THE MONTHLY VIEW

A look back at last month and an outlook on the months ahead

WHAT WE LIKED

- Both unemployment and underemployment have continued their downward trends in further positive signs that the Australia's economy is bouncing back quickly from COVID-19. The official jobless rate dipped again from 6.6 per cent in December to 6.4 per cent in January, with the ABS estimating that 29,100 extra people were employed last month.
- Australian NAB Business Confidence rebounded sharply in Q4, 2020. The Australian business confidence index rose 22 points to +14 from -8 in the third quarter, suggesting a strong rebound from the large pandemic-related hit to activity in early 2020.
- Job growth returned to the U.S. in January, with nonfarm payrolls increasing by 49,000 while the unemployment rate fell to 6.3%. Economists surveyed by Dow Jones had been looking for growth of 50,000 and the unemployment to hold unchanged at 6.7%.
- Average hourly earnings in the U.S. for employees on private nonfarm payrolls rose to $29.96 in January, up 6 cents from December. Another positive was a 0.3% improvement in the average hours worked per week.
- Industrial Production in the United States expanded by 0.9% on a monthly basis in January. This reading followed December's increase of 1.3% and came in better than the market expectation of an 0.5% increase.
- Japan’s industrial output rose for the first time in three months in January thanks to a pickup in global demand, a welcome sign for an economy still looking to shake off the drag of the coronavirus pandemic. Factory output advanced 4.2% in January, boosted by sharp rises in production of electronic parts and general-purpose machinery, as well as a smaller increase in car output.

WHAT WE DIDN’T

- Australian and Chinese trade tensions continue to simmer away, leaving potential for further trade restrictions during 2021.
- The speed with which Australian (and other countries) 10-year bond yields rose during February. The Australian 10-year yield began the month at around 1.1% and finishing closer to 1.6%. This places pressure on the government borrowing cost and potentially has ramifications through to household interest rates.
- U.S. housing starts decreased 6.0% to a seasonally adjusted annual rate of 1.580 million units in January. Reuters had forecast starts would drop to a rate of 1.658 million units in January, showing a slowdown in activity in a sector that has been amongst the first to recover.

- The U.S. Conference Board said its consumer confidence index rose to a reading of 91.3 this month from 88.9 in January. While showing improvement confidence remains well below its lofty reading of 132.6 last February.
- The European Union's statistics office Eurostat said that according to its preliminary flash estimate, gross domestic product in the 19 countries sharing the euro fell by 0.7% quarter-on-quarter, for a 5.1% year-on-year decline. Economists polled by Reuters had expected a 1.0% quarterly fall and a 5.4% annual contraction, while better than expected it exhibits the severity of impact of lockdowns on European economic activity.

BASE CASE

Our view of the most likely scenario for markets over the coming months, for which our portfolios are currently positioned.

72% Probability

Continued improvement in social mobility, COVID induced hospitalisation and number of cases globally will be the key driving theme as vaccination levels increase. While the economic improvement is not expected to be linear, markets will continue to focus on expected economic improvement over the rest of the year. Following very strong upward moves in markets, particularly in companies that are leveraged economic activity, we may see a continued period of consolidation. This is expected to coincide with bouts of volatility as the market juggles an improving economic picture that raises the spectre of inflation with potential ramifications for central bank liquidity support being adversely affected.

Despite these concerns central banks globally are expected to continue with unprecedented amounts of stimulus to support global economies and financial markets alike. Central bank speakers have continued to call for supportive monetary support as they see inflation as transitory. On the fiscal front governments have indicated they are willing and able to step up with spending to support their economies. Further progress has been made regarding US President Biden' call for a $1.9 Trillion stimulus package being passed through The House. Ratification of the bill will be positive for equity markets and the U.S economy in the medium and long term.

Despite the expectation for significant Central Bank and government support we remain alert to economic risks in global economies and within the financial system. Those we view as most prescient include China and Australia trade tensions, possibility of new COVID strains that minimise vaccine effectiveness and stimulus packages that underwhelm expectations.

This scenario is likely to see us maintain a constructive view on growth assets, despite the expectation for short-term volatility, with capital preservation targeted through appropriate company and sector allocations. Overall asset allocation will retain a bias to growth assets.

BEAR CASE

Our worst-case scenario for the coming months, which we are prepared to position for should conditions deteriorate.

