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The Overview 27 July 2021

14 Jul 2021

Growth rebound dominates mid-year outlook

By Simson Sanaphay, chief investment strategist for Citi Australia

As we seek to exit the pandemic what lies beyond? We look at opportunities arising and how to keep a long term perspective on the trends that drive portfolio performance

We ended June and entered the second half of the year with a positive outlook for the second half. That position has not changed but COVID-19 continues to be a spanner in the works, taking the edge off what may otherwise be an ever synchronising growth story.

Also looming is the threat of inflation. On July 13 the US Labor Department released June inflation data showing a 12-month hike in the US consumer price index of 5.4 per cent, the fastest pace of growth in 13 years.

While economists played down the hike and considered it ‘transitory inflation’ that had been pumped up by temporary price increases, it is an issue that has continued to attract market interest throughout the year, and led to expectations the US Federal reserve will raise interest rates in 2023. Our view is the Fed will raise rates in December next year.

We have seen similar changing expectations in Australia, with some commentators forecasting the Reserve Bank of Australia would raise rates as early as next year.

The RBA has been clear it does not share these expectations and has continued to push the line that low wages growth and headwinds from the persistent economic effects of COVID-19 means it does not expect rates to rise until 2024.

We mostly share the RBA's outlook and expect rates will not rise until late 2023 or into 2024.

Virus rears its head

As of early July, things were looking particularly grim in Sydney as a three-week lockdown of the greater Sydney area looks like it will need to be extended by perhaps another month, as the Delta strain of the pandemic spreads in the community and threatens other states as cases spread across state borders.

Each week of lockdown in Sydney costs the national economy about $1 billion a week, representing 0.05 per cent of nominal annual gross domestic product (GDP).

Given the resurgence of the virus and impact on consumers mobility, we expect consumer sentiment to take a significant hit. The Westpac-Melbourne Institute Index of national sentiment was already down 5.2 per cent in June to a five-month low following the lockdown in Melbourne that preceded the issues in NSW.

With a watered-down stimulus program for businesses affected by the lockdowns, we also expect soft labour data in the months ahead as some businesses succumb to the continued disruptions caused by COVID-19.

Nevertheless, on the basis we can be successful at 'living with the pandemic', we have revised upwards our GDP growth this year to 5.7 per cent and next year to 3.2 per cent.

The opening of the United Kingdom will be a litmus test of what 'living with the pandemic' looks like. England scheduled July 19 for the end of almost all legal restrictions. This is despite government scientists expecting the current wave of COVID-19 cases would peak at 1000-to-2000 hospital admissions a day in mid-August.

As of mid-July, more than 45.9 million people - or 87 per cent of adults in the UK - have had at least one dose of a Covid-19 vaccine. And more than 34.8 million - around two-thirds of adults - have had both doses, according to UK health data.

Other parts of the world are also re-opening and we expect that to accelerate strongly next year, which brings us to two trends we identify as paths for injecting growth and stability into investment portfolios.

1) Benefiting from market normalisation is one way to exploit the pandemic's distortions to the economy. There are still COVID-cyclical sectors that will only recover sharply when the global economy reopens in 2022 - including travel, hospitality and certain real estate sectors.

2) Artificially low interest rates combined with a risk of higher inflation can threaten your portfolio. Focus on assets that offer positive real income streams and diversification.

What does this mean for equities?

As of early July, the Australian share market was 5 per cent above its pre-pandemic mid-February peak, but it has significantly underperformed international markets over this period. For instance, the US market barometer, the S&P500 is up 28 per cent since the start of the year to July 14, according to Bloomberg data.

That rise has led some commentators to suggest equities are looking expensive, but there is more to the story.

Although individual shares move on a daily basis and can be influenced immediately by a single event, typically across the stock market, share valuations are based on where investors expect the market to be in about 12 months time.

This means companies can be reporting poor results but market prices can still rise if the outlook is positive for future better earnings. And that is exactly what has happened.

Markets have rallied this year on the expectations of higher future earnings. That initial jump can push out valuations – commonly expressed as price to earnings multiple (PE). A price to earnings multiple of 17x is not unusual, but if the market rises rapidly PE's can also rise rapidly, making stocks look expensive.

