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Nikko Asset Management

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Market commentary

The S&P/ASX 200 Accumulation Index returned 2.8% during the month. Australian equities lagged most developed markets in August. In major global developed markets the US S&P 500 was up 7.2%, Japan's Nikkei 225 was up 6.6%, the DJ Euro Stoxx 50 was up 4.5%, while the UK's FTSE 100 was up 1.8%.

The Reserve Bank of Australia (RBA) reaffirmed its commitment to support the financial system through a historically low cash rate of 0.25% and yield curve control to keep 3 year bonds at 0.25%. The RBA also announced it is extending the Term Funding Facility in both size and duration. These measures are intended to keep funding costs low and sustain credit availability.

Domestic economic data releases were brighter in August. Employment rose by 114,700 positions in July, exceeding market expectations. The unemployment rate rose to 7.5%, which was also better than feared, however this was the highest jobless rate since November 1998. The NAB Survey of Business Conditions continued to rebound in July, turning positive at +3 points, with business confidence remains weak at -14. Retail sales were up 2.7%. National CoreLogic dwelling prices continued to fall in August, ending the month down 0.4%.

Overall the August reporting season was better than feared, with a number of stocks showing surprising resilience during the COVID-19 crisis. There were generally more beats than misses and cash flow was strong. Stocks that showed resilience were largely in the consumer staples, building materials, discretionary retail, gaming, general industrials and insurance sectors. Overall FY21 EPS was revised downwards, with downward revisions primarily in the industrials and financials, while resources saw positive EPS revisions thanks to rising iron ore and copper prices. Some of the negatives to come out of reporting season were that approximately one third of stocks have withdrawn guidance and 60% of stocks have cut or suspended their dividend.

Sector returns were mostly positive in August. The best performing sectors were information technology (15.5%), consumer discretionary (8.7%) and real estate (7.5%). These were followed by industrials (4.6%), healthcare (4.0%) and energy (3.4%) which also outperformed the broader market. Sectors that lagged included materials (1.2%), financials (1.0%), consumer staples (-0.4%) and communication services (-3.8%). Utilities (-4.8%) was the worst performing sector.

The information technology sector continued its recent outperformance, following the lead of global IT stocks. Afterpay (33.4%) continued its ascent, while Xero (12.3%) and Wisetech Global (36.5%) also significantly outperformed.

The consumer discretionary sector also outperformed during August. Aristocrat Leisure (8.4%), Wesfarmers (4.1%) and IDP Education (50.9%) were the key drivers of sector performance.

The real estate sector also outperformed the broader market, despite the challenges of COVID-19. Key contributors included Goodman Group (8.2%), Stockland (24.1%) and Scentre Group (10.8%). Stockland was the best performing real estate stock during the month, having reported strong residential sales in June and July.

The consumer staples sector lagged the broader market. It was dragged into negative territory by A2 Milk Company (-11.8%), Treasury Wine Estates (-14.4%) and Coles (-0.9%). Treasury Wine Estates was negatively impacted by an announcement from China that they are launching an anti-dumping investigation of imported wine from Australia.

The communication services sector underperformed. Sector heavyweight Telstra (-11.3%) was the key driver of underperformance. Despite meeting expectations on sales and profit, Telstra underperformed due to a lowering of expected rates of return which puts greater pressure on management to reduce costs to maintain future dividends.

The utilities sector was the worst performer in August. Sector heavyweights AGL (-7.9%) and APA Group (-5.2%) were the main detractors. APA disappointed the market after marginally missing its initial guidance, due to issues around the Orbost Gas Processing plant, which was meant to be up and running mid-FY20 but is now expected to be fully up and running by the end of FY21.

Market outlook

During the August reporting season, most companies were impacted by COVID-19 in some way; however, a range of companies have performed well ahead of pre-COVID expectations whereas others have experienced disastrous impacts. E-commerce and some retailers for example, have had extraordinary results given the various stages of lockdowns, reduced avenues to spend and government wage stimulus. Caution is warranted in capitalising this increase as the economy moves back to a more normal level. However, there is no doubt that some companies will be lasting beneficiaries of this economic shock with potential changes in consumer and business habits.

Preservation of cashflow was evident in tighter control of working capital, with many companies reducing inventories and extending payables. There were also many instances of discretionary capital expenditure being put on hold. Many companies have deferred, reduced, or cancelled their dividend.

The FY21 earnings outlook deteriorated with only 23% of companies upgrading, whereas 40% downgraded. Materials provided the highest number of upgrades due to resource based names which benefitted from a weaker US dollar and the prospects of a recovery in the global economy.

Weak results were not necessarily met with the typical sell-off as the market seemed to look through the near-term COVID-19 weakness. There were a large number and quantum of "one-offs" during the month, typically an asset write-down, and as such, they were non-cash in nature. This rebasing has the impact of enhancing future reported earnings and apparent forward earnings growth—with little influence on cash generation. We last saw such a large increase in one-offs in the GFC.

While the ongoing global COVID-19 situation and ensuing uncertainty makes forecasting difficult, we continue to reassess our earnings estimates. This includes reviewing short-term earnings and implications for dividends and balance sheet risk, as well as long-term earnings, which has implications for valuations. As well as assessing the risks associated with stocks in the portfolio currently, we are also actively assessing opportunities thrown up by any aggressive and, in some instances, indiscriminate sell-offs.

Economic shocks like we are currently experiencing typically result in social and economic adjustments. Ultimately the impact on long-term earnings estimates and valuations will be a function of the depth, duration and damage inflicted during this period of enforced subdued activity. Some of the more obvious potential transformations include: 1. employees working from home for all or part of the week; 2. office space required may be less, given the work from home theme; 3. reduction in the use of public transport and more car travel; 4. business travel may reduce given the improving technology and thus more use of virtual meetings; 5. e-commerce and omni-channel retail has had an accelerated shift in market share; and 6. low interest rates and government stimulus have been surprisingly positive for housing with early signs of increased interest in moving away from the inner CBD suburbs. It is still too early to be confident that these adjustments will be longstanding or perhaps just a one-off. As such, the Nikko AM team will invest significant time post the reporting season looking to identify and thus appropriately value any of the structural winners and losers.

The combination of extreme positioning and valuation differentials that are still evident always provides strong forces when the market reverses. Recessions are typically the catalyst for style leadership to change and our expectation is for history to repeat with value outperforming—particularly when the world becomes less sensitive to the COVID-19 situation via a vaccination or therapeutic solution. Like other large market corrections, it is always difficult to pick the bottom and thus rotating slowly into some of the beaten down value names funded by reducing and exiting the outperformers is an approach that we have found has worked well in these type of markets.

Important Information