

Market Rally Increases Equity Market Risk

July 2020 | Bruce Apted, State Street Global Advisors

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Should the recent rally provide comfort or concern for investors? The recent equity market rally has provided relief and some hope to investors but in the face of deteriorating fundamentals, it increases the risk for equity investors. Figure 1 below highlights the extreme price movements we have seen in Australia in 2020.

Figure 1. Recent rally a continuation of the roller coaster

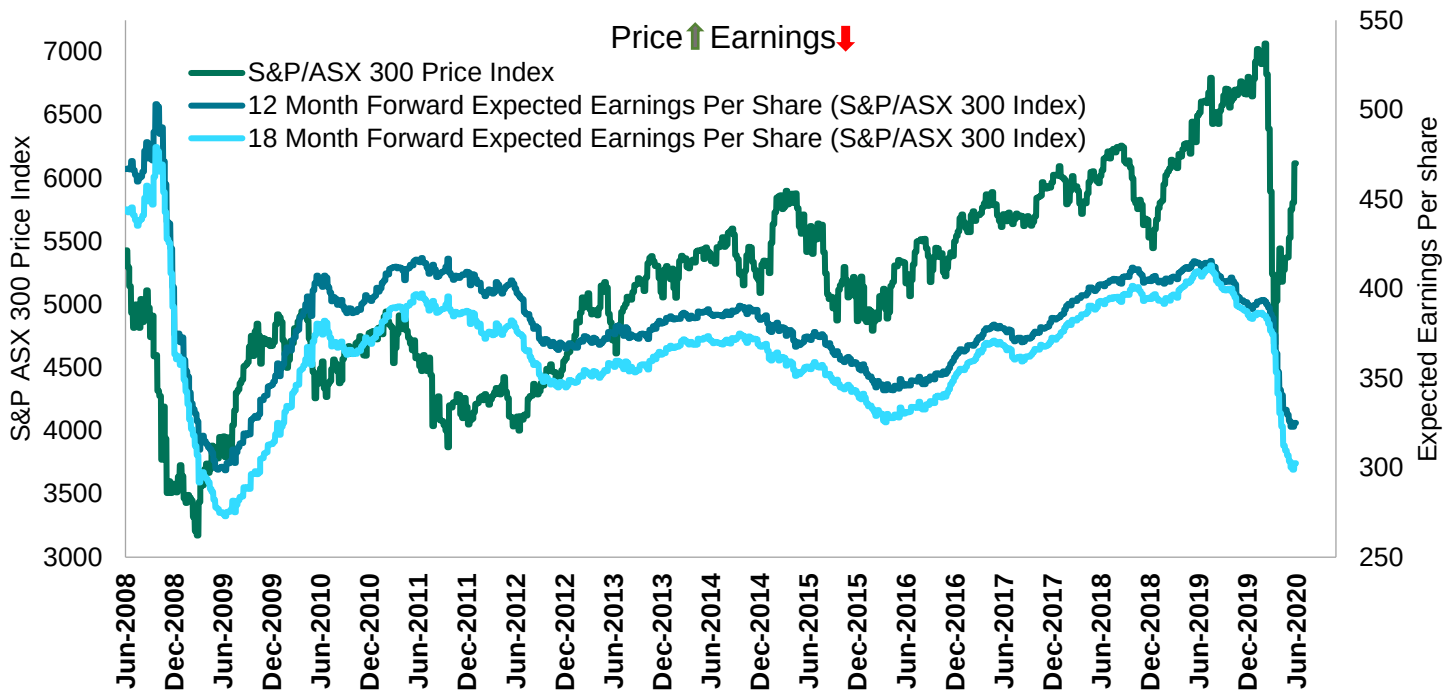
Period	S&P/ASX 300 Index Return	Description	Emotion
31-Dec-19 to 22-Jan 20	+6.71% (15 days)	Continuation of 2019	Euphoria
20-Feb-20 to 23-Mar-20	-36.5% (22days)	COVID-19 Pandemic	Fear & Panic
23-Mar-20 to 9-Jun-20	+35.2% (53 days)	Liquidity Driven Rally	Hope & Relief

Source: Thomson Reuters, S&P as at 12 June 2020.

