2020-21 financial year in review

12 July 2021

John Owen

Portfolio Specialist

While COVID-19 remains a serious global health issue, government and central bank stimulus successfully engineered a remarkable economic recovery, resulting in strong share market returns.

2020-21 was a remarkable year of economic and market recovery, but COVID-19 risks remain

Despite the ongoing threat of COVID-19, massive fiscal and monetary support measures were successful in engineering an extraordinary global economic recovery. Share markets recorded very strong gains in response, offsetting the large losses in the March quarter 2020 when COVID-19 first spread across the world. Confidence that the recovery in economic activity and corporate earnings can be sustained received a significant boost in November 2020 when the successful development of a number of vaccines were announced. Markets are hoping that rising vaccination rates will reduce the necessity for disruptive social and business activity restrictions. However, vaccination progress varies across countries and the emergence of COVID-19 variants such as the highly infectious Delta strain means that the world has a long way to go before returning to 'normal'.

Table 1: Asset class returns in Australian dollars – periods to 30 June 2021

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	0.1%	1.0%	1.3%	2.2%
Australian bonds	-0.8%	4.2%	3.2%	4.9%
Global bonds (hedged)	-0.2%	4.0%	2.9%	5.3%
Australian property securities	33.9%	8.2%	6.2%	12.0%
Global property securities (hedged)	30.2%	4.9%	4.7%	8.3%
Australian shares	27.8%	9.6%	11.2%	9.3%
Global shares (hedged)	35.3%	13.0%	14.0%	11.9%
Global shares (unhedged)	27.7%	14.0%	14.4%	13.9%
Emerging markets (unhedged)	29.2%	10.7%	12.8%	8.1%

Benchmark data: Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Bloomberg Barclays Global Aggregate Index Hedged to $A (global bonds), S&P/ASX200 A-REIT Total Return Index (Australian property securities), FTSE EPRA/NAREIT Developed Index (gross) hedged to $A (global property securities), S&P/ASX200 Total Return Index (Aust shares), MSCI All Country World Indices hedged and unhedged (net) in $A (global shares), and MSCI Emerging Markets (gross, unhedged).

* Annualised returns. Past performance is not a reliable indicator of future performance.
Sources: FactSet, MLC Asset Management Services Limited.

COVID-19 concerns prevail but the global vaccine rollout has commenced

The COVID-19 virus remained a global threat throughout the financial year. After its emergence in the first quarter of 2020, global virus infections grew to around 200,000 per day by the beginning of the financial year. Public health policy failures in some countries and the decision by some governments to reopen economies saw daily infections rise to over 600,00 by the end of the 2020 calendar year. This surge in new infection cases was centred on Europe and the US while India and other emerging countries suffered similar devastating infection numbers in the second half of the year.

The indifference of the Trump administration towards the virus and lax approach to imposing social activity restrictions in some American states caused infection rates and deaths in the US to soar in the final quarter of 2020. The response in Europe to the surge in infections was more strident and decisive with widespread activity restrictions including the closure of bars and restaurants while some countries also imposed curfews. The UK introduced similar restrictions on business and social activity.

Confirmation in November of the successful development of a number of vaccines raised hopes that social and economic circumstances may return to 'normal'. In the US, President Joe Biden's election led to targeted measures to both reduce the infection rate and accelerate the vaccination of the population. This was largely successful with infection numbers and deaths falling dramatically. In Europe, lockdown measures were also successful in reducing infections. Tragically however, infections in India soared to over 400,000 cases per day by May as a new highly contagious 'Delta' variant emerged. As with the original COVID-19 virus, the Delta strain has spread globally. The Delta strain contributed to an alarming spike in UK daily infections late in the year while in Australia the virus necessitated lockdowns that at one stage affected nearly half the population.

In a welcome contrast to the first months of the pandemic, hospital admissions and deaths fell dramatically as many countries successfully implemented their vaccination programs. By the end of the financial year, around 11% of the world's population was fully vaccinated and around 23% partially vaccinated. However, country specific vaccination rates varied considerably. In the US, 46% of the population were fully vaccinated by 30 June while in the UK, 48.7% were fully vaccinated. European vaccination rates are improving after a slow start with many of the larger nations like Germany and France having fully vaccinated between 30% - 40% of their populations. However, vaccination progress has been slow in Asia with Singapore's 35.8% fully vaccinated status looking an outlier compared to Japan's 12.1%, South Korea's 9.8%, Indonesia's 4.9% and India's 4.2%.

