IML INVESTORS MUTUAL LTD

Investor Series: Where to for the Economy and Sharemarket?

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We Are Living in an Extraordinary Time

Looking at the sharemarket's performance over the last few months, you could be tempted to assume the worst of the economic damage inflicted by the COVID-19 virus is behind us. Economically sensitive sectors like the banks and resources have led the rally, while many of the strongest-performing stocks have been some of the most speculative, such as those in the 'buy now pay later' sector.

Government income supports, loan payment deferrals, superannuation drawdowns, further interest rate cuts, and central bank bond-buying have all helped boost liquidity and spending power when many businesses have been closed and unemployment has spiked to levels not seen for several decades.

Company earnings and share prices both locally and globally have been – and are still being – driven by an unprecedented combination of factors. Some sectors, such as retailers like **JB Hi-Fi** and **Bunnings**, have benefitted substantially from the short-term sugar hit of COVID-19 income support. Others – such as travel, tourism, tertiary education and hotel accommodation – have experienced dramatic collapses in activity.

More broadly, a decade of ultra-low monetary policy stimulus has injected massive liquidity into the global economy and significantly influenced investors' expectations and behaviours. Low yields from term deposits and bonds have also driven investors into the sharemarket in search of yield. There has also been feverish momentum-driven buying of ostensibly glamorous sectors such as the 'buy now pay later' companies. This has all created a 'perfect storm' in which focusing on good quality, defensive stocks that represent good value and have a proven ability to generate and grow recurring earnings over time has led many funds – such as Investors Mutual – to continue to underperform the broader sharemarket.

So is the sharemarket rally justifiable and sustainable? Have governments and authorities done enough to buffer the economy from the worst of the recession so the economy can get to the 'other side' of the pandemic smoothly as things return to 'normal'? These are almost impossible questions to answer given the diverse factors at play, although we remain very cautious about the outlook. In this article, we will explain why we are investing your money defensively.

Reasons for Caution

The stimulus we talked about earlier injected around A$64 billion into workers' and businesses' pockets in each of the June and September quarters. This stimulus is due to taper off to about A$24 billion in the December quarter, a fall of A$40 billion representing around 9% of GDP. When this is combined with reduced access to superannuation withdrawals, a fall in liquidity of some A$68 billion in the December quarter appears likely. To put these numbers into context, Australian GDP economic growth was A$1.95 trillion in fiscal year 2019, or about A$500 billion per quarter. Reducing liquidity by A$68 billion is approximately 13.6% of GDP in a normal quarter in a quarter when tourism, hotels, hospitality, international education and many other industries are going to remain heavily affected.

Another reason for caution is apparent apathy from many investors about the recession. Measures of sentiment from US sharemarket investors suggest that many do not appear to be expecting any downside from sharemarkets. When complacency is this extreme, it's often an indicator that a market correction is not far away.

Another indicator which makes us cautious is the enormous growth in the number of day traders, potentially indicating a high level of speculative sharemarket activity. People with time on their hands and the availability of effectively free, technology-driven trading have entered or re-entered the market, producing a wall of 'hot money' which has further pushed up many companies' already rich valuations.

Another significant issue for investors is the increase in the amount of US corporate bonds with negative yields. The US Federal Reserve has been supporting bond markets – including the 'junk bond' market – by buying US$120 billion a month of bonds to keep the system flush with liquidity and to support financial markets. This 'quantitative easing' is not sustainable in the longer term. At some stage, bond markets can be expected to return to some sort of normality, where investors are actually paid a return in the form of interest for taking some risk! This will also affect sharemarkets, as equity risk premiums will rise to better reflect rising bond market returns.

Outlook Going Forward

It's still extremely difficult to understand what 'normal' is going to look like for many sectors as we head towards 2021. The JobKeeper and JobSeeker income supports have been extended until March, which will help reduce pain for many individuals and businesses and provide further near-term support for some sharemarket sectors. But it's difficult to see how this can be sustained indefinitely.

The other major issue is higher unemployment in the year ahead. On top of the current official 7.4% unemployment rate, Macquarie Bank has estimated that around 3.5 million of Australia's 14 million-person workforce – 25% of the registered workforce – are on JobKeeper. How many of these 'stood down' workers will have a job to return to? The number of unemployed could rise rapidly to over 10%, a major headwind for the economy.

Diminished household spending power, record household debt, and higher unemployment are likely to weigh increasingly on economic activity and on many Australian companies' earnings. Many companies are also actively reducing their labour forces and deferring or cutting capital expenditure because of the uncertain outlook.

The run-up to the US Presidential election in November and escalating US-China trade disagreements are also likely to inspire potentially greater volatility on world markets.

Conclusion

We believe that the economic recovery will be prolonged, rather than 'V-shaped'. Weaker household income and an uncertain corporate earnings outlook are likely to lead to sharemarket volatility. We have therefore positioned your investments to focus on companies whose earnings are not dependent on a V-shaped recovery and which we believe are reasonably valued, have strong competitive advantages, and are run by experienced, capable management teams that can navigate the impending uncertain economic times.

In an environment where an increasing number of companies are likely to report lower earnings and dividends, investors will gravitate towards companies with defensive characteristics such as proven sustainable earnings and dividend yields. We believe this will be more supportive of the prices of the quality industrial companies we favour, such as **Amcor** and **Orica**, and we expect these companies to do well as we head towards 2021.

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