Australia 2021 Market Outlook: Cautiously Optimistic

Reduced global uncertainty is positive for Australian equities.

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KEY INSIGHTS

- Joe Biden's US election victory and positive vaccination news have reduced uncertainty over the 2021 global outlook and are positive for Australian equities.
- We are cautiously optimistic toward the market in 2021. Short-term costs and disruption from the coronavirus do not detract from the longer-term attractions.
- Australian equities are less at risk from a small number of highly valued large-cap growth stocks, with returns that are more evenly distributed across sectors.

Global Backdrop Improving for Australia

In terms of the global backdrop, the election victory of Joe Biden in the US and news of several potentially highly effective vaccines against COVID-19 (the disease caused by the coronavirus) have significantly reduced uncertainty over the global outlook for 2021 and beyond, which is positive for all markets, including Australia. Short term, for the next three to six months, some headwinds remain, notably the impact on the US and European economies of second coronavirus waves this winter, plus delayed and possibly smaller fiscal stimulus.

With regard to positive news on vaccines, the undertaking of manufacturing and distributing vaccines on a global scale is huge and without precedent. The logistics and financing are not straightforward, and it may well take longer than we currently expect.

Nevertheless, a degree of optimism is warranted. On current production plans, it should be possible to inoculate a significant proportion of the world's population next year. 'Herd immunity' may take a bit longer to achieve, and an early return in 2021 to pre-COVID conditions could yet prove wishful thinking. Stock markets are forward-looking mechanisms, however, and good news on the vaccination front has given investors hope. Under a best-case scenario, the global economy could embark on a broader, more sustainable recovery from the middle of next year. The Organisation for Economic Co-operation and Development (OECD) believes that early vaccine availability could add as much as 2% to world gross domestic product (GDP) growth in 2021, raising it to 7%.

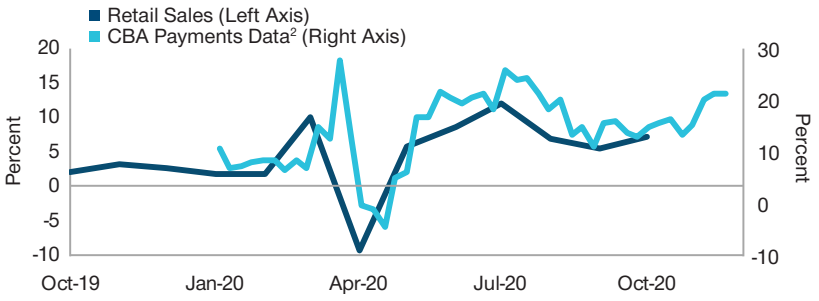
For now, economic forecasts for 2021 for both the domestic economy and the world remain highly uncertain, with low visibility

> ...overall 2021 is likely to be a better year than 2020...

Spending Indictor Suggests Strong Recovery in Retail Sales

(Fig. 1) Retail sales and CBA[1] consumer spending indicator (% year over year)

Australia—Retail Trade Growth



As of 25 November 2020.
[1] Commonwealth Bank of Australia.
[2] Weighted average of 'goods' and 'food services'.
Sources: Macquarie Macro Strategy, Australian Bureau of Statistics and CBA.

> Strict lockdown restrictions have already been lifted in Victoria...

also for corporate earnings. One thing we can be reasonably sure of, however, is that overall 2021 is likely to be a better year than 2020, with more light at the end of the tunnel as the year progresses. The negative short-term economic costs and disruption from the coronavirus do not detract from the longer-term positive case for Australian equities. The global center of economic activity continues to shift away from the US and Europe toward the Asia Pacific region, the Asian middle classes continue their ascent, and Asia leads in many of the new technologies whose adoption the coronavirus has accelerated. These positive secular regional trends will also benefit Australia.

