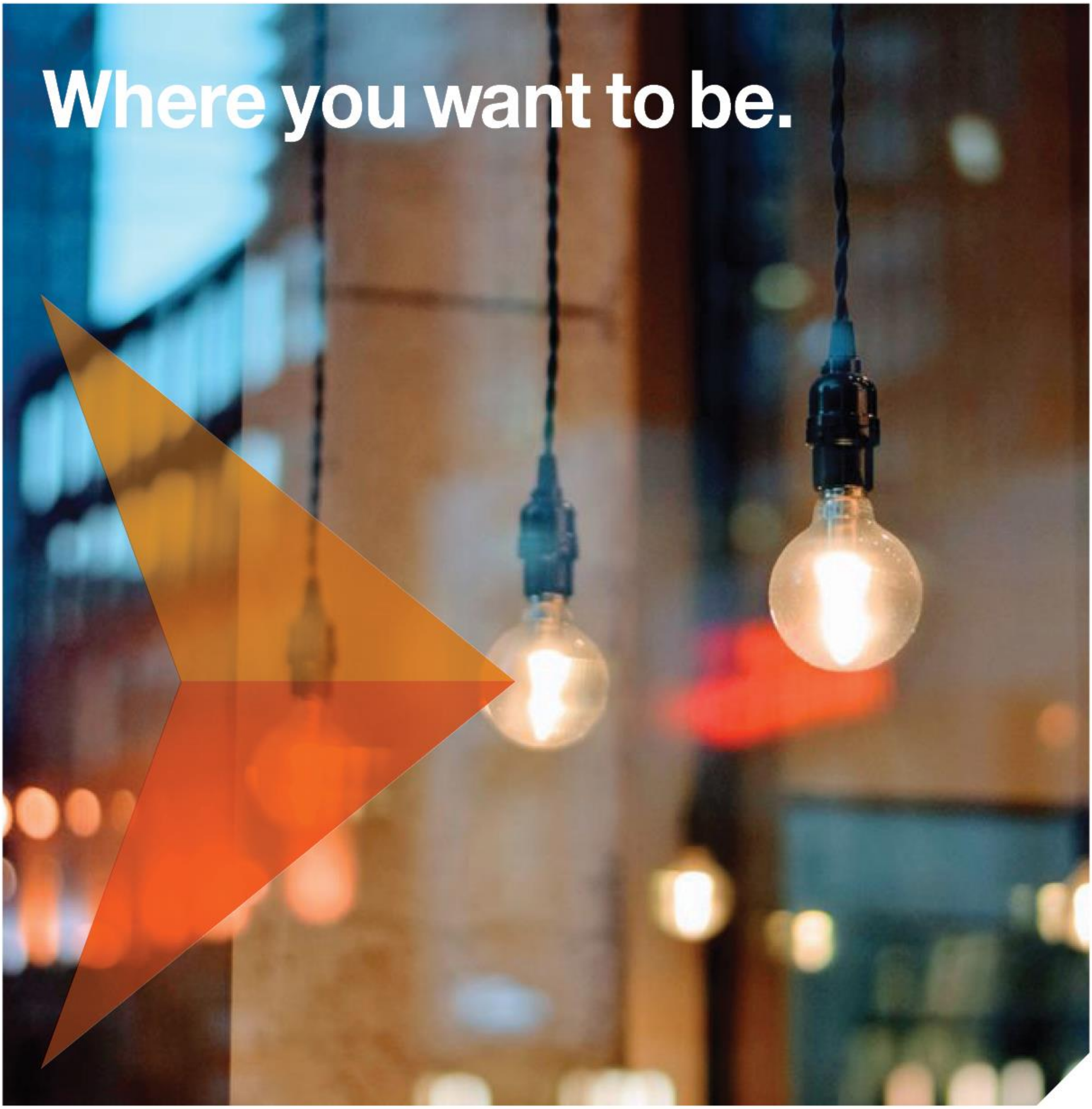

Economic Snapshot

February 2021 in Review

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In summary

February was a re-run of January in that markets started on a strong note, with equities posting very good gains in the first half of the month, only for conditions to reverse later in the month. However, while online trading caused the volatility in January, it was the bond market that caused the trouble in February.

