NEWSLETTER

December 2020

SHANLEY
FINANCIAL PLANNING

Introduction

Welcome to the December newsletter, our last for the year. And what a year it has been! In this edition we take a deep dive into the performance of the Australian share market during 2020. In our first edition next year, we will look back on the impact of 2020 on residential property prices and ponder what 2021 might have in store.

Thanks for your support in 2020. Have a safe and relaxing holiday season. You have earned it!

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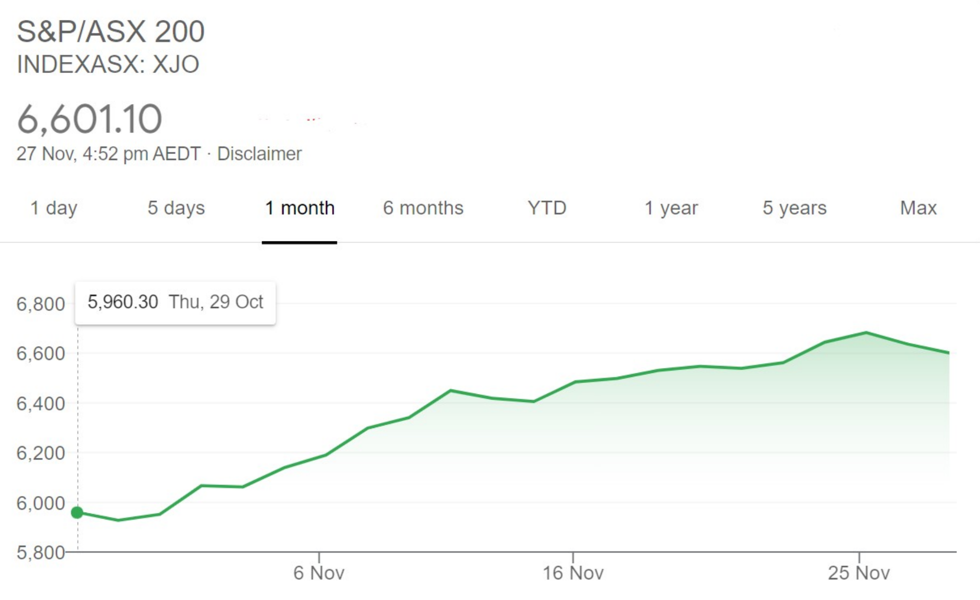
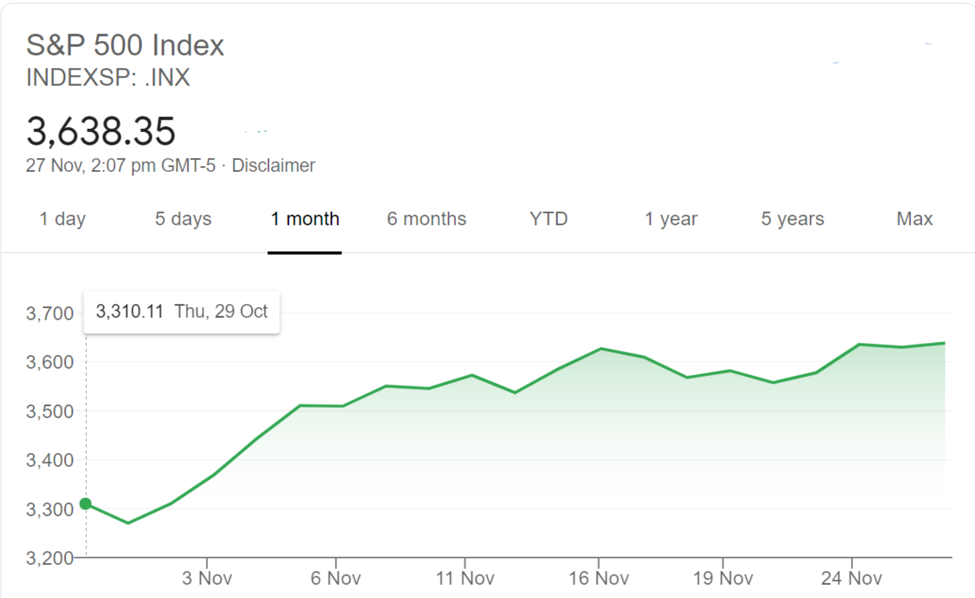
The Share Market

