Private Capital Advisers

Markets and economies moving in opposite directions

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Over the past quarter we have seen generally positive market movements amidst a generally deteriorating economic environment. While on the face of it this seems odd, it is not really that unusual and is largely a continuation of the adjustment to the market's over-reaction in March. As can be seen in the table below, Australian equities and listed property are still lower than their levels of a year ago despite the post-March recoveries.

Table 1: Performance to period ending 30 September 2020

	3mo	1 year	2 years	3 years
Australian Equities[1]	1.1%	-8.8%	1.1%pa	5.5%pa
International Equities[2]	4.1%	4.5%	6.6%pa	9.1%pa
Listed Property[3]	7.0%	-16.6%	0.7%pa	3.7%pa
Term Deposits[4]	0.6%	2.5%	2.6%pa	2.7%pa

1.ASX All Ords; 2.MSCI World Ex Aus Index; 3.ASX A-REIT Index; 4.RBA data

Covid-19 back on the march

In Australia, the spread of Covid-19 is largely under control – but life is far from being back to normal. Particularly in Victoria and in the central business districts of most cities. For the latter, return to former working practices is very slow and in some ways the changes will be permanent. Nonetheless, economic activity is slowly improving.

The same cannot be said of the majority of the developed world where a powerful second wave of the virus has taken off causing considerable doubt as to the speed of economic recovery in the US, Europe and the UK.

Despite the possibility of a second wave of shutdowns markets have largely shrugged off these concerns and have continued to move slowly higher. We put this down to two things, government support is likely to be extended and valuations are still reasonable.

Government support likely to be extended

One major concern of market participants has been the possibility that governments do not extend their Job-Keeper style programs beyond the original timeframes. What seems to be occurring in most countries is that these programs are being extended but generally in a somewhat reduced fashion. This makes sense on two counts. Firstly, the programs were, in many cases too generous, and secondly, as economies slowly return to normal the size of the need is declining as well.

Love them or hate them, governments around the world have, by and large, got their economic responses to the pandemic much more right than wrong. This has contributed greatly to the recovery in markets since March.

The US election a non-event for long-term market returns

The US election has the capacity to create a good deal of short-term uncertainty and volatility in markets. This is best ignored. Over and over again, we have seen that government impacts on market returns, while real, are generally not sufficient to make an attractively priced market unattractive or an unattractive market to become attractive. In other words, our long-term decisions should remain similar regardless of the election result.

Valuations remain reasonable – especially when compared to returns from cash and Term Deposits (TDs)

What really matters for our investment decisions is whether we are likely to get better returns out of growth assets than defensive assets such as TDs in the long-term. To assess this likelihood, we produce ten-year forecasts of returns across a variety of markets. At current market levels we expect returns from growth assets to be modest when compared to historical levels but that are nonetheless much higher than those likely to be produced from TDs. These are shown in Table 2 below under our base case Short, Sharp Shock scenario.

Because the long-term outlook remains much more than usually uncertain, we also show a much more pessimistic Doomsday scenario which has been styled on the Great Depression in the 1930's. We view this scenario as unlikely but possible in the event that Governments responses to Covid-19 begin to fail, both medically and economically.

While returns in this pessimistic scenario are much lower than our base case, they remain better than the outlook for TDs.

Table 2: Scenarios for Expected Returns

Short, Sharp Shock	**Australian Equities**	**International Equities**	**Listed Property[1]**	**Unlisted Property[2]**	**Term Deposits**
Income	5.3%	2.1%	5.0%	5.2%	1.5%
Currency impact		0.5%			
Earnings growth	3.0%	2.4%	1.8%	-0.3%	0.0%
Valuation change	-1.3%	0.4%	1.0%	0.4%	0.0%
Forecast	**7.0%**	**5.4%**	**7.8%**	**5.4%**	**1.5%**
PE now	19.9	18.9			
PE 2030	17.4	19.6	4.5%		

Doomsday scenario	Australian Equities	International Equities	Listed Property[1]	Unlisted Property[2]	Term Deposits
Income	4.0%	1.6%	3.2%	3.9%	0.7%
Currency impact		0.5%			
Earnings growth	0.0%	-0.8%	-0.7%	-2.8%	
Valuation change	-1.3%	0.4%	1.0%	0.4%	
Forecast	**2.7%**	**1.6%**	**3.5%**	**1.6%**	**0.7%**
Index Level	6312.5	353.6	1345.9		

1. Commercial Property traded on the sharemarket; 2. Commercial Property in unlisted fund

Indices: All Ords, FTSE All World Local, ASX A-REIT

Tim Farrelly

PCA Investment Committee Member

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