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# Woodhall's Wrap

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## Short-term uncertainty taints 2021 prospects

**COVID-19 vaccines rolling out**
**China trade dispute with Australia**
**Brexit deal clinched**

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## The Big Picture

When we try to look back through the events of 2020, it is hard to see back through to the beginning of the year without getting caught up in the impact of the pandemic. On reviewing our monthly update reports we can get a clear view about what we and others were writing about throughout the year – and not coloured by opinions as they evolved over time.

Twelve months ago, the big news was that the anticipated China Phase I trade deal might end the tariff war with the US and the prospective impeachment of Trump. Of course, at home we also had massive bushfires and floods to deal with.

In our March issue we noted that COVID-19 had not yet been classed as a pandemic and that the World Health Organization (WHO) proclaimed that the virus was 'flu-like and would only have a mild impact on most people'.

Come the run-up to the November US presidential elections everyone seemed to believe that they knew back in January what they would have or should have done. Everything is easy in hindsight.

Many countries tried different approaches to containing the virus with very different outcomes. There were no real winners but Australia and New Zealand didn't fare too badly by comparison.

With vaccines starting to be rolled out in the UK, US, Europe and soon Australia, health authorities can start to get on top of the virus. However, there are likely to be a number of hiccups along the way. We think the markets were a bit too optimistic in the last two months of 2020 given the potential downside risks.

Not all of the vaccines have proven to be effective and some clinical trials were contaminated with miscommunications about dosages. Of course, there are major distribution issues to be dealt with. And we cannot ignore the irresponsible attitudes of some groups of people in Australia and overseas.

In addition to the virus, the China-US trade spat dissipated leaving China's ire directed at Australia. With very little explanation, China has been refusing significant imports of coal, lobsters, wine, beer, barley, timber, etc. If these refusals continue and even escalate, there will be a significant impact on Australia's trade balance and economic growth.

It is too early to tell what impact Christmas and New Year's celebrations will have on future restrictions to combat the spread of the virus. Our quarter three

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(Q3) economic growth came in at a solid 3.3% after the two negative quarters of growth. We could easily slip back into negative growth in the first half of 2021 if people are not vigilant in practicing social distancing.

Macro-economic data for Australia, the US and China largely finished the year quite strongly but the job is far from done. A new more infectious variant of COVID-19 was identified in London and the surrounding south east of the country. That brought about a fresh lockdown in that region. There are reports of this and other new strains appearing in other countries including Australia. What is not yet known is whether the vaccines will deal with the new strains as effectively as they apparently deal with the original virus.

On top of the uncertainty due to new strains developing, we do not yet know if those who have been vaccinated can still pass on the virus to others. Also, it is not known how long immunity from the virus will last after vaccination. Spokespeople are seemingly confident in their media releases but what else can they say? There is yet no data.

Our research points to markets being much better in a year or two but we cannot rule out a dip in share markets in the first part of 2021. And we feel that not just because of the virus and China trade disputes. Trump hasn't yet made a gallant exit. He only just signed the virus-compensation package bill into law but it was too late to stop many millions missing out on certain welfare payments for a short while.

The Georgia run-off senate elections on January 5th could have a big impact on who will really govern the US for the next period.

But 2020 did end with one very good piece of news. The UK reached a trade deal with the EU which rules out tariffs and quotas. There has been no reported large-scale migration of the London finance sector to Europe. For the last four and a half years many were predicting a disaster for Britain. It has had a very bad year because of the virus but the longer-run future is now looking brighter.

Britain got most of what it wanted. The only real disappointment was EU access to UK fishing resources. The EU's share will be scaled back over the next five years from a 50% share now to 25%.

Our outlook for 2021 is largely positive subject to some speed bumps along the way. Vaccines may well eliminate the main threat of infection by the end of 2021. Some businesses and jobs may have been lost forever but there is also a pent-up demand for certain goods and services that can be satiated in part by increased household savings over 2020.

## Asset Classes

### Australian Equities

The ASX 200, not including dividends, finished down -1.2% over 2020 but that statistic doesn't tell the full story. The index was up +7% to its peak in February but then plummeted -37% to its March low – and then rose +45% into the end of the year. If we look at the sectors over the whole of 2020, about half were up and half were down. But, at the extremes, the IT sector was up 56% and the Energy sector was down by -30%. It was easy for stock pickers to get on the wrong side. And that's why prudent investors try to diversify their risks.

We had the market precariously over-priced at the February peak and massively under-priced in March. We believe that the market was over-sold in March because nobody really knew how bad or how long the shutdown would be. So, sell now and ask questions later was the plan for many investors.