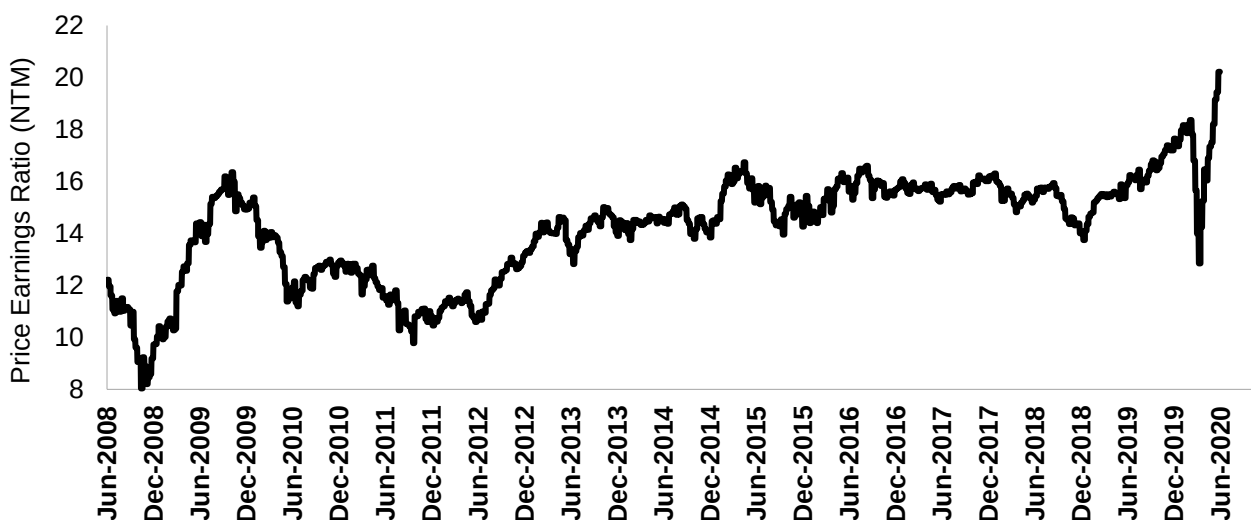
Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

We are all aware of the lower level of economic activity in our communities. We can all see tangible evidence of the slowdown in our daily lives, from the activity in the streets and stores and from restaurants to real-estate. So far, Australia and New Zealand and other select countries have fared better than many, but our economy still faces much uncertainty from either a second wave or from a deteriorating outlook for the global economy. Company earnings have been significantly impacted as can be seen in Figure 2 below. The earnings per share estimates (blue lines) for the S&P/ASX 300 Index are still trending down. Figure 2 also illustrates the recent rally of the S&P /ASX 300 index (green line), compared to the expected earnings for the next 12 and 18 months (blue lines). The divergence between the market rally (green line) and expectations for company earnings (blue lines) is clear. The recent rally now places the equity market on the highest multiple in the last 12 years. The recent equity market rally has priced in a V shaped recovery exposing investors to risks if the recovery does not eventuate as priced.

Figure 2. **Growing Divergence Between Price (Green line) and Earnings (Blue lines)**



Valuation: Price Earnings Ratio based on expected Earnings Per Share (EPS) for the next twelve months (NTM)



Source: Refinitiv Datastream as at 12 June 2020.

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The blue lines are the expected earnings per share for the S&P/ASX 300 index. It is looking at both 12 months forward and 18 months forward. The green line is the price index for the S&P/ASX 300 index.

Explosion of online brokerage accounts

A number of online brokers are reporting an increase in new accounts being opened¹. The prevalence of very low cost trading, combined with volatility, financial market liquidity and the COVID-19 lockdown boredom might partially explain the increased presence of online trading. Robinhood.net is a popular online trading platform that also provides analytics on its users trading behavior. For example, Hertz recently filed for bankruptcy and has traded to a closing low of \$0.56 on the 26th of May². The shares subsequently rallied from \$0.56 to above \$6.00 (+971%) on the 8th of June. Over the same period we observed a significant increase in the number of Robinhood.net users holding Hertz. The company found itself in an unprecedented situation of doing an equity raising at the same time as filing for Chapter 11 bankruptcy.