The Regional Comprehensive Economic Partnership (RCEP) trade agreement, for example, points to increasing regional economic liberalisation and integration. These positive secular trends are not being called into question. The Association of Southeast Asian Nations and five other Asian countries, including Australia, signed a deal that will eventually form a free trade area that includes over 30% of the world's GDP today, rising to around 50% by 2030, even without the participation of India. It brings China, Japan and South Korea—the three largest regional economies—under a regional trade deal for the first time.

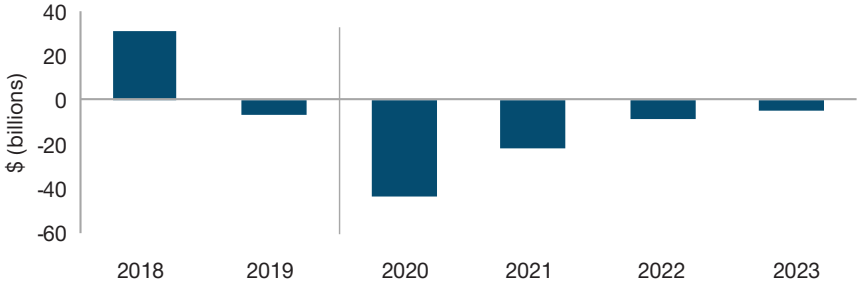
It is a development with potentially greater longer-term than immediate significance for a highly competitive market economy like Australia. The RCEP economies already have intra-regional trade shares of 50% or more (based on exports), and increased regional integration should see this rise over time. The agreement eliminates tariffs and quotas for 65% of regional trade in goods, with an ultimate target of 90% in 20 years' time. It can be expanded in the future to include other areas such as services, becoming a driver for closer Asian economic integration.

Economy Well Placed to Rebound

There are also a number of reasons for optimism in Australia's case over the 2021 outlook. Strict lockdown restrictions have already been lifted in Victoria and, more specifically, Melbourne, while other states have avoided a resurgence in COVID-19 cases. State border controls have largely reopened, and as the country enters the summer period, seasonal factors could slow the spread of the virus. In Australia's favor, there is also a correlation between population size and success in controlling the coronavirus. Finally, we will all learn to live with the coronavirus more easily once vaccines are generally available.

Impact of Coronavirus on State Budgets Will Fade

(Fig. 2) State net operating balances[1] (fiscal year to 30 June)



As of 25 November, 2020.
[1] Excludes Queensland and the ACT.
Sources: Macquarie Macro Strategy, Macrobond and State budgets.

> RBA easing has provided strong support to the Australian housing market...

Australia's economic recovery is still likely to be uneven, and the country is expected to continue to suffer from the drag of strict international border closure for some time yet, but any further easing of domestic restrictions coupled with the extensive fiscal and monetary support deployed places Australia in a favourable position relative to many other countries. With key state and federal elections due in 2023, fiscal policy is not expected to tighten much as the pandemic programs start to unwind. Also, with the Scott Morrison government doing well in the polls, an early federal election in 2021 cannot be ruled out, despite the prime minister affirming recently that he is a 'full termer'.

Public construction spending on buildings and works in 2020 has followed a strong countercyclical trend, providing an offset to weak private sector spending. While payments under the JobSeeker and JobKeeper emergency support schemes are set to taper off, a major 'fiscal cliff' is not expected. The servicing costs of large fiscal deficits is low, thanks to the aggressive monetary easing by the Reserve Bank of Australia (RBA). At its November meeting, the central bank decided to do all it could to kick-start recovery, cutting the cash rate and three-year yield targets to 0.10% with purchases of government bonds (QE) of AUD 100 billion over the next six months. At the same time, the RBA promised not to lift rates until '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'. RBA easing has provided strong support to the Australian housing market, with little forced selling due to COVID-19 thanks to record-low mortgage rates, loan deferrals, JobSeeker income support payments and stamp duty reform in New South Wales that is encouraging more first-time buyers into the market.