Australia's track record in limiting the spread of the virus was superior to most countries although rising case numbers did at times force state governments to impose restrictions. All of the major cities have imposed lockdowns at some stage, with Victoria's extended lockdown from July to October 2020 being the most troubling. Melbourne, Sydney, Brisbane, Perth and Darwin struggled with lockdown as recently as June 2021. Australia's vaccination program was plagued by a number of problems, including cancelled or delayed internationally sourced vaccine supplies, a slow start to local production and delivery issues. The Federal government's decision to recommend limiting the AstraZeneca vaccine to people over 60 following instances of blood clotting in younger recipients also contributed to below target vaccination rates. As a result, only 5.9% of the Australian population had been fully vaccinated by 30 June. However, the vaccine rollout is expected to accelerate when the anticipated supply of Pfizer and Moderna vaccines increases towards the end of the calendar year and state governments open more mass-vaccination centres. The vaccination rate should also improve once people who are partially vaccinated receive their second injection.

The global economy staged a remarkable recovery despite the presence of COVID-19

The economic recovery has been 'multi-speed' with the US and China rebounding strongly while Europe and Japan have lagged in comparison, due principally to social mobility restrictions to halt the spread of the virus.

Thanks to the powerful combination of monetary and fiscal support by the US Federal Reserve (the Fed) and the US government, the US economy recovered strongly from the disastrous decline in the June quarter 2020. The economy grew at an annual rate of 6.4% in the March quarter 2021. The recovery that was evident by the end of the 2020 calendar year was reinforced by the massive spending agenda of newly elected President Biden. Two stimulus packages were announced in the first 100 days of his Presidency. The US$1.9 trillion American Rescue Package which passed through Congress in March provided US$1,400 individual payments to all Americans (following December's $600 payment) plus a range of handouts including an extension of support for the jobless until August. President Biden also proposed a US$2 trillion infrastructure spending plan though this was scaled back to $973 billion to help its passage through Congress. As the economy improved, the unemployment rate fell from a high of 14.8% in May 2020 to 5.8% by May 2021, although this remains well above the pre-pandemic 3.5% in February 2020. According to US payrolls data, there are still 7.6 million fewer jobs than in February 2020.

China's economy rebounded strongly following the sharp contraction early in 2020. China's assertive stimulus measures helped the economy grow by 18.3% in the March quarter although this is measured from a low base a year ago. Signs that China's economic activity was moderating emerged later in the year as stimulus measures were wound back or removed.

In Europe, the implementation of activity restrictions including curfews across the continent late in 2020 in response to high rates of infections slowed the eurozone's recovery. The 0.7% decline in the December quarter's gross domestic product (GDP), followed by a 0.6% contraction in the March quarter, represents the eurozone's second technical recession in 12 months.

The UK economy experienced similar challenges as COVID-19 infections were high for much of the year. UK GDP has yet to return to pre-COVID levels. However, the UK has implemented its vaccination programme with great success, allowing for restrictions to ease. Barring the spread of the new more infectious COVID-19 variants, the Bank of England expects the economy will recover strongly in the remainder of 2021.

Japan's economic recovery has also lagged other developed economies as it has been forced to contend with waves of virus infections and a comparatively low population vaccination rate. In April, a third state of emergency was reintroduced covering Tokyo, Osaka and two prefectures to combat the latest outbreak of infections. This has entrenched divergent performances within the economy with exports surging from last year's lows as a result of the global economic recovery while domestic based industries such as retail continue to struggle. Japan faces the added pressure of hosting the Olympic Games commencing on 23 July following their postponement last year.

Australia's economy also staged a remarkable turnaround, although at considerable cost as the Federal Budget deficit forecast of $161 billion is the highest for decades. However, the deficit is below earlier forecasts, thanks to a better than expected economic recovery and the 108% rise in the price of iron ore which is Australia's largest export.