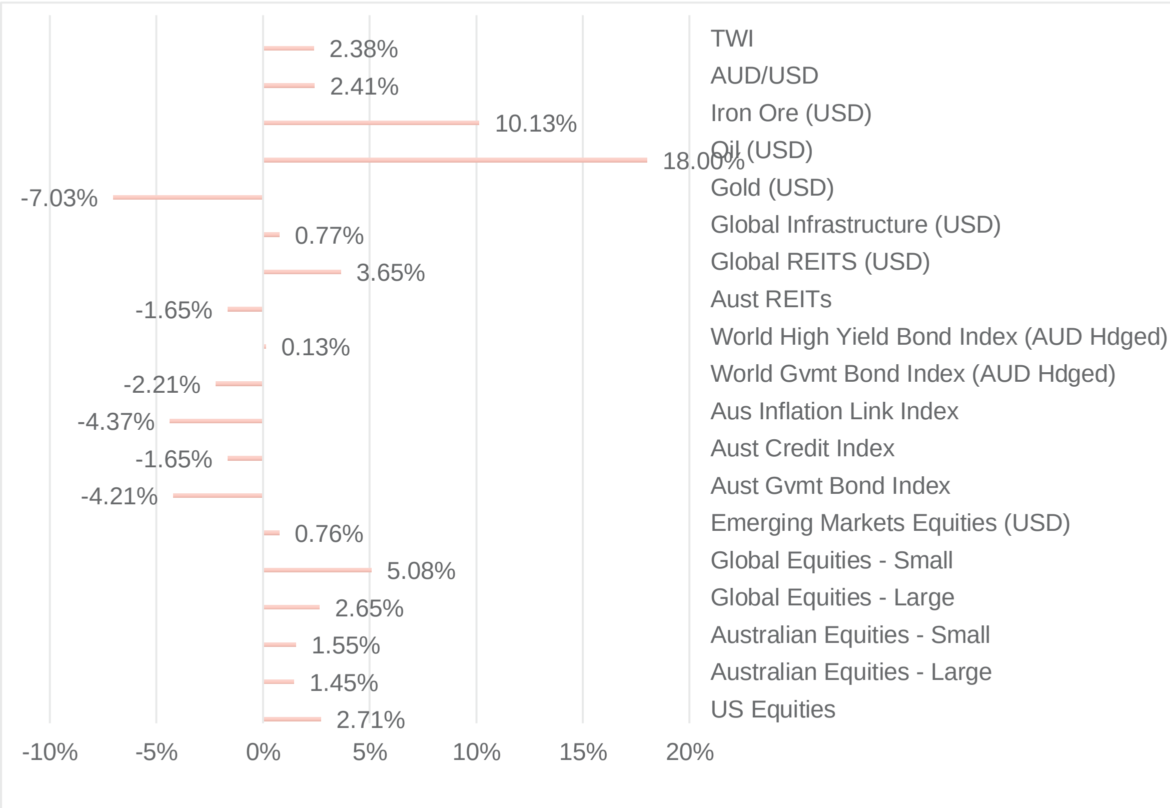
US government bond yields have been rising for a few months as investors price expectations of higher inflation, but in February it was more a case of expectations of higher growth. This spilled over into bond markets around the world. Here in Australia, the 10-year government bond yield rose from 1.11% at the start of February to 1.87% at the end of the month.

Higher bond yields are a threat to the expensive valuation of equity markets, especially tech stocks. Equities fell in the second half of the month, with emerging markets and growth stocks hit the hardest. AREITs underperformed in the month.

The A$/US$ rose to just over US$0.80 on 25 February before dropping back to close the month at US$0.783. The A$ was supported by a higher iron ore price and a wider differential of Australian bond yields over US bond yields.

The price of gold fell 7% in February as US real bond yields rose. The price of oil rose 18%, driven by expectations of stronger demand for oil as global growth improves, and by the reduction in supplies caused by the extremely cold weather across US oil producing states.

Pressure from bond markets undermined equity markets in the second half of February



Sources: Thomson Reuters, Bloomberg

Key developments in February 2021

February was a re-run of January in that markets started on a strong note, with equities posting very good gains in the first half of the month, only for conditions to reverse later in the month. However, while online trading caused the volatility in January, it was the bond market that caused the trouble in February.

US government bond yields have been drifting up for a few months, but the pace increased sharply in February. The 10-year bond yield started the month at 1.08% and finished at 1.45% with most of the move occurring in the second half of the month. These pressures spilled over into bond markets around the world. Here in Australia, the 10-year government bond yield rose from 1.11% at the start of February to 1.87% at the end of the month. The Australian government bond index posted a loss of 4.2% for the month. Yields rose so quickly that it looked like a degree of forced selling was involved and not just a re-assessment of underlying economic conditions.

Since late last year the US bond market has become increasingly concerned about the risk of higher inflation in the US in the wake of a massive spending program from Biden on top of the already huge Fed stimulus. This was reflected in the difference between nominal and real yields, which rose from around 1.7% in late November to 2.1% at the end of February. These figures indicate how much inflation the bond market expects. Importantly, this increase in inflation expectations was driven by nominal yields rising, while real yields were quite steady.

