COVID losses recovered

Rotation growth to value accelerates

The past month has seen ongoing developments in the various headings considered in the February Blog.

Fixed Interest

"Avoid long duration where any firming of the ten year bond is currently causing capital losses on those bonds" was the concluding sentence of the February Blog. The move to higher ten-year interest rates has caught many by surprise. The Australian ten-year rate has firmed by 0.9% to 1.9%, whereas the US ten year also had a strong upward move, before likely Federal Reserve intervention to be 1.6% currently.

Both these moves in the ten-year bond are material and changed the dialogue with respect to valuations. In particular, technology stocks on high valuation multiples have shown retracement inversely with the rise in the ten year bond.

US technology

There are elements in the US of current market price behaviour, which is symptomatic of earlier bubbles. The common elements are:

- Valuation multiples above 30 years of earnings (P/E > 30x) and in some cases, where stocks have no profits, infinity.
- Populist investing by non-advised retail investors based on sentiment, brand names, IT loyalty and anything but sound valuation principles.

- A belief like the 2000 tech bubble that one can pay anything for a technology stock and will be rewarded.

The 2000 technology bubble correction is likely to have some replay in the US. While the catalyst(s) for such corrections are difficult to predict, the following head-winds are possible candidates:

- The rising ten-year bond rate means that future earnings are worth less and this impacts more on growth stocks. If the growth shows any signs of faltering and not being delivered, the fall in such stock prices can be dramatic.
- US corporate tax rates reduced from 35% to 21% during the Trump presidency. President Biden in his campaign indicated an intention to increase the rate back to 28%, together with increases in personal tax rates for higher income brackets.
- Also weighing on technology stocks are privacy issues, including payments for news content, which had been raised by the Australian and other Governments.
- Global technology companies have used the double tax agreements to strip profits royalties from countries such as Australia and pay a 10% royalty withholding tax, so that the bulk of the profits are directed to low tax jurisdictions such as the Netherlands and Ireland. With the appointment of Mathias Cormann as CEO of the Paris based OECD (Organisation for Economic Co-operation and Development), it is likely that the proposal to tax global technology companies based on the percentage of revenue in each country may finally receive support. This would mean if say Facebook had 5% of revenue in Australia, then they would pay 5% of corporate taxation in Australia.

Whatever the factors be, extreme valuations in some technology stocks will correct over time. This is not to say all technology stocks in the US are overvalued, with some of the traditional technology stocks such as Cisco, Intel and Oracle trading at acceptable valuation multiples.

Global Economic Recovery & Commodities

The ordering from more people at home during COVID has shown a preference for ordering goods, as it is harder to order services from home and in the COVID impacted countries, there is reluctance to have visiting service people in one's home. As a result, the demand for goods produced by countries such as China has resulted in rapid manufacturing recovery. In turn, the demand for commodities including Australian iron ore has been at record levels as countries such as China respond to the global demand for goods.

There is some hype about this commodity resurgence with some press reports referring to it as a commodity super cycle. That hyperbole is likely not justified. However, it does mean that maintaining portfolio weightings in resource and materials stocks appears to be good sense.

As commented in the February blog, oil prices have also recovered in line with the global economic recovery. Australia is not a material oil-producing nation, but the LNG price trades at a percentage of the oil price. The combination of the cold winter in northern Asia together with the demand for goods has resulted in sharp rebounds in LNG prices. We see the Australian gas producers as being beneficiaries of this ongoing recovery.

Electric Cars- a Side Show?

Much has been made of the green energy movement and consumer demand for electric vehicles. Two years ago when lithium demands seemed assured, the Chinese in July 2019 removed their subsidies on electric vehicles and sent the lithium industry into an 18-month downward spiral. That seems to have bottomed just before Christmas 2020, but not before a number of players failed in the ensuing melee.

The election of the Biden administration with the green energy policies has seen lithium stocks rebound. A cautionary note is that we have not seen the second stage of the development of electric car batteries. One might see the current electric car batteries as being an equivalent to the big black batteries attached to mobile phones in the early days. To date as it has been difficult for the electric car battery industry to move to the next stage, which was to be solid-state batteries. These batteries were to charge twice as quickly and discharge at half the pace, resulting in electric vehicles being able to travel at double the distance with less charging. So far, moving from the laboratory bench to practical production has been a slow process.

At the same time, Japan has decided to adopt hydrogen technology. That is a significant opportunity for Australia. As one expert in the field said, if you have Japan coming to Australia as a customer with large demand for hydrogen, you do not need to think too long about whether you should respond. The response would hopefully not involve using coal-fired power from Tarong to split water into hydrogen and oxygen. A more likely solution is the erection of solar farms in central Australia to harvest the hydrogen and transport it along the Darwin train line to export to Japan.

If Australia grasps this opportunity, it may be that ultimately Australia's green car technology is hydrogen rather than lithium. It is too early to be definitive, but the Japanese approach is certainly an opportunity for Australia.

Australia

The Australian economy has continued to recover and so has the Australian stock market. A number of portfolios are now up 20% for the financial year to date and have recovered all of the COVID losses, currently trading above 1 July 2019.

It is tempting to lock-in some of these gains, as we have certainly had years where there were excellent returns year to date, only to lose them in May and June. Burrell advisors are reviewing stocks on high valuation multiples and those where it seems prudent to take some of the gains which have accrued. It is possible that a US technology correction (and Australia to a lesser extent) provide further buying opportunities over the balance of the calendar year.

The expiration of Jobkeeper and the rundown in the homemaker income support will test a number of businesses which are exposed, including tourism, students and immigration. Innovative solutions such as a bubble with Singapore and its green countries including China and Taiwan as well as New Zealand may provide some relief before year-end.

