KENNEDY PARTNERS WEALTH

KPW – Note to Clients 20th Sept 2021

Embrace for a Period of Volatility

Following a record reporting season in August, where the miners announced record profit, banks bought back stock at a record amount and the number of beats on consensus analysts' forecast continue to grind higher, the investment team at Kennedy Partners Wealth were cautious on the medium term returns for domestic and broader markets.

We have always taken a long-term view of markets and will continue to allocate capital in asset classes where we believe the risk-return is justified. As you may know, equity markets have benefited from a windfall of fiscal and monetary support over the past 18 months where global indices have returned to all-time highs.

This is because the market is forward looking, many investors were able to see past the near-term uncertainties around vaccine rollouts, reopening, supply chain risks and shortage of labour.

However, we believe the current market is mispricing some periods of elevated uncertainty that are too big to ignore. Due to the unwavering amount of stimulus injected in global economies, this created a short-term mismatch between demand and supply and subsequently the debate of whether inflation is "transitory" have once again been reignited.

Central bankers around the world are in the consensus that inflation will be "transitory" and that a minority of one-off items have so far contributed to an elevated headline number (second-hand cars, discretionary expenditure, rent). Bond yields have remained range-bound for the last couple of months with breakeven inflationary expectations still above the target 2-3% range. The market is willing to ignore those short-term pressures to stimulate growth and that is reflected in equity and debt markets.

Globally, we believe the world is at an inflection point where central bankers and policy makers will need to decide when to taper (reduce bond holdings) and eventually raise interest rates. Since the market is forward looking, many policy markets have been forward signaling their intentions at a potential taper generally months in advance through their "dot-plots" and regular meetings (US FOMC, RBA Minutes). Many commentators believe the US will begin to taper in November/December with the RBA pushing out their taper program to February 2022.

Elsewhere, in China we have been monitoring the deterioration of their local property market. Housing activity fell sharply in July and weakened in August. With the market increasingly gripped over concerns of Evergrande- China's second largest property developer at risk of a potential default. Our current base-line scenario is for the local PBOC (People's Bank of China) which the state bank to step in abate pressures. However, the contagion risks are so far unknown in both financial and property markets and will most likely cause a sharp revision of growth GDP outlook for Q4.

Recent regulatory crackdowns in China have also unnerved investors, with an exodus of foreign capital flushed out of the domestic market. Sectors such as education, technology, gambling and overseas dual-listed companies were targeted in the notion of "common prosperity". In addition, a zero-tolerance for COVID means it is unlikely overseas borders will be open for quite some time.

Australia's has historically been the primary direct beneficiaries of the industrial boom in China over the past two decades, as reflected by our large cap miners. The sharp recent sell-off in our number one export (iron ore) have caused concern about our reliance on our key trading partners. It remains likely iron ore will continue to suffer short-term downward pressures if demand from China wanes and supply from overseas competitors comes back online.

So Where to Next?

We believe in the short-term profit taking is prudent along with a rotation towards energy and healthcare. Both sectors have lagged peer sector recovery on a twelve-month basis and current mid-cap companies undervalued and oversold.

Despite the rise of ESG since the pandemic, a reliance on renewables in Europe won't be sufficient to meet demand as dwindling inventories along with poor weather conditions have caused supply pressures. Therefore, energy demand from fossil fuels will be needed to provide support especially as Europe transitions to a harsher winter climate.

Healthcare will benefit in a post-pandemic world due to an ease of restrictions. Many companies have fortified their balance sheet during COVID and proved to be resilient despite ongoing operational uncertainties. We remain optimistic on this sector given their higher pricing power and pent-up demand.