After contracting -7.0% in the June quarter 2020, Australia's GDP expanded by 3.4% in the September quarter, 3.1% in the December quarter and a further 1.8% in the March quarter. While the rate of recovery has moderated, the economy still grew 1.1% in the year to 31 March to be above pre-pandemic levels. This is an impressive result, especially as the state of Victoria was forced to implement stage 4 restrictions in early August for an extended period due to a spike in COVID-19 infections. The tapering of some government support measures also created challenging circumstances for some households and businesses.

Signs of Australia's recovery were widespread although some sectors remain constrained as a result of COVID-19. The revival in the jobs market and hours worked saw the number of people employed recover to pre-pandemic levels by March 2021 and the unemployment rate fall from a high of 7.5% in mid-2020 to 5.1% in May 2021. Record low interest rates contributed to a 40% rise in housing construction approvals and prices for dwellings increased across the country. The 5.4% March quarter rise in residential property prices was the strongest quarterly growth since the December quarter 2009. Consumer spending has rebounded strongly while recent business and consumer sentiment surveys suggest that Australia's economic recovery still has considerable momentum, barring a serious rise in infections.

Out with deflation, in with inflation

One of the unexpected consequences of the global pandemic and the economic recovery that began in the middle of 2020 has been the emergence of inflation pressures.

The higher inflation readings were accentuated by the 'base effect' as current prices for goods and services are measured against prices a year ago that were generally lower due to the pandemic-induced collapse in demand. The substantial economic recovery following the rollout of massive fiscal and monetary support measures caused demand to rebound, outpacing the supply of many goods and services. This was especially the case for manufactured goods as the closure of factories early in the pandemic, firstly in China followed by the rest of the world, created supply shortages at a time of rising demand. The pandemic also changed demand patterns with stay-at-home workers shifting their consumption to goods at the expense of services.

Supply chain and transportation disruptions also contributed to price inflation. Sea and air freight capacity fell due to shortages of containers and fewer flights, resulting in higher container and freight costs. Aside from the impact of supply bottlenecks and disruptions, prices for some commodities were pushed higher by investors seeking inflation hedges. In the year to 30 June, the London Metal Exchange price of copper was up 55.4% while the price of silver increased 44%.

Evidence of reflation was widespread although not all economies experienced inflation pressures to the same degree. Canada's 3.6% inflation rate for the year to the end of May was the highest for a decade. Britain's 2.1% inflation in the year to May 2021 was above the Bank of England's 2.0% target for the first time in two years while in the US annual headline inflation reached 5.0%, the highest it has been since August 2008. Eurozone inflation increased to 1.6% in April and there are expectations that it could continue rising and exceed the European Central Bank's (ECB) 2% target as the economy continues to recover in the second half of 2021.

In contrast, deflationary conditions persist in Japan with the -0.1% year on year decline in consumer prices the eighth consecutive month of falling prices. At 1.1% for the year to 31 March, Australia's inflation pressures remained subdued and well below the Reserve Bank of Australia's (RBA) 2-3% target band. However, as in Europe and other parts of the world, the RBA expects inflation to rise temporarily as the economy continues to recover. It's in the US where a sustained pick-up in inflation is more likely as massive spending by the government and ultra-low interest rates could result in a further substantial economic expansion.

Despite the widespread evidence of higher inflation and potential for further rises in the second half of 2021, most central banks have avoided changing interest rate policies. This is because they expect price pressures to be "transitory" and eventually recede as supply side disruptions abate. In Australia, the RBA's guidance is that interest rates are on hold until 2024. In the eurozone, the ECB is keeping its policy settings and bond purchasing program steady despite upgrading growth and inflation forecasts for the second half of 2021. The Bank of England maintained the Bank Rate at 0.1% and continued with its supportive bond purchase program as it expects any move in inflation above its 2% inflation target to be temporary. However, the US Fed sent the first signal in June that the era of low interest rates will eventually come to a close while also maintaining the view that recent inflation pressures will transition lower to its target range.

Global share markets produced great returns

After enduring sharp and substantial market falls in the March quarter 2020, share investors have enjoyed a remarkable rebound. For the year to 30 June, global shares returned 35.3% on an Australian dollar hedged basis. This was higher than the 27.7 % return for global shares on an unhedged basis as the Australian dollar appreciated in value against some major currencies.