We had the market quite over-priced again in December for the opposite reason. Investors were 'relieved' that vaccines were at last going to be available and scrambled to get back in for fear of missing out. We have broker forecasts of dividends and earnings pointing to a strong twelve months' capital gain. But, with the market slightly over-priced by our measures and certain headwinds possibly ready to blow, caution should, as always, be exercised.

### Foreign Equities

The S&P 500, the Nikkei, Emerging markets and the world index all posted double digit growth in 2020. Of the other indexes we follow, the DAX was flat and the FTSE was down -14%.

The S&P 500 was quicker out of the blocks than the ASX 200 in 2020 posting +15% to our +7% to the February peak. But this index fell a little further than ours at -40% compared to our -37% in March. However, it climbed much better to the end of the year at +67% to our +45%.

Many analysts are saying that it is hard to work out what, or by how much, stocks are overpriced when bonds have close to a zero return. We agree, but we are less inclined to brush the problem under the carpet. We prefer to hold a more conservative view that the US market is a bit over-priced.

Much of 2020s gains on Wall Street were due to the growth in big tech companies. At the best of times, these companies are hard to price. We remember the dotcom boom and bust. However, its is a new age and we must take on some additional risk to stay with the trade.

The Yahoo Finance website lists the forecasts of a dozen respected houses for the end-of-year S&P 500 index. The median is 4,150 with the low and the high forecasts being 3,800 and 4,400. Our forecast is between this median and the high value. The end-of-year close for the index was 3,742 making the median forecast being 10%.

### Bonds and Interest Rates

The US Federal Reserve cut its 'Fed funds rate' three time during 2019 down to a range of 1.50% to 1.75%. At the beginning of 2020 the Fed was predicting one 0.25% hike in 2020 and another in 2021. Instead, it effectively did six cuts in March 2020 down to a zero rate. Further QE (quantitative easing) took place throughout 2020 and it is predicted to continue.

The Fed has repeatedly stated that rates are lower for longer. Not only do they and market participants now expect no hikes in 2021, they do not expect any in the following year.

The Reserve Bank of Australia (RBA) overnight rate started 2020 at 0.75% and it cut to a 'creative' 0.1%. It has been trading bonds to keep the three-year rate at about 0.1% and longer rates lower than they otherwise would have been.

Central banks in the US, Australia and most other countries have done about all they can to help their flagging economies from grinding to a halt. Since the 'recession' was wilfully created by public health measures to stop the spread of the virus, it was left to governments to expand fiscal policy for more economic stimulus.

The US launched a massive aid program earlier in the year but it dragged its feet in keeping that initiative going. Eventually, Trump signed a bill for around $900bn of coronavirus aid just after Christmas. The Democrat-led lower house then sought to increase one-off payments in the bill from $600 to $2,000. So far, the Senate has rejected that plan.

The Australian government was far more proactive in providing aid. Various programs such as JobKeeper and JobSeeker have helped those in most financial need. However, these programs are being scaled back as the economy recovers.

We start 2021 with central banks left with little wiggle room but governments willing to create a mountain of debt to prevent economic disaster. Australia is now looking at a one trillion-dollar government debt in 2021.

With interest rates near zero, the debt is less of an issue but steps must be taken to address the problem as soon as the economy improves.

### Other Assets

There were major movements in commodity prices over 2020. The price of iron ore was up about 75%; oil prices were down around 20% to 25%; the prices of copper and gold were each up around 25%.

The Australian dollar (against the US dollar) started the year at 70 cents, plummeted to 56 cents in March and finished the year having gone above 77 cents.

It should be stressed that some of the recent apparent strength in our dollar has been due to the weakness in the US dollar rather than an inherent strength in Australia. If China continues to intensify its trade war with us, our dollar could start to retreat.

Volatility on Wall Street, as measured by the VIX 'fear' index, started the year at an average level of 14 but climbed to 82 at the worst of the pandemic crisis. It finished the year moderately above average at 23.

## Regional Analysis

### Australia

Australia was unable to avoid a recession using the simplistic definition of two consecutive quarters of negative economic growth. This policy-induced recession was the price of maintaining public health standards. The economy bounced back sharply in Q3 with a growth of 3.3% in just one quarter but that left GDP still 4% below where it was in the last quarter of 2019.

Unemployment was unexpectedly quite resilient in 2020. It was 5.1% in December 2019 and rose to a peak of 7.5% in July and finished the year at 6.8%. The RBA had predicted the unemployment rate would finish 2020 at 9.3%. It, like many other agencies, admitted that, in hindsight, they were far too pessimistic at the height of the pandemic fallout in March. Of course, the cap on the unemployment rate must at least in part be due to the government's action with jobs programs.