11% Probability

The effects of the global health pandemic last longer than expected, with countries across the globe struggling to control further outbreaks. In addition, the manufacturing and distribution of a vaccine proves to be more difficult than anticipated, delaying the expected economic recovery further.

Additionally, stimulus from central banks and governments underwhelms, placing the nascent global economic recovery at risk. In such an instance the economic impact becomes more severe resulting in company earnings not recovering as quickly as currently expected.

In this instance we may see central bank stimulus and fiscal support from governments as lacking the required potency to provide economic stabilisation and increased consumer confidence. Any failure of governments across the globe to extend or further stimulate their economies through increased fiscal spending would further erode confidence in economic normalisation. Such a scenario could see further dislocation in financial markets across the spectrum.

A more elongated downturn may also see social unrest across affected economies, further exacerbating the negative impacts. In such an environment, we may experience volatility at similar levels to early last year, with certain pockets of the financial system coming under heavy pressure in relation to earnings and solvency.

This scenario will see us take an even more defensive position and potentially add downside protection measures. The overall focus will remain on capital preservation.

BULL CASE

Our most optimistic view for markets over the coming months.

17% Probability

Countries across the developed world continue to control the spread of COVID-19, accelerating the nascent economic recovery. This will allow markets to look through any softness in global economies and begin pricing in rapid economic improvement for the remainder 2021.

Strong fiscal support from governments around the world continue to fill the demand hole left by measures being used to suppress the spread of the virus, while debt burdens are delayed and kept manageable due to historically low interest rates. In the event central banks maintain measures aimed at supressing interest rates we would expect this to further fuel growth asset appreciation, while any acceleration of these policies would have the potential to accelerate the expected upward re-rating of growth asset pricing.

Such an environment would see substantial improvement in economic activity globally. This would occur as pent-up demand from business and consumers combined with massive government and central bank stimulus measures create a potent environment for risk assets as demand returns with a vengeance. High levels of excess saving built up over the past 12 months amongst consumers and corporates will further fuel the expected demand. Sectors expected to benefit most in this environment are those leveraged most to economic activity, in many cases these are the same companies that were most adversely affected by the COVID-19 induced lock downs.

This scenario would be cheered by financial markets as a combination of monetary and fiscal stimulus act to fuel demand for growth assets in a low to negative real interest rate environment. We would act by reducing our cash levels further and adding to the growth asset allocation.

STOCK IN FOCUS

Insurance Australia Group Limited (IAG) is the largest general insurance company in Australia and New Zealand. The Group's businesses underwrite almost $12 billion of premium per annum, selling insurance under many leading brands.

From its beginnings as a motor vehicle insurer in New South Wales ("NSW"), Australia, IAG has grown to become a general insurance group diversified by product, distribution channel and geography.

The Group's heritage dates back to 1920 when the National Roads and Motorists' Association ("NRMA") was established and subsequently offered motor insurance to its members. Following demutualisation in 2000, the insurance arm of NRMA was listed on the ASX as NRMA Insurance Group Limited, and renamed Insurance Australia Group Limited in 2002.

The Group grew organically and through acquisitions primarily in its home market of Australia, and in New Zealand.

In Australia, IAG is the largest personal lines insurer, offering short tail motor and home products across the country under a range of brands, as well as long tail Compulsory Third Party insurance (CTP) offerings in NSW, the Australian Capital Territory and South Australia. IAG also sells a range of commercial insurance products across Australia, with a strong small-to-medium enterprise emphasis, and a leading market share in rural areas. The Australian business operates as Direct Insurance Australia and Intermediated Insurance Australia.

In New Zealand, IAG is the leading general insurance provider across both the direct and intermediated channels. Insurance products are sold directly to customers, and through intermediaries (insurance brokers and authorised representatives). Personal lines and commercial products are also distributed under third party brands by IAG's corporate partners, including large financial institutions.

IAG's focus is on its core Australian and New Zealand businesses. As a consequence, IAG continues to weigh up options for its remaining Asian general insurance interests, including divestments where appropriate. IAG's remaining Asian interests are a 49% interest in AmGeneral Holdings Berhad in Malaysia, a 80.4% interest in AAA Assurance Corporation in Vietnam and a 16.9% interest in Bohai Property Insurance Company Ltd in China.

IAG's business portfolio comprises leading and established brands across its home markets of Australia and New Zealand. Exposure to concentrations of insurance risk is mitigated by a portfolio diversified into many classes of business and by the use of reinsurance.