SO FAR, SO GOOD AS THE RECOVERY RALLY CONTINUES

PERPETUAL PRIVATE INSIGHTS
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For Australian equities it's been another strong quarter to close out the market's best year since 1987. This momentum looks set to continue in the new financial year, making equities our preferred asset class in 2021.

Despite optimism among investors, risks to the market rally include the emergence of the Delta variant and uncertainty over whether sustained inflation could force major central banks to raise interest rates sooner than current 2023 or 2024 forecasts.

In Perpetual Private's quarterly investment update for April to June 2021, we look at the returns for Australian and global markets, where opportunities lie and gauge the risks to a broadly diversified portfolio in 2021.

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A strong end to a record year

The last quarter of the 2021 financial year saw a strong rally in Australian equity markets with the ASX/100 surging 8.5%. For the full financial year, the ASX/100 gained 27.9% – its best annual increase in over 30 years – as the market continued to rally off March 2020 lows.

Much of the quarter was characterised by a sense of calm. While the vaccine roll-out didn't meet targets, low case numbers let investors look forward to what a post-COVID world might look like.

Together, this post-COVID optimism, high levels of government spending to support the economy and record-low interest rates combined to fuel the rally in equities. It was a similar story around the world, with the MSCI world index also posting a gain of 9.0%.

Investors continued their equity rotation out of growth stocks (such as the technology sector) to value stocks, such as the banks and energy companies. More simply, stocks that were most sold off in 2020, have rallied the most in 2021. The question is – will this trend continue in FY22, and finally bring an end to the longest period in history of growth stocks outperforming value stocks?

Bond market caution

As equity markets locked in gains, bond market volatility showed that investors are increasingly concerned that rising inflation could force the Reserve Bank of Australia (RBA) and other major central banks to raise interest rates sooner than they have previously indicated.

As recently as the July meeting of the RBA, Governor Philip Lowe reiterated his commitment to maintaining official interest rates at 0.1% for the medium term, saying that substantial and sustained wage growth was a key variable for deciding when to raise interest rates.

"The central scenario remains that the condition for a lift in the cash rate will not be met until 2024," Mr Lowe said.

In the US, the Federal Reserve has also suggested that any spike in inflation will likely be transitory and they would allow inflation to run above target for some time before intervening. These dovish views on inflation and interest rates soothed the nerves of wary investors and allowed the equity market rally to continue.

Looking beyond lockdowns

The COVID-19 lockdowns in many parts of the country in June and July have shown how fragile our economic recovery really is in the face of a COVID-19 outbreak. More lockdowns will naturally impact the economy, for the benefit of some industries, such as online shopping and the detriment of others, such as tourism.

Nonetheless, the increase of vaccine supply in the second quarter of FY22 and the acceptance that the virus cannot, ultimately, be eliminated has meant that investors are taking the long view, and COVID-19 is not likely to be a major market disruptor.

The outlook ahead

For Aussie equities, it's likely to be 'more of the same', at least in the near term. Economies continuing to reopen will likely lead to sharp recovery in business activity and global economic output. IMF and World Bank predictions of global economic growth of between 5% - 6% in 2021, (albeit led by a few large economies) is set to fuel equity markets.

Headwinds remain, including vaccination rates and the emergence of Delta variant, as well as the prospect of higher inflation which may lead to market corrections, but we still expect equities to outperform other asset classes in the first half of the 2022 financial year.

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