As they are inherently forward looking, share markets chose to look beyond the immediate social and economic dislocation caused by the global spread of COVID-19 and instead focussed on prospects for economic and corporate earnings recovery. These expectations weren't misplaced as supportive stimulus measures implemented by governments and central banks led to encouraging signs of economic recovery by the September quarter 2020. Market confidence in the longevity of the recovery received a significant boost in November when Pfizer, Moderna and AstraZeneca confirmed they had developed vaccines with encouraging trial results.

Most major share markets closed out the financial year with positive returns. The US share market was by far the best developed market performer, rising by 40.1% (in local currency terms). Aside from the positive response to the vaccine rollout, strong economic data and exuberant forecasts for US corporate profit results underpinned the market's spectacular rise. Investors were also encouraged by expectations that the new Democrat President Biden would implement more fiscal stimulus measures while also struggling to get the planned 7% corporate tax rise through the Republican controlled US Senate. The US market had been narrowly led prior to the vaccine announcements in November with technology and online shopping giants such as Facebook, Apple, Microsoft, Google and Amazon accounting for much of the market's rise. However, the focus of investors broadened after the vaccine announcements to include sectors and companies more exposed to the improving economic cycle.

The performance of European markets strengthened throughout the year due to the gradual relaxation of lockdown restrictions, good progress with vaccinations, improving economic conditions globally and the ECB's commitment to keeping interest rates low, all of which underpinned confidence that Europe's economy would recover strongly through the remainder of the 2021 calendar year. Germany's DAX Index increased by 26.2% and the French CAC Index rose by 35.5%. Despite the dire economic consequences of COVID-19 in the UK in the December half and a worrying escalation in the rate of infections late in the year, the UK's FT 100 Index still managed to rise by 18.0% over the year. China's strong recovery helped the MSCI China Index to increase by 16.8%, which also contributed to the 29.2% (unhedged) return of the MSCI Emerging Markets Index. Elsewhere in Asia, Japan's Nikkei Index gained 31.3% as the global economic recovery benefitted its manufacturing exporters.

Our share market also performed strongly

Australia's share market also performed well with the ASX200 Accumulation Index returning 27.8% in the year to 30 June. This was our market's highest financial year return for more than three decades. As in other parts of the world, supportive fiscal measures by the Federal and state governments and initiatives by the RBA that included reducing the cash rate to a historic low of 0.1% were successful in restarting the economy. Corporate profits improved with some companies, particularly the large banks, increasing dividends and payout ratios.

As numerous lockdowns across Australia during the year forced people to spend more time at home and prevented travel, the industry sector that produced the best return was Consumer Discretionary with an increase of 46.1%. Companies such as Wesfarmers, JB Hi-Fi and Harvey Norman experienced significant demand growth as people spending more time from home undertook maintenance and put in place work-from-home office infrastructure. Information Technology increased 39.8%, emulating in part the performance strength of the US technology companies as well as strong price performance by AfterPay.

The Materials index was another strong performer. The 34.5% rise was due largely to ideal market circumstances for the iron ore miners BHP, Rio Tinto and Fortescue Metals Group as strong Chinese demand and constrained Brazilian supply pushed the iron ore price upwards by 108.4%. This led to higher earnings and dividends for shareholders.

Of greater significance to the market and a key contributor to its financial year return was the revival in performance of the four large banks - Commonwealth Bank, ANZ, National Australia Bank and Westpac - which collectively account for approximately 18% of the ASX200 index value. The Financials ex A-REIT index increased 40.6% in the year. After suffering sharply lower profits last year which resulted in markedly lower dividends, the banks have been significant beneficiaries of the economic recovery in Australia and New Zealand. Bank share prices rebounded as investors grew confident that the economic recovery would result in lower loan deferrals and bad debts and revive credit growth. Commonwealth Bank reached an all-time high of over $100 per share during the year. The strength of the Australian residential property market and high demand for housing finance also benefitted the banks. The most recent half year profits were above the previous half year results and dividends were also higher. While limitations imposed by the prudential regulator APRA on banks' dividend payout were removed late in 2020, bank payout ratios (dividends paid as a % of earnings) remain below pre-COVID levels.

Fixed income markets also recovered

The recovery in the global economy was reflected in varying ways across the fixed income landscape. While plentiful government and central bank support provided a strong tailwind to most credit assets, this also gave rise to higher inflation expectations, which hurt the performance of long duration fixed income securities.