However, if analysts continue to raise earnings expectations, the PE falls back towards more 'normal' levels, and that can provide investors with confidence that a rising market run still 'has legs' – again, this is what has happened, and is the position we currently find ourselves.

The transition has not been as dramatic in Australia but it is influencing investor appetite as we look for an emergence from the pandemic.

Our analysts have forecast earnings per share (EPS) for the year to June 30 to rise by 32 per cent, and by a further 16 per cent the following year, indicating an outlook for a rising sharemarket.

However, risks remains, including another wave of infections resulting in more state lockdowns, and interruptions to the vaccine rollout relative to other countries and any impact this has on opening up international borders.

Sector flash points

- Financials account for 30 per cent of the ASX 200 index. We have a neutral view on the major Australian banks, noting the 'buy the sector' trade has concluded with absolute valuations reflecting the Covid-recovery in underlying returns on equity.
- Materials sector earnings are dominated by iron ore, and cycle-high prices are driving phenomenal cash flows for the large-cap miners. Given under-geared balance sheets, we expect this to result in high dividend yields.
- China's expected imposition of steel production restrictions, though, may lower iron ore prices and put pressure on share prices. For investors, the trade-off is potentially lower share price versus high dividend payments.

What does it mean for rates?

Citi expects the RBA to remain dovish in light of the recent lockdowns. The central bank did signal a step-down of government bond purchases from $5 billion to $4 billion and that's up for a review in November, despite this so-called tapering, the RBA is unlikely to lift before other central banks.

The RBA governor, Philip Lowe, also reiterated that the unemployment rate needed to be close to 4 per cent for wages to rise meaningfully.

Our year average 2021 forecast for headline inflation is now 2.6 per cent (+0.2pp from the previous estimate). The increase is largely thanks to stronger employee compensation, stronger domestic demand and petrol, which has been partially offset by falling food prices and a small baseline improvement in productivity, following the pandemic's influence in 2020.

Will it impact mortgage rates?

We expect the strong growth in lending to continue, benefiting consumers with competitive mortgage rates. This scenario is likely to continue to favour entry by first home buyers and those looking for a housing upgrade. Against a tight outlook for housing stock, we expect the near-term dwelling price outlook could remain strong, although affordability concerns will be starting to creep in for specific postcodes.

Deposit rates are also expected to stay at historical lows, meaning investors need to diversify out of cash products to get a decent return. The reason is banks are currently spoilt for sources of cheap funding to drive loans books, and while that remains the case there is a lack of pressure on banks to offer higher deposit rates, particularly as savings rates have risen sharply as households seek to put away funds in case of job loss or other financial pressures caused by the pandemic.

What does it mean for the Australian dollar?

The dollar has solid underlying support driven by rising commodity prices and strong economic recovery. The latter should be further boosted as Australia's vaccine rollout gains pace in coming months, providing support for the dollar.

Looking further out, downward pressure could emerge if most G10 central banks hike interest rates before the RBA, which currently looks a distinct possibility. If Australia has lower market interest rates than its country peers, it means investor funds could flow out of Australia and put downward pressure on the dollar.

The Australian dollar also typically comes under downward pressure when the US dollar appreciates. We expect the latter could occur next year when the Federal Reserve provides more detail on how it will move away from supportive asset purchasing and seek to normalise monetary policy.

What should investors do?

Citi Australia's Strategic Asset Allocation: Looking forward, we continue to see more moderate financial market returns in the coming year after the collapse and surge in values during 2020. At present, the early stage of global economic recovery and negative real interest rates, still suggests stronger risk-adjusted returns for equities vs bonds (or cash for that matter). This is particularly true for non-US equities which have posted half the positive returns of the US since year-end 2019.

In the past eight economic recovery cycles, EPS has fallen in a second or third year of recovery only once. We are mindful of equity returns in mid-cycle periods are below those of the earliest periods of recovery from recession, yet they differ little from long-run average returns (our Global Investment Committee see a strategic equity return of around 5 per cent over a 10 year horizon).