The so-called China/Australia trade war which really related to a small number of commodities and goods was the beneficiary of some support on 16 March with the Biden administration saying they would not leave Australia alone on the field. Saying to China that the US will not relax any of the Trump tariffs until China adopts more friendly trading and geopolitical stances with impacted nations is a helpful diplomatic approach for Australia.

Nevertheless, the ending of income support measures should result in the movement of some labour e.g. from surplus labour attached to restaurants and hotels to picking strawberries. Such movement of labour is useful, as the Australian economy cannot bear the costs of these income support measures indefinitely.

Further infrastructure stimulus is expected in the May budget and this is a sector, which should continue to benefit from Australian economic recovery.

Changed behaviours

As a result of the COVID pandemic, there are a number of behavioural changes. The use of Zoom, more people at home, more shopping online, a significant decline in business travel. Thinking through these changed behaviours and the rate of which Australian listed companies are recovering and are impacted by these changes is useful for understanding likely stock performance.

A significant debate is around commercial property. Industrial property is being supported by the demand for goods from people at home as noted above. Indications are that the trend to more online retail shopping is continuing, notwithstanding the low COVID incidents in Australia and imminent vaccinations.

Office property is the most debated property sector. On the one hand those that can and want to work from home are being heavily featured. It is true that the traffic into CBDs in Australia is noticeably less on Mondays and Fridays, with the middle three days being more normal. Property managers report that new office fit outs are requesting densities of one person to 10 or $12m^2$, as compared to pre- COVID one person to $6m^2$. In addition, more breakout rooms and meeting spaces are likely in new office fit outs to provide for collaboration when those out of the office join the team. In businesses such as ours, where the information set changes daily and good collaboration is essential across the team, we have basically returned to our pre- COVID flexibility arrangements with the vast majority of personnel working in the office and available to talk and see clients. It is likely that where office trusts are trading at significant discounts, that the discount to net assets will close, as it has already with over sold industrial property trusts since COVID.

Implications of the above for 2021

A number of themes were raised in the February blog based on the above economic and portfolio touchstones.

a) Industries recovering at different rates
   Different industries and sectors are recovering at different rates. A number of defensive sectors were beneficiaries of COVID e.g. packaging. Some of those industries have a second leg up e.g. hygiene including hand wash and disinfectants.

For others the COVID uptick is temporary e.g. drive through bottle shops and to some extent supermarkets.

Of some interest are companies which lag the general economic recovery. Where the stock prices for these industries continue to be depressed e.g. malt for brewing businesses, such stocks may be expected to show further recovery as the US brewing industry reopens with vaccinations increasing.

b) Some overvaluation

It is important that stocks held in portfolios be continually reviewed for overvaluation where a return to more normal valuation metrics may result in corrections.

c) Banks

The banks have continued to recover and are responsible in a material way for these strong portfolio returns in the December/March period. However, the 40% fall in bank share prices in March 2020 means that those portfolios carrying significantly overweight bank positons need to consider whether being over weight in the sector continues to be appropriate. The Commonwealth Bank was one of the world's most expensive banks prior to the COVID fall and has largely recovered all of the price falls.

d) Oil & gas stocks

As noted above this area appears to have further to recover based on global market recovery and industry supply and demand fundamentals, particularly as these relate to LNG in Asia.

e) Stronger commodities cycle

The favouring of goods over services supports a stronger commodities cycle. We need to be careful not to underestimate the strength of the commodity cycle as economies continue to recover post the COVID-vaccine.

f) Infrastructure

Infrastructure is a likely beneficiary globally as governments move from broad based income support measures such as Jobkeeper to supporting the replacement of aging infrastructure. The US Government has already foreshadowed a significant second stimulatory bill for infrastructure, complimenting the first $1.9T income support measures passed a few weeks ago.

g) Agriculture & weather

The breaking of the drought at the beginning of 2020 was a theme pre-COVID. COVID has also supported a number of themes including the Mediterranean diet and the substitution of cheaper protein for beef e.g. chicken.

h) Growth stocks

The February Bourse suggested categorising growth stocks into growth at reasonable prices (GARP), growth at realistic prices (higher PE but justified by the growth and profits) and other growth stocks (which should be viewed as speculative). Game-stop was an example in the past month of the last category. Growth stocks generally require a new lens to be applied to their valuation before venturing. It is likely clients should be looking for pullbacks in growth stocks based on the factors outlined above.

i) Corporate actions

There have been a number of takeovers and corporate actions in recent months, which have led to above normal gains for those stocks. We saw locally the Bank of Queensland rights issue announced with a very short time-table as BOQ merged with Melbourne based ME Bank. There are a number of other stocks in corporate play, several of which are recommended for client portfolios.

j) International

Care with respect to the populist sectors of the US market is advised. A key feature in the last month is the rotation from growth stocks to value stocks in the US market. One commentator opined that this would now be the dominant theme for the next ten years!

k) Fixed Interest

To conclude where this blog began, investors should avoid long duration until the ten-year bond settles in both Australia and the US. This is likely to be in the 2-2.5% range. Once the fixed interest market has adjusted and settled, it should be safe to revert to more traditional fixed interest investment strategies.

The continual jawboning by central banks that they will keep short-term interest rates at historic lows together with the banks being flooded with cash by governments means that short-term interest rates are unattractive. Some diversification from term deposits is possible without taking undue risk to achieve high interest returns. The Burrell fixed interest desk is busy and available for those wishing to discuss alternatives. Of course, the best alternative for some of the funds may well be equities. We see the balance of the year as being around stock selection rather than indexes or broad based investments.

Happy Investing,

Chris Burrell