Firstly, let's look at the performance of the Australian share market for the month of November. As measured by the ASX 200, here is how our market looked for the four weeks to the second last day of November. Again, thanks to Google and the ASX for the graph:



As you can see, the market rose from 5,960 points on October 29 to close at 6,601 on Friday November 27 – a rise of 10.75%. This was reminiscent of the US market, whose performance looks like this as measured by the S&P 500 index:



In the US experience, the market rose from 3,310 points on October 29 to close at 3,638 on November 27 – a rise of 9.9%. In normal circumstances, these rises would both be extraordinary in such a short period of time. But 2020 is not, of couse, normal circumstances, and November was not even the single biggest move over a one month period for the year: between March 23 and April 23rd, the ASX 200 rose by 14.7%. In the month immediately prior to that, of course, the market had fallen by 36%. This was a year of big price swings.

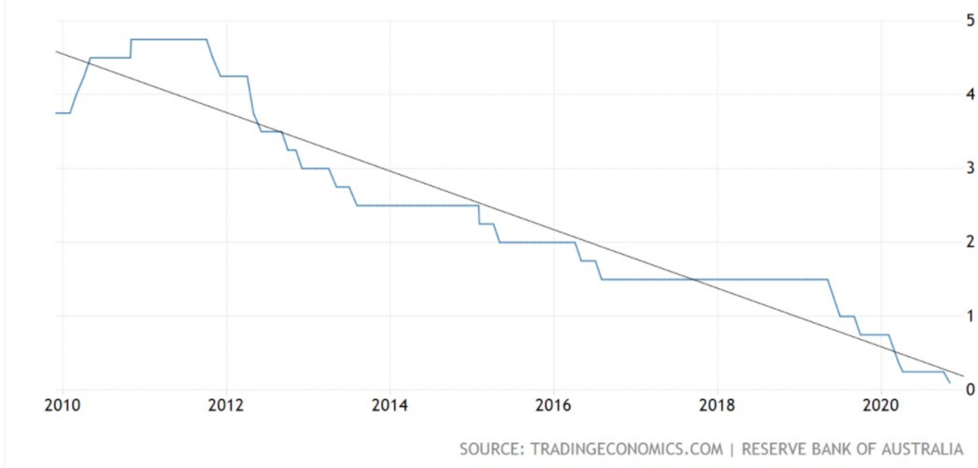
All this means that, while the market was very high at the end of November, it has still not re-attained its all-time high from February of this year, when the ASX topped out at over 7,100 points:

Overall, from the start of 2020 to the end of November 2020, the Australian market is down by just over 1.3%.

Given all that has happened in 2020, this is quite extraordinary. When the full seriousness of Covid-19 became apparent earlier this year, no one could have expected to see the share market in this territory. In seeking to explain this extraordariness, a couple of factors are worth considering in particular. Let's think about each of these in turn.

Are Investors Chasing Income?

As we reported in our article last week, interest rates are at unprecedented low levels in 2020. Here is a graph of the official interest rate target set by the Reserve Bank Board. The graph comes from the website Trading Economics, and shows the target cash rate since the last time that rate rose – in 2009:

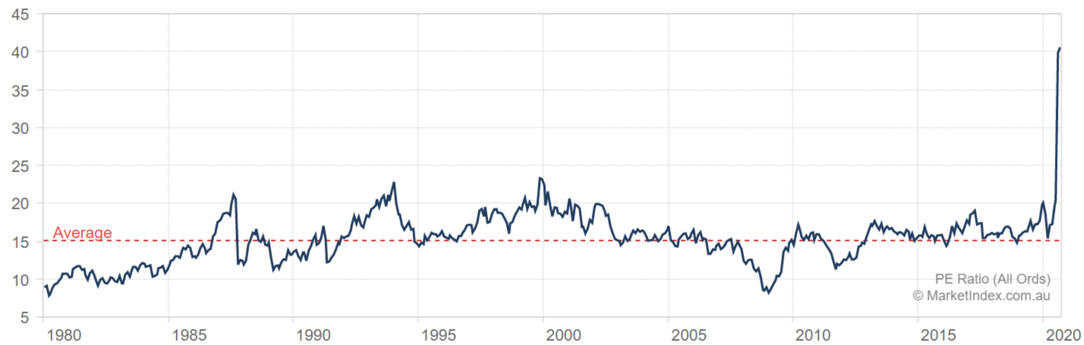


As you can see, official target interest rates have been trending down for the last decade, and are now barely above 0%.