With that said, equity market corrections remain routine, with one pullback of 10 per cent or slightly more on average each year. Our overall portfolio construction seeks to balance these risks and rewards, employing geographic diversification and being sector selective with a tilt towards relative value in financials, materials and industrials, with an eye on secular growth, particularly in healthcare where valuations underpin the investment narrative and information and technology as the global economy continues to digitize.

In Fixed Income, we see credit fundamentals well supported by economic recovery. In contrast, we see gradually building risks for interest rate sensitive assets. The 10-year US Treasury note yield is nearly 100 basis points below the 10-year average expected US inflation rate. We see the yield climbing to 2.5 per cent before dropping in a more distant, future recession.

Three key considerations for Bond Investors:

1) Reduce low yielding/long duration fixed rate bonds holdings as they are more sensitive to long term yield increases.

2) Increase yield by adding credit where fundamentals are expected to improve on the economic recovery – such as consumer cyclicals and financials.

3) Be open to pockets of opportunity such as Sustainability Linked Bonds or Green Bonds as ESG (environmental, social and governance) is top of mind for investors with long investment horizons.

Previous day's top warrants by value and volume					
Warrant Code	**Value**	**Citi**	**Warrant Code**	**Volume**	**Citi**
XJOKOP	$773,391	Citi Buys	AWCKOA	280,000	Citi Sells
XJOKCG	$598,539	Citi Sells	SLRKOA	254,200	Citi Buys
XJOMOX	$511,886	Citi Buys	Z1PKOB	241,651	Citi Buys
XJOKOR	$430,730	Citi Sells	SLRKOC	200,000	Citi Sells
Z1PKOB	$422,740	Citi Buys	XJOKOP	136,065	Citi Buys

Stopped Out Warrants

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Warrant Code	Strike	Stop Loss	Remaining Value	Stop Loss Date	Final Listing Date
BHPMOV	60.4443	52.1	$8.370	26/07/2021	28/07/2021
COLKCQ	20.7824	17.7	$3.090	26/07/2021	28/07/2021
SPFKOZ	4576.9782	4408	$2.290	26/07/2021	28/07/2021
NDXKCX	15750.5049	15012	$10.010	26/07/2021	28/07/2021
CSLKOQ	346.3338	295.05	$50.580	26/07/2021	28/07/2021
DJXKCS	36350.3184	35015	$18.090	26/07/2021	28/07/2021
NI2KOC	26344.3803	27658	$1.620	26/07/2021	28/07/2021
BHPMOV	60.4443	52.1	$8.370	26/07/2021	28/07/2021

Overnight Summary

HEADLINES

- U.S.-China talks started off on a tense note in Tianjin, the discussion covered Hong Kong, Xinjiang and cyber-crime. Meanwhile, U.S listed China firms continued to plunge on Beijing's education and technology crackdown.
- California saw the record wildfire forcing over 8,000 evacuations whilst Utah police reported 7 deaths during a sandstorm. A massive typhoon hit Shanghai and made landfall.
- Moderna will conduct an expanded trial of its vaccine in kids under 12 years old on reports of heart inflammation in young individuals due to vaccination.

RATES

AUS 3yr 99.70 (0.0bp) | AUS 10yr 98.79 (-3.5bp) | US 10yr 1.29 (1.3bp) | Bund 10yr -0.42 (0.2bp)

- U.S. Treasury yields ended Monday little changed as investors await this week's meeting of Federal Reserve policy makers. Treasuries ranged around unchanged levels over the U.S. session after a sharp selloff in the early hours of the London open. There was muted reaction in the market to weaker-than-forecast U.S. new home sales and Dallas Fed manufacturing activity, while there was strong demand for Treasury's $60bn auction of two-year notes, which was awarded at 0.213% vs 0.215% WI yield at the bidding deadline and attracted a bid-to-cover ratio of 2.47, slightly below the 2.55 the average for the past six auctions. Front-end Treasuries were slightly better bid following the auction. 10-year yields finished the day little changed at 1.281%, while the 30-year yield rose 0.7bps to 1.927%. The Eurodollar strip steepened aggressively, with white-pack contracts unchanged and the reds off by around 6bps. Three-month Dollar Libor fixed 0.3bps higher to 0.1316%.
- Bunds were weaker overnight after Belgium debt sales pressured bonds lower, giving up earlier gains that were spurred by weaker-than-expected German Ifo data. Italian bonds also declines ahead of today's BTP short-term debt sale, while Gilts pared gains as domestic stocks retraced losses. Gertjan Vlieghe became the latest BoE member to rule out supporting any attempt to curtail the central bank's stimulus, noting that, "yes, the economy has been growing rapidly, but on the most recent data it remains an average recession away from full employment". The BoE is scheduled to meet next Thursday.
- Australian bond futures bear-steepened overnight in line with off-shore moves. YMs unchanged at 99.7 while XMs were off 3.5bps to 98.785.