It is too early to tell how big any 'new waves' of virus outbreaks will be – following Christmas and New Year celebrations. The federal health minister has predicted 80% of Australians can be vaccinated by October 2021 – with health workers and aged care residents being at the head of the queue.

We think it is quite possible we will see modest or negative economic growth in 2020 Q4 and/or 2021 Q1. But, providing the government keeps doing what it has been doing, the impact on the population will be largely contained. However, the fly in the ointment is China.

For at least two months, China has been refusing imports of various Australian exports: coal, lobsters, wine, barley, timber, etc. Although some vague environmental reasons have been given, these actions are widely interpreted as payback for Australia's stance against China on its handling of the coronavirus and our close ties with the US.

If the China-Australia trade spat is not resolved – or, indeed, if it escalates – the chance of negative economic growth in Australia increases.

It is for the reasons of possible fresh lockdowns and trade wars that we are pencilling in a possible temporary downturn in the ASX 200 in the first half of 2021 despite our strong forecasts for the longer term. We think it is too hard to try and trade through any market volatility. If one's investment strategy was appropriate for the longer term before any major volatility begins then riding the waves is the prudent way to go if one believes the long-run is indeed solid.

## China

China was first into the pandemic and arguably the first out. Because of its style of government, it was better able to control lockdowns and fiscal stimulus. In recent months its economic data were consistently strong.

China weathered the trade war with the US. Big tariffs are still in place with much of its trade with the US. It is not clear what Biden will do, if anything, come his inauguration on January 20th.

China certainly turned its attention to Australia later in 2020. Give its size, Australia is a smaller target than the US and it is seen as a close ally to it.

At first, refusing entry of lobsters and some shiploads of coal seemed a bit random. But the list keeps growing without resolving any of the former issues. Since there seem to be no clear guidelines on what will happen going forward, owners of the exports do not know what to do with their cargoes and the shipowners have their capital languishing around Chinese ports.

It is a brave (or is it foolish?) person who predicts what China may or may not do. China iron ore prices have doubled since the 2020 low. Are they planning a strategy around influencing the price of that commodity?

## US

Although the US presidential election result was called some time ago, Trump has not yet really accepted defeat. Nevertheless, Biden will be sworn in as president on January 20th. Before then, on January 5th, a run-off election will be held in Georgia for both of its seats in the Senate.

Different US states can have different voting rules. Georgia is not a first-past-the-post state so it must hold a fresh election after no candidate reached 50% of the vote in November. (They do not have preferential voting as we do in Australia)

It is also unusual for two seats to be up for election at the same time. The second seat came into play because a sitting senator resigned before the election and so a temporary senator was sworn in.

Both seats were held by Republicans going into the election and Georgia has usually been a Republican state. However, there are so many new factors at stake it is hard to predict who might win. If both seats go to the Democrats, the Vice President, Kamala Harris, gets the deciding vote and the Democrats hold both houses. Otherwise, there is a split Congress as there was under Trump and Obama. Split Congresses usually force the President to soften some policies to gain sufficient support from the opposing party.

US economic data picked up strongly in Q3 but renewed lockdowns of varying intensities make for some to predict some negative growth in coming quarters.

Biden was committed to a variety of tax increases (income, company and capital gains) but the fragile nature of the US economy and a probably spilt Congress should soften his agenda.

Because Trump delayed in signing the latest COVID relief package, millions of Americans will have gaps in their welfare payments. Many will now get only a $600 relief cheque compared to $1,200 in 2020 and the $2,000 wanted by many for 2021.

No doubt the US will muddle through managing its economy but we do not see the new government moving swiftly through its agenda. Not only might

Congress be split but there are factions to deal with within both parties – as there are in our governments.

### Europe

Boris Johnson and his team of negotiators pulled a rabbit out of the hat on Christmas Eve. Brexit negotiations which seemed to go nowhere for four and a half years suddenly came to fruition and both sides claim to be winners!

Britain got what it wanted on trade, regulation, competition policy and the movement of labour. They did have to give ground on access to British waters. The deal allows for Europe to have a 50:50 share of fish trawled in 2021 falling to a 25% share in five and a half years.

What is surprising is that the side that was pro-Europe in the referendum and thereafter were calling for all sorts of mayhem including a mass exodus from London's financial centre. Clearly that is now seen to have been a massive miscalculation.

But Europe has imposed strong travel bans on flights from the UK because of the new strain of the virus. Because there will effectively be free trade between the UK and Europe, and certain drains on UK resources to Europe will cease or be limited, UK growth may recover strongly from its disastrous growth in 2020. However, the transition will not be quick.

### Rest of the World

While vaccines are being rolled out in some of the wealthier economies, it is not yet clear how developing countries will be allocated vaccine supplies. In order to insulate the world from further outbreaks, all countries need access to appropriate healthcare.