January 2021 — Over the Horizon Market Commentary by David Offer

January was a subdued month for the Australian share market, with the All-Ordinaries Index gaining just 20 points to close at 6,871. However, thus far February has been a different story; with the Australian share market up 4% or 278 points at the midway point for the month. The Australian share market is now less than 2% from pre COVID highs reached last February before the onset of the global pandemic. In the last 12 months, the Australian share market has fallen 39%, nearly all of which occurred last March; to then recover almost in full the subsequent 11 months. It really has been an extraordinary year for investors to endure.

The share price strength experienced this month can be largely attributed to a **statement** made by Philip Lowe, Governor of Australia's Reserve Bank (RBA) on 2nd February. In this statement, the RBA advised it will extend its current Quantitative Easing program by a further $99bn. In effect, the RBA will be effectively financing all, plus some, of this year's federal budget deficit. We had thought the current tightening of Australia's labour market, early indications of an effective vaccine overseas, and the extraordinary fiscal and monetary stimulus provided since the onset of COVID, would have been enough for our Central Bank to hold back for now and telegraph a tightening in interest rates later this year. Instead, the RBA has surprised by stimulating the economy further and would appear to be taking out some insurance against the vaccine not working as effectively as presently predicted. Tellingly, the final paragraph of the announcement reads *'The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest.'*

Interest rates operate like gravity for share markets. Without, valuations are free to float up to any level. The significance of this announcement is that the RBA, by suggesting no interest rate rises for the next three years, appears to be indirectly facilitating an asset bubble in both the property and share markets. There are ample signs that both markets are obliging. Further, it appears RBA policy settings going forward will be more reactive rather than pre-emptive in nature. The short-term implications for the Australian share market are that despite high share market valuations, particularly in growth shares, valuations may still track higher. With money abundant, we are also likely to see a significant increase in mergers and acquisitions.

While bull markets are fun, the aftermath is not. Renowned fund manager Jeremy Grantham has provided this Bloomberg interview that is well worth watching at the following link; **https://youtu.be/RYfmRTyl56w**. Jeremy considers that the US share market may be on the brink of a significant downturn that could, in his opinion, occur on the conclusion of the vaccine rollout at which time the US share market may receive a reality check. He highlights 4 key points;

1. <u>When overconfidence has reached its peak</u> - Perhaps ironically, if the market is feeling good, then it shouldn't. Grantham looks for when market exuberance is at a high and warns this is when investors should be more cautious. "When confidence has reached these levels, history books are pretty clear. It's very difficult to increase your enthusiasm from a state of mild hysteria where we are today."

2. <u>Stocks which are overvalued and underproducing</u> - Overvaluation on its own isn't a sign of impending doom, but there needs to be a watchful eye on the underlying numbers. Grantham says that overvaluation can drag on for years, but he notes a concerning trend of overvalued companies with no sales, no profits and yet are some of the biggest companies on the market.

3. <u>High unemployment levels and no levers for central banks</u> - In March 2020, the US Federal Government announced a raft of monetary policy to reduce the economic impacts of COVID-19. But unemployment rates have not recovered, and the Feds have pulled nearly all the available levers they have in order to keep markets afloat. "If you go back to before COVID what you see is we have lost considerable strength in the economy. We have fewer people working, and we have a reduced stream of goods and services, and yet the price is much higher… You can have a lot of rescues when you have a long US Government bond at 16%. At the lowest rates in history, you don't have a lot to put on the table."

4. Bubbles don't always burst alike - The bubble can ride on for a long time in a holding pattern. The problem with a bubble is not that you don't realise you're in it – it's that you don't realise when it's game over.

Thanks to extreme central bank policy which our own Reserve Bank is participating in, we can't turn our backs on investing as cash rates at zero will guarantee a permanent loss of capital, from both the impact of inflation and being forced to draw down capital to meet costs of living. As such, there is no safety in holding cash long term. We are living in a world where there is no truly safe or risk-free investment available at this time. The purpose of cash now is to take advantage of opportunities in other investment areas when they present.

As we have written about repetitively, we are extremely conscious of the high valuations in many areas of the share market and certain investment markets in general such as bond markets. We are doing our best to avoid these areas. While we will not be immune from any broad-based selling should it arise, by holding real world investments on sensible valuations, we have confidence that capital will ultimately be preserved and long-term enhanced. Thankfully, we see reasonable value within a number of pockets of the share-market and we can structure portfolios to focus on these areas.

While much is made of the technology revolution we have experienced over the last two decades and on which much of the current share market exuberance is focused, it appears likely that we are on the cusp of a new revolution as the world moves to one of low carbon emissions. The transition to a low carbon world appears to be the case irrespective of government policy, which is belatedly playing catch up to real world developments. For example, a lack of funding available for carbon intensive power generation such as coal mines and coal fired power stations, with such investment now deemed excessively risky by investors. Many carbon intensive corporates are also signalling dramatic changes in corporate direction. Examples here include energy giants BP and Shell, which have stated they wish to eliminate or offset all carbon emissions from operations and the oil and gas they sell to customers by 2050. Another significant example is US car maker General Motors announcing that they will cease production of vehicles with a combustible engine by 2035. This is placing pressure on other car manufacturers to announce their plans on reducing carbon emissions. As such it appears that the car sector and related industries are about to enter a period of profound change.

Ironically, against this backdrop, oil consumption continues to rise. However, it is likely the world will reach peak oil demand within the end of this decade, from which point global consumption will gradually diminish. That is not to say the oil price will necessarily fall, as the majority of oil consumed will still need to be replaced. At the current time, minimal exploration and development is taking place in the oil and gas sector and this increases the probability of a much higher oil and gas price in the medium term. In addition, gas is most likely to replace coal and oil for base load power generation, which is set to dramatically increase as electricity becomes the norm to power cars into the future. For these reasons, and somewhat ironically, we like oil and (predominately) gas companies like Woodside and Origin. Their presently depressed share prices potentially provide investors with an opportunity should oil and gas prices recover.

Finally, February is interim reporting month for many shares listed on the ASX. We will look forward to providing an update on some of the more notable announcements in next month's communication

If you would like to discuss the above or any aspect of your portfolio, please do not hesitate to contact our office.

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