EQUITIES

S&P500 4,422 (0.24%) | Stoxx600 461 (-0.08%) | FTSE100 7,025 (-0.03%)

- In the U.S., the S&P500 initially fell from its record high as Chinese stocks tank on China crackdown. The Wall Street gauge pared losses and finished the day up 0.24%. Hasbro (HAS) gained 12.24% as the toy and entertainment company reported second-quarter sales and EPS that "far exceeded estimates". Aon (AON) rallied %8.21; the company called off its planned $30 billion takeover of Wills Towers Watson after failing to convince officials that the deal would not be anticompetitive. On the other hand, Wills Towers Watson (WLTW) lost 8.98% after the deal collapsed. Carnival Crop (CCL) surged 5.46% after the U.S. court reversed

its previous ruling that CDC could enforce the Conditional Sail Order. Cruise lines can now sail with unvaccinated passengers at least in Florida. Twitter (TWTR) lost 4.18% despite reporting stellar earnings.

- The London stocks declined 0.03% as investor weighed the end of banks' dividend ban against lacklustre sentiment from China crackdown. Miners rallied with Rio Tinto (RIO) and BHP up 3.1% and %2.87; they are expected to lead the bounce-back in dividends as miners report bullish results on surging iron and copper prices. Anglo American (AAL) gained 3.19% whilst Glencore (GLEN) rose 3.31%. Oil heavyweights Royal Dutch Shell (RDSA) and BP advanced 2.55% and 2.87%. International Consolidated Airlines (IAG) recovered 4.59% after the sharp sell-off last week. Heathrow CEO sees U.K. ready to open up to fully vaccinated Americans by the end of this month. AstraZeneca (AZN) dropped 2.22%.

FOREIGN EXCHANGE

AUDUSD 0.7382 (0.57%) | DXY 92.6360 (-0.25%) | EURUSD 1.1803 (0.26%)

- The Greenback went offered across the complex overnight as 10y real yields tumbled to record lows, and the market likely is looking to enter the FOMC with flat positioning. High beta FX in particular taking advantage of the offered Dollar, aided also by the rise in oil prices and the faint risk-on tone across markets.
- The Antipodes managed to retrace Asia session weakness, with AUDUSD and NZDUSD both gaining ~0.55% on then night. Similarly, EUR gained ~0.26% to 1.1803, while GBPUSD realized a ~0.57% to 1.3819 ignoring Gilts being the outlier in core duration markets which broadly steepened. USDJPY was up ~0.19% on the night.

COMMODITIES

Gold 1,797.58 (-0.25%) | WTI 71.91 (-0.22%) | Copper 4.45 (3.09%) ^

- Energy: In a largely unthematic session crude oil in NY saw it's first loss in five sessions. WTI lost -0.22% to $71.91/bbl while brent made small gains. Elsewhere in energy, natural gas was the outperformer with futures in Europe jumping over +5% on strong demand for power generation. Stormy weather over drilling regions also supported prices.
- Metals: Bullion dipped back below the 1800 level; declining by -0.25% ahead of the Fed's monthly policy statement. Silver was more or less unchanged on the session resting at $25.19/oz. Elsewhere, base metals were yet again broadly higher on strong demand, with copper leading the way. The eternal metal gained +$294/ton overnight.
- Agriculture: In the agriculture space coffee futures were again the big movers—jumping an enormous +9.95% on the night. Reports from various organizations have released estimates of how much harvest will be lost to the severe frost; with numbers ranging from 11 – 25%. Weather reports also suggest growing regions might be out in the cold a while longer.

