic. While many sectors of the share market appear overvalued, equally there are numerous sectors that offer compelling value at this time. As such, we are viewing share market dips as an opportunity to selectively add to portfolios.

Finally, as part of meeting our ongoing compliance obligations we are legally obligated to provide to you an updated copy of **Pershing's Financial Services Guide** (FSG). In providing a revised Pershing FSG, I confirm there is no change to our dealing arrangements with Pershing.

David Offer
Investment & Financial Advisor
phone: 08 9791 9188
fax: 08 9791 9187
email: david.offer@horizonis.com.au
website: www.horizoninvestmentsolutions.com.au

HORIZON INVESTMENT SOLUTIONS | UNIT 4, 2-4 JETTY ROAD, BUNBURY WA 6230