Although GDP may contract by 4.0% plus in 2020, this is old news. A strong rebound is forecast for 2021, and we regard the Australian economy as being in as good shape as any of the developed economies. Australian society is largely back to normal, companies are seeing activity and profits rebound and Australians, with few foreign travel options, are spending more at home, with the result that some areas of the domestic economy are doing well. Australians typically spend more on tourism and foreign travel than other OECD countries as much greater distances dictate longer holiday trips.

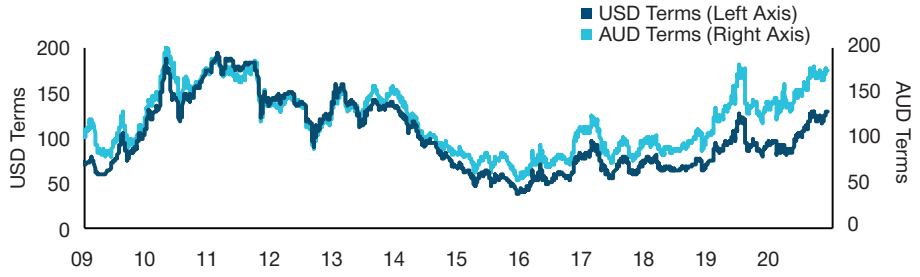
The China Factor: Plus or Minus?

China's economy has also largely returned to normal, the only major economy to have done so, and this is good news for Australia, despite

> ...consensus expectations are not too demanding, with EPS growth of just 6% in FY21...

Australia's Exports Benefit From a High Iron Ore Price

(Fig. 3) Spot price of iron ore in Australia and US dollars



As of 25 November 2020.
Sources: Bloomberg Finance L.P. and Macquarie Macro Strategy.

increased trade tensions and the cooling in political relations between the two governments. We expect to see strong demand by China for Australia's commodity exports in 2021. While Beijing has imposed trade restrictions and informal bans on a number of Australian exports, demand for Australian iron ore is significantly higher year on year. We see some scope for China-Australia relations to warm up a bit rather than cool further.

Investment Opportunities: Warming to Quality Cyclical Growth

Turning to investment opportunities, we favoured some of the high-quality growth stocks that can benefit from a low-growth, low-inflation low interest rate world. Companies like medical device manufacturer Resmed, for example, are showing that their business conditions are starting to improve and normalize. We believe the company is well placed to return to strong growth in its sleep apnea business over the next six to 12 months.

There are a number of other quality growth stocks, which we believe are in a similar favourable position to Resmed, such as James Hardie, Seek Group and Aristocrat. In contrast, after the recent strength we have taken some profits on iron ore producers and the materials sector, as we think the best news on China's economic recovery in momentum terms is behind us.

Given the challenges of rolling out the coronavirus vaccine globally, we are cautious toward the market's rotation into lower-quality cyclicals or heavily impacted sectors like travel and question the sustainability of the recent move. For the market, the real story for earnings is more likely to concern 2022 rather than 2021, when investors will be looking for strong, sustainable earnings per share (EPS) growth. At the macro level there are still numerous risks to the earnings outlook for 2021, such as rising non-performing loans at the banks, weaker commodity prices and an assumption of no more lockdowns. In view of these risks, we have continued to maintain exposure to some defensive growth names as well as quality cyclical growth. On the positive side, consensus expectations are not too demanding, with EPS growth of just 6% in FY21 following a 20% decline in FY20 (MSCI Australia in US dollars).

Concluding Thoughts

Pulling the above together, we are cautiously optimistic toward Australian equities in 2021, the only developed equity market that is favoured as an overweight by our global multi-asset colleagues. The Australian share market has supportive valuations (the price to book value ratio is close to its five-year average at 2.0), a decent dividend (trailing dividend yield of 3.2%), while FY20 earnings estimates have bottomed and are being revised higher (three-month change = 2.7%). The market is also less at risk from a small number of highly valued large growth stocks, and returns this year have been more evenly distributed across sectors, including consumer discretionary and communication services.

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