While this has been good news for borrowers, it has been bad news for investors seeking a return on savings held in relatively low risk investments such as term deposits, cash management accounts or, for the more complex arrangements, bonds (often held indirectly through a managed investment). Returns on these investments have fallen to virtually nil and, it seems, this has led at least some people to move money into the sharemarket in the hope and expectation of accessing income returns in the form of dividends from that source.

This theory is somewhat borne out when we examine the ratio of price to earnings as experienced in the ASX. The PE ratio is the price of a company's shares divided by the earnings per share for that company. It tells you how many times higher the share price is compared to the earnings that share is entitled to.

Just as we do with an index such as the ASX 200, we can examine the 'average' PE ratio across the whole market to get a sense of how prices generally are tracking as compared to the underlying earnings that relate to those shares. The aggregated data for PE ratios often has a lag, so here is the data up the end of September 2020, thanks to www.marketindex.com.au:



As you can see, the long-term average PE ratio is about 15. This would suggest that if a company was generating earnings per share of $1, then the shares in that company would be trading at $15. Looked at another way (and we will examine this in more detail below), a shareholder who buys a share for $15 can look forward to earnings for that share of $1. These earnings may or may not be paid out as dividends, but either way thay (in theory) the earnings represent a 1 in 15 return, or about 6.66%.

As you can also see, the most recent PE ratio is well above this long-term average. For September, the figure is over 40, which is easily the highest it has been for the last 40 years.

A high PE ratio is the result of some combination of two things: low earnings per share and/or rising share prices. As we have seen earlier, share prices have risen, but similarly many companies have reported lower earnings due to the economic impact of Covid-19. So, the high PE is a combination of high P and low E.

A PE ratio of 40 implies a total return of just 2.5%, which is well below the long-term average of 6.66%. Dividends derive from this total return. So, on average in the current market, the income return for investors is well below where it usually is. However, 2.5% is still above the returns that are being experienced for defensive, cash-based assets such as term deposits. Indeed, as of November 29, the highest interest rate being paid by one of the bug four banks for a 12 month term deposit is just 0.6% (source: Canstar).

It is this disparity that leads to the conclusion that many investors who would ordinarily hold money in defensive cash-based assets have decided that the returns in that type of investment are not adequate. These investors have invested in shares in the hope that dividends received on those shares will replace the income previously provided by interest on savings.

This is, unfortunately, a risky move: unlike an investment such as a term deposit with a big four bank, the capital value of an investment in shares can fall. So, if investors have moved into the share market to chase the return available there of 2.5% or so, rather than the return of 0.5% or so for something like a term deposit, they will see all of that additional return wiped out if the share market falls by just 2.1%.

This is one of the reasons why we always recommend that a share-based investment needs to 'make sense' in the medium to long-term. Share prices are volatile and this volatility needs to be managed when people move in or out of the market. Moving money 'temporarily' into the share market in the pursuit of income is a high-risk move.

Is the Underlying Economic Situation Actually Quite Strong?

One of the really extraordinary features of 2020 has been the acceptance with which Australian Governments at all levels have approached the need for deficit budgets. The most obvious way in which this has been done has been with the Commonwealth stimulus spending. As a single example, the JobKeeper payment will see the Government spend an estimated $101 billion for the 2019/20 and 2020/21 years. (Source: Treasury). Governments have seen that they need to compensate for the fact that private economic activity has had to be reduced due to Covid-19.

One of the perhaps unexpected impacts of all this stimulus was a massive increase in the extent to which the stimulus money was *saved*, rather than spent, by those who received it. Here is a graph, again provided by Trading Economics, showing the proportion of household income that was saved for each quarter up to June 2020:

As you can see, almost 20% of all income received was saved, rather than spent, in the June 2020 quarter. This was a massive increase over the recent average, which (if we remove the March 2020 quarter, during which the economic impact of Covid-19 was already starting to make itself known), was well below 4%.

Some of this saving was undoubtedly a result of there simply being fewer things to buy. At various times around the country, we have faced closures of things that people typically spend money on, such as restaurant meals, gyms, entertainment, etc. People have saved because, to some extent, they had no choice.