Finding opportunities in a volatile environment

We are seeing extreme price moves in 2020, both at the index and individual stock level. We are observing some curious price action that is a reminder of the emotional elements of trading and an inefficient market. Since the start of the year the S&P/ASX 300 Index is now trading at a price earning multiple of 20.2 times next year's earnings which is 12% more expensive than it was in January 2020 when it traded on 18 times next year's earnings. The sectors that have increased the most in valuations include, Energy, Industrials, Information Technology and Consumer Discretionary. These sectors are most at risk should growth expectations slow. Looking within each sector we see a wide range of valuations for different companies and look to avoid the more expensive parts of the S&P/ASX 300 Index. We continue to hold no exposure to the Information Technology space, only a small exposure in select Industrials and a small exposure in energy.

Figure 3: Volatility in returns, valuations and earnings creates opportunities

	PE (NTM) Jan 2020	PE (NTM) June 2020	PE Change
S&P/ASX 300 Index	18.0	20.2	2.2
Energy	15.0	27.2	12.3
Industrials	26.0	38.0	12.0
Information Technology	34.3	43.5	9.2
Discretionary	22.0	26.5	4.6
Communications	20.4	22.2	1.8
Materials	14.2	15.8	1.6
Financials	14.7	16.3	1.5
Banks	14.0	15.3	1.3
Utilities	23.0	23.3	0.2
Real Estate	17.4	17.0	-0.4
Health	37.7	36.6	-1.1
Staples	24.1	23.0	-1.2

¹ TD Ameritrade is an online brokerage platform in the United States reported a record of 608,000 new funded accounts in the March quarter. E-trade and Charles Schwab also reported above average increase in new account openings.

² Source: Robinhood.net

Source: Thomson Reuters, State Street Global Advisors. Valuations are as at 15 June 2020. Past performance is not a reliable indicator of future performance. This information should not be a recommendation to buy or sell any security or sector shown. It is not known whether the sectors shown will be profitable in the future.

PE (NTM) = The price earnings ratio based on earnings for the next 12 months.

The Bottom Line

Should we be concerned about the recent rally? We believe the significant rally in the equity market has factored in considerable good news and places many stocks at a greater risk should the V shaped recovery³ not occur as expected. We are wary of over exuberance and herd behaviour driving short term prices. Now more than ever it is time to focus on real businesses that are reasonably priced and can generate earnings and surplus free cash to provide optionality for uncertainty that may lie ahead.

Portfolio Attribution and Performance⁴

The increased volatility and uncertainty creates a wide range of security pricing creating opportunities for active stock selection. Our focus as always is on higher quality more stable businesses that can be owned at reasonable valuations with an improving growth outlook and acceptable risk. As this market continues to rally ever higher we remain defensively positioned.

Rising confidence in government stimulus and a continued easing of lockdown measures saw global markets rally again in May. The S&P/ASX 300 Index was up +4.6%, led by IT, Communication Services and Materials. Defensive sectors like Health Care, Staples and Utilities were the worst performers. While earnings forecasts continued to see downgrades in May, the rate of these downgrades decelerated – a similar trend we have been observing in other developed markets. Dividends have also been cut quite deeply during the month, with the largest negative DPS revisions being issued for Energy, Financials and Industrials sectors.

The State Street Australian Equity Fund underperformed its benchmark during May after fees (in-line gross of fees). From a sector perspective, good stock picking within Health Care (not holding CSL) was offset by negative stock selection within Utilities (AusNet Services and AGL Energy) and the higher than benchmark exposure to Staples. Calendar Year to date the fund outperformed its benchmark after fees. The fund's outperformance can be largely attributed to our lower than benchmark weight in Financials (not holding big 4 banks) and higher than benchmark weight in Gold.

³A V-shaped recovery is characterised by a quick and sustained recovery in measures of economic performance after a sharp economic decline.

⁴Bloomberg Finance, L.P. SSGA. As at 29 May 2020. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

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