Overnight Summary					
	Last Price	1d (net)	**1d (%)**	1m (%)	YTD (%)
Equities					
S&P 500	4,422.30	10.51	**0.2%**	3.3%	17.7%
Nasdaq	14,840.71	3.72	**0.0%**	3.3%	15.1%
Dow Jones	35,144.31	82.76	**0.2%**	2.1%	14.8%
Euro Stoxx 50	4,102.59	-6.51	**-0.2%**	-0.4%	15.5%
FTSE100	7,025.43	-2.15	**0.0%**	-1.6%	8.7%
TOPIX	1,925.62	21.21	**1.1%**	-1.9%	6.7%
KOSPI	3,224.95	-29.47	**-0.9%**	-2.4%	12.2%
Shanghai Comp	3,467.44	-82.96	**-2.3%**	-3.9%	-0.2%
ASX200 Futures	7,329.00	20.00	**0.3%**	1.7%	12.1%
VIX Index	17.58	0.38	**2.2%**	12.5%	-22.7%
Foreign Exchange					
DXY	92.6210	-0.26	**-0.3%**	0.8%	3.0%
AUDUSD	0.7381	0.00	**0.5%**	-2.5%	-4.1%

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EURUSD	1.1803	0.00	**0.3%**	-1.0%	-3.4%
GBPUSD	1.3818	0.01	**0.5%**	-0.5%	1.1%
USDJPY	110.3800	0.12	**0.1%**	0.2%	-6.5%
USDCHF	0.9157	0.00	**-0.4%**	0.4%	-3.3%
Fixed Income - 10y	%	bps		bps	bps
Aus (Fut.)	1.22%	**4.00**		-35.50	20.00
United States	1.29%	**1.40**		-23.28	37.65
United Kingdom	0.57%	**-1.35**		-20.79	37.74
Germany	-0.42%	**0.24**		-26.24	15.34
France	-0.08%	**1.17**		-27.31	26.54
Italy	0.63%	**1.08**		-29.37	8.73
Commodities					
WTI Crude	72.16	0.09	**0.1%**	-2.6%	48.7%
Brent Crude	74.79	0.69	**0.9%**	-1.8%	44.4%
Copper c/lb	459.85	19.20	**4.4%**	7.1%	30.7%
Nickel	19,372.00	450.00	**2.4%**	7.2%	16.6%
Zinc US$/mt	2,963.00	24.50	**0.8%**	2.4%	7.7%
Aluminium US$/mt	2,502.50	19.50	**0.8%**	2.6%	26.4%
Iron Ore US$/mt	214.00	0.60	**0.3%**	-0.2%	37.3%
Gold US$/oz t	1,797.76	-9.62	**-0.5%**	1.1%	-5.3%
Silver US$/oz t	25.20	-0.07	**-0.3%**	-3.5%	-4.6%
Bitcoin USD	38,095.46	3,612.25	**10.5%**	21.7%	31.4%
DLCs	Last Price	Aud Price			Spread
BHP Billiton PLC	2,328.00	43.59	**3.1%**	7.8%	19.1%
Rio PLC	6,110.00	114.40	**3.1%**	0.8%	13.7%
South 32 - Lon	161.00	3.01	**2.2%**	-0.1%	-0.8%
South 32 - J'burg	3,266.00	3.00	**1.9%**	3.9%	-0.2%
Janus Henderson	40.52	54.91	**1.4%**	3.3%	-1.9%
Virgin Money	192.85	3.61	**1.7%**	-5.6%	-3.3%
Resmed Inc.	259.74	35.20	**0.0%**	6.2%	0.2%
NWS A	24.80	33.60	**0.2%**	-3.6%	-3.9%
ADRs	Last Price	Aud Price			Spread
BHP	79.03	53.54	**3.4%**	7.9%	-3.1%
Rio	86.05	116.60	**4.0%**	1.2%	11.6%
CSL	108.33	293.58	**-0.3%**	-0.3%	-0.3%
James Hardie	34.40	46.61	**-0.3%**	-1.7%	-0.9%
Amcor	11.49	15.57	**1.7%**	-1.0%	-0.4%

Source Bloomberg

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