People also save when they are concerned for their future. They spend when they are confident that they will be able to replace the money spent with future earnings. So, the rise in savings was in part related to a fall in consumer confidence. Once again, this is borne out by the data. For example, have a look at this table, sourced from the Roy Morgan Institute, and which shows the monthly consumer confidence data for each month in the last ten years:

2010	128.7	126.3	127.6	125.4	119.9	119.2	123.9	125.6	123.5	127.5	123.7	120.6
2011	122.3	118.5	117.0	119.3	117.0	111.0	108.6	107.8	112.0	111.3	114.6	111.0
2012	117.5	114.9	111.6	110.7	110.6	109.7	109.8	113.0	114.1	114.8	114.1	115.7
2013	120.9	119.7	121.0	121.9	115.3	114.6	116.2	115.6	122.3	121.8	121.1	116.3
2014	116.7	113.4	112.8	113.4	102.4	103.3	109.8	112.4	112.5	112.9	114.2	112.2
2015	112.6	111.2	111.3	110.5	111.9	113.5	111.7	112.9	110.0	112.4	115.3	114.8
2016	114.0	112.7	114.6	113.5	114.6	116.3	115.6	118.0	116.6	118.5	115.9	115.8
2017	118.6	116.7	113.2	112.2	111.1	112.5	114.7	112.0	113.2	113.3	114.3	115.6
2018	121.4	118.9	117.7	116.8	119.9	120.7	120.1	116.9	117.3	116.8	117.2	118.4
2019	116.1	115.4	112.0	115.7	116.7	116.1	116.6	115.7	112.8	111.9	111.2	108.4
2020	107.4	108.4	88.5	79.8	92.6	96.3	90.8	89.1	91.8	96.6	103.5**	

Being an index, a score of more than 100 reflects optimism about the economic future. A score below 100 reflects pessimism. As you can see, the score of 88.5 in March 2020 (the third column in the bottom row) was the first time the index had fallen below 100 for the last ten years. The index then stayed below 100 until November 2020, the most recent data point, when it rose again to be above 100. So, throughout the period when savings were rising, consumer confidence was low.

Taken together, the savings data and the consumer confidence data suggest that consumers are about to start spending again. As of November, people again feel positive about the future and, what's more, they have a larger than usual store of money to spend. The economy may be about to 'bounce back.' This prospect was hinted at in the most recent statement of the Governor of the Reserve Bank, which included the following comment:

> "*Encouragingly, the recent economic data have been a bit better than expected and the near-term outlook is better than it was three months ago.*"

This combination of confidence and capability may well be making its presence felt in the share market, where investors are purchasing shares in the expectation that sales, and therefore earnings, are about to rise for the underlying companies.

This speaks to an inherent limitation in any analysis of PE ratios such as the one we provide above: the (P) price people pay for a share is (theoretically, at least) based on what they expect the *future* returns on that share to be. But the E figure in the PE ratio comes from *past* earnings. So, in some ways the PE ratio mixes the recent past with the short to medium term future. When things are relatively unchanging, this does not matter much because the recent past and the near future are likely to be similar. But when times are very much changing (did we mention the share market rose by 10% last month? Having fallen by 25% in a four week period earlier this year), this mix of the past and the future can be misleading. The near future can be quite different to the recent past and this can lead us to compare apples and bananas.

If it is the case that confidence is returning and there is saved money waiting ready to be spent, then we can expect future earnings to rise from the levels seen so far in 2020. When earnings rise, PE ratios fall (unless prices rise by the same proportion). Therefore, an increase in earnings can be expected to reduce the average PE ratio from its current very high levels.

An expected rise in upcoming earnings would go at least some way to explain why prices have risen so much, to the extent that they are almost at the same level as they were in January, before the pandemic. Investors are assuming that earnings will return to those levels, as well.

That said, from this point earnings would have to more than double for the PE ratio to revert to it's long-term average of just over 15 without prices falling. At this point it is worth observing the very next comment that the RBA Governor made in his most recent statement:

> *"Even so, the recovery is still expected to be bumpy and drawn out and the outlook remains dependent on successful containment of the virus."*

The share market seems to think that Australian economy is now 'out of the woods.' Time will tell. Things like the average PE ratio tend to come back to average over time. Rising earnings would have this effect, but so would falling prices. The market is guessing on the earnings side of this equation.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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