What was interesting in the second half of February was that real yields started rising as well as nominal yields. Real yields are a guide to market expectations about real GDP growth. The higher real yields reflected markets upgrading their expectations of US growth this year. So, while the market's inflation expectations were unchanged between the start and end of February, its growth expectations went up.

On the face of it, that should sound like good news. A stronger economy would be a good sign for employment, incomes and profits. However, the markets worry that a stronger economy will lead the US Federal Reserve to lift interest rates sooner than the 2-3 year timeframe that the Fed has indicated. Higher interest rates and bond yields can adversely impact the valuation of equities, especially the higher growth stocks such as tech which are trading at very high levels.

The market's focus on the valuations rather than profits led to a sharp drop in equity markets in the second half of February. The developed market equity indices, including Australia, fell 2% - 3.5% at this time, while the emerging equity market index fell nearly 7%. Value stocks, which do better in a rising interest rate environment, beat growth stocks by a big margin. AREITs, which are sensitive to higher bond yields, fell in February.

In other markets, the A$/US$ rose to just over US$0.80 on 25 February before dropping back to close the month at US$0.783. The A$ was supported by a higher iron ore price and a wider differential of Australian bond yields over US bond yields. The Reserve Bank will not be pleased about the strength of the A$ and will likely resume its program of buying local government bonds to keep yields down and thereby limit further A$ appreciation.

The price of gold fell 7% in February as US real bond yields rose. Higher bond yields do not help the gold price, especially when the higher yields start to reflect expectations of stronger growth rather than higher inflation.

The price of oil had a big month, rising 18%. This was driven partly by expectations of stronger demand for oil as global growth improves, and partly by the reduction in supplies caused by the extremely cold weather across US oil producing states. These weather conditions will pass, and OPEC is meeting soon to consider increasing the supply of oil. It is likely the price of oil will retrace some recent gains rather than rising to US$100 per barrel as some have suggested.

Outlook

As economic conditions continue to improve, we expect equities to remain attractive, especially in those countries and sectors that are more heavily geared towards a recovery.

We anticipate the Australian, European and Emerging markets to outperform the US market which has a higher exposure to expensive technology stocks and growth sectors. Bond market conditions remain challenging, as yields are likely to push higher in the short term, although Central Banks will do everything in their power to limit the upward drift. Bond strategies that are less exposed to interest rates should outperform in this scenario.

MAJOR MARKET INDICATORS

	28-Feb-21	Changes over periods shown:*			
		1 Month	3 Months	6 Months	12 Months
Cash rates					
Australia	0.10%	0.00%	0.00%	-0.15%	-0.65%
USA	0.08%	0.00%	0.00%	0.00%	-1.50%
Japan	-0.10%	0.00%	0.00%	0.00%	0.00%
Europe	0.00%	0.00%	0.00%	0.00%	0.00%
10 Government bond yields					
Australia	1.87%	0.78%	0.98%	0.89%	1.07%
USA	1.45%	0.35%	0.61%	0.77%	0.30%
Japan	0.16%	0.12%	0.13%	0.12%	0.31%
Europe	-0.26%	0.26%	0.31%	0.14%	0.35%
Equity markets					
ASX200	6673	1.0%	2.4%	10.1%	3.6%
AREITs	3106	-2.2%	-7.8%	3.0%	-15.9%
S&P 500	3811	2.6%	5.2%	8.9%	29.0%
Topix	1864	3.1%	6.2%	15.2%	23.4%
EuroStoxx	3636	4.5%	4.1%	11.1%	9.2%
MSCI Emerging Markets	1339	0.7%	11.1%	21.6%	33.2%
VIX volatility index	27	-15.7%	35.4%	5.4%	-30.2%
Currency markets					
Aud/Usd	0.7829	2.4%	5.9%	6.5%	20.0%
Aud TWI	64.50	2.4%	4.9%	3.0%	13.2%
Usd/Yen	106.54	1.8%	2.2%	0.5%	-1.2%
Euro/Usd	1.2138	-0.1%	1.5%	1.5%	10.5%
Commodity markets					
Gold	1727.4	-7.0%	-2.6%	-12.2%	8.9%
Oil	61.6	18.0%	36.2%	44.4%	37.3%
Iron Ore	174.0	10.1%	33.3%	39.2%	105.9%
Coal	84.9	0.0%	35.4%	68.2%	24.1%

* For cash rates and bonds the changes are % differences; for the rest of the table % changes are used.

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