JMI Wealth

Economic & Investment Market Review

September 2020

Optimism Finds Expression in Share Prices

Companies with June balance dates reported annual earnings in August. This period covered the first period since the onset of the COVID 19 virus and enabled an assessment of the degree to which companies' trading has been impacted by the virus and the effectiveness of managements in responding to the new paradigm.

While the health and economic effects of the virus are still becoming apparent sharemarkets are evaluating the potential outcomes and investor sentiment is being expressed in share prices. At a headline index level investors are expressing confidence. The S&P 500 was up 7.2% in local terms in the month of August.

Similarly, the S&P/NZX 50 gross index has also experienced gains, up 1.8% for August, while the S&P/NZX 50 Portfolio index rose 3.4% over the month.

Market Breadth Still Narrow

A deeper analysis into the composition of the gains shows that the appreciation in value is relatively concentrated in a small number of companies and is yet to broaden. Most notable in the US market has been the rise of Apple and Tesla. Apple became the world's largest company by market capitalisation at the beginning of August and exceeded US$2 trillion by mid-month. A shareholder friendly board has built on this momentum in the month with continuing share buybacks and recently the completion of a share split. Although Tesla is not yet part of the S&P 500, the company has experienced a stellar rise since 19 March up more than 500% post a share split. These gains are not reflected in the broader market. As of 25 August, the largest 5 stocks in the S&P 500 were up 41% year to date whereas the other 495 stocks were down 2% for the same period. As of mid-month, 29% of the S&P 500-member ship remained in bear market, i.e. down 20% or more year to date.

In response to recent earnings season results companies that have exceeded expectations have been rewarded with further price appreciation. In contrast where a company's result has disappointed the marginal investor has tended to respond by selling the company. The result may have been strong in an absolute sense but failure to achieve lofty expectations results in a reversion in the share price. Locally this phenomenon was evidenced in the post result response of the A2 Milk share price. The company recorded a $358 million net profit up 34% on the prior year but the shares declined 5% in the immediate aftermath of the result. Those companies with capital light business models or are resilient in the face of COVID 19 continue to bid up to high multiples. The FANG issuers are exemplars of this. Amazon traded at a forward PE multiple of 85 times as of 28 August.

Second Wave Reverberation

It is arguable the extent to which the continuing economic effects of COVD 19 have held markets in check given headline performance. In Australasia economic optimism has been tempered by the re-emergence of the virus and the implementation of measures to limit its effects. Victoria remains in lockdown and represents approximately 25% of Australian GDP. Auckland's re-entry into Level 3 restrictions has not only disrupted the local economy but has also held back the normalisation of the rest of the country. The return to normality in cross-border activity remains a remote prospect.

Vaccine Progress

Despite these second waves of virus disruption there is continuing optimism as to the development and approval of a vaccine. Accelerated development has resulted in 7 potential vaccines in phase 3 efficacy trials at month end. Western candidates from AstraZenca, Pfizer and Moderna have all made positive progress. On current development rates and pre-approval manufacturing commitments, a best-case scenario could see a vaccine available in the first quarter of 2021. A demonstrably effective vaccine would result in a resurgence in market confidence on top of the existing technical bull market and likely result in a broadening of investment demand to consumer discretionary expenditure businesses.

Savings Build-Up

One of the features of the current economic disorder and uncertainty has been the increase in bank deposits despite the downturn in the level of economic activity. As a precautionary measure both households and businesses reduce expenditure and increase saving. In Australia the growth in wages and government benefits paid into CBA accounts currently is growing at 18% above the equivalent levels last year. In July New Zealand household deposits grew by NZ$1.25 billion from June representing an 8% increase year on year. In the March to July period all bank deposits rose by more than NZ$25 billion. This indicates that much of the stimulus provided by governments and central banks is finding its way to bank deposits. Eventually on a return to confidence this funding base will be available to reinvigorate economic activity. In the near term given the decline in interest rates the capital that is being recirculated is finding its way to non-consumption assets.

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Central Bank Policy Re-adjustment

August has seen further evolution in monetary policy in response to current conditions. The Federal Reserve has advised that it intends to adopt an average inflation targeting regime. This new approach will allow the rate of inflation to rise "moderately above 2% for some time" following periods where inflation has been below target for a sustained period. The implication of this change in policy is that if the Federal Reserve is successful in lifting inflation it will not be followed by rising interest rates. A lower for longer policy is interpreted as positive for sharemarkets as the weighted average cost of capital will remain low for a longer period of time. The other implication of an average inflation target approach is that if inflation does rise and is maintained at higher levels owners of long-term bonds will require a higher rate of return to compensate for inflation. This in turn may result in some steepening of the yield curve in anticipation of higher inflation.

The RBNZ has also confirmed that New Zealand financial institutions should be prepared to implement negative interest rates post March 2021. This policy differs from that of the US and Australian reserve banks in that it emphasises the short end of the yield curve as a primary monetary policy transmission mechanism. Additionally, the RBNZ during the month has expanded its LSAP programme from $60 billion to $100 billion and extended the term of the programme to 22 months. The RBNZ policy has a similar implication for investors in that the intention is to supress interest rates by anchoring the yield for an extended period.

Future Outlook

The outlook for individual companies remains clouded by the depth of the downturn, the degree to which the operational environment has evolved and the place within the economic system that a business exists in. The extent to which consumer demand will remain impaired is a function of the level of resulting unemployment. To date government subsidisation schemes have mitigated the extent to which unemployment or under employment is evident. It is unlikely that levels of employment will be restored to pre-COVID levels, however there are signs for optimism. Official New Zealand unemployment reported during August for the June quarter was 4% lower than the 4.2% rate in the March quarter. Statistics New Zealand however, estimates unemployment has risen during the final week of June to 6.2%. Similarly, in the United States unemployment data has been better than initially feared.

Initial claims for unemployment insurance have steadily declined since April and fell below 1 million in August. In the United Kingdom the unemployment rate for June was 3.9% versus 4.2% expected. The unknown in respect to employment and consequently consumer demand is the extent to which those still employed are working for zombie companies.

If pessimistic analysis proves correct, then consumer weakness will be accentuated by inability to meet mortgage payments. Mortgage deferral schemes remain in effect. In the event that mortgagees are unable to service loans and support is diminished this will find expression in house prices and construction volumes.

However, the impact of monetary stimulus is being demonstrated in terms of housing values and construction locally. Both New Zealand and US housing starts are rebounding. US housing starts reached 1.5 million in July exceeding the 1.2 million expectation. In New Zealand new dwelling consents for the 3 months to July at 10,430 was the highest since the 1970s.

As the COVID 19 restrictions have begun to ease the timelier performance indices have generally moved to expansionary levels. These outcomes are supportive of a rapid normalisation of activity but should be interpreted with caution as in the short-term pent up demand is released.

Conclusions

Given current market momentum it is tempting to accept that stimulus measures will be entirely successful. In the absence of alternative secure income generating opportunities some investors are embracing additional risk. This thesis appears to be compelling but is not a one-way bet. Investor enthusiasm can quickly become irrational exuberance. To a degree this can be argued to be the case with the pricing of buy now pay later companies in Australia . The market response to the share splits by Apple and Tesla are also indicators. A number of large loss-making floats are also proposed indicative of the current investor appetite for risk. These signals support continuing participation in risk markets but reinforce the need for continuing vigilance and circumspection.