By July last year, financial markets were already firmly in recovery mode, thanks to the extraordinary levels of fiscal and monetary support. While this was effective at providing liquidity and preventing the cascading wave of defaults and distress that many investors had feared, it was the combination of the US election results (and associated promises of further massive stimulus) and the approval of several vaccines that led to real confidence in a strong rebound from the pandemic. This was reflected in a rapid rise in government bond yields in February and March this year, as investors sought higher-returning opportunities elsewhere. Rising inflation expectations were another driver of rising bond yields, due to a combination of stronger than expected consumer demand, supply chain disruptions, promises of continuing plentiful fiscal stimulus, and central banks committing to letting inflation run somewhat higher than target until the economy has fully recovered.

In the US, 10-year government bond yields rose from 0.9% at the beginning of the year to 1.7% at the end of March, a sell-off that led to one of the worst quarters of performance for bonds in the last 30 years. It was similar in Australia, with the 10-year bond yield rising from 1.0% to 1.8% over the quarter, and there were even signs of life in Germany with the 10-year bond yield rising from-0.6% to -0.3%. The last three months of the financial year saw some reversion, as the US Fed in particular showed signs they might respond to inflation pressures by hiking cash rates earlier than expected, thus reducing the chances of an inflation break-out over the longer term.

In credit markets, the support provided by policy makers allowed companies to raise record levels of debt as they sought to build a buffer to see them through the COVID-19 crisis. However, the cost of that borrowing has been extremely low, and at the same time earnings have been stronger than feared, meaning companies are generally well capitalised and unlikely to face financial difficulties over the next year or two. Default rates over the past 12 months were much lower than expected this time last year, and looking forward, default expectations even among the lowest-rated companies are lower than they have been for many years. This has been reflected in pricing, with credit spreads compressing to post-GFC lows across most sectors of the credit markets, delivering strong outperformance for credit relative to government bonds.

In terms of index performance, global government bonds delivered -1.4% over the year to 30 June, with investment grade corporate bonds higher at 2.7% over the year in Australian dollar (hedged) terms. Australian bonds (-0.8%) slightly underperformed global bonds (-0.2% hedged). High yield bonds performed strongly to deliver 10.0% (hedged) for the year to 30 June, outperforming floating rate bank loans (9.4%). Australian inflation-linked bonds returned 4.3%, well ahead of nominal bonds, benefitting from higher than expected inflation and rising inflation expectations.

Geopolitical issues were prominent as the year progressed

The US Presidential election in November was a major focus for markets. The strong performance of the US economy at the beginning of the year was expected to favour the incumbent President Trump. However, the economic damage caused by COVID-19 and the indifferent and inadequate response by the Trump administration to the worsening health crisis enabled the Democratic nominee Joe Biden to win the Presidency. Predictions the Democrats would easily win majorities in both the House of Representatives and Senate proved to be wide of the mark. The Democrats held the House but with a smaller majority while the Democrats secured the balance of power in the Senate (early in 2021) after winning two run-off elections in the state of Georgia. The incoming Vice-President Kamala Harris will have the casting vote in the Senate as both the Democrats and Republicans have 50 seats each for the next two years.

The Brexit saga continued through the year. After securing parliamentary agreement early in 2020 for the withdrawal, the terms of Britain's exit from the European Union was finally agreed between Brussels and London and ratified just days before the 31 December deadline.

A concerning development was the deteriorating diplomatic and trade relationship with China, our largest trading partner and destination for approximately a third of Australia's total exports. A number of issues over an extended period have contributed to the growing tension, including banning Huawei from tendering for the 5G mobile network, introducing "foreign interference laws" on national security grounds, Australia speaking out on the South China Sea and human rights issues in China and the call for an inquiry into the origins of the coronavirus pandemic. China imposed high tariffs or import restrictions on a range of Australian agricultural and food exports such as barley, beef and wine and also coal. Exports of iron ore to China have not been affected so far as it is a commodity that is crucial to China's ongoing infrastructure development and supply from Brazil remains restricted. Should this change, the impact on Australia's economy, government revenue, share market and currency would be great.

MLC portfolios continue to search for attractive risk-reward opportunities

The current investment environment represents a challenging point in the economic cycle. The combination of high share market valuations, low return potential from cash and fixed income, an unstable inflationary outlook and lingering risks to growth from new COVID-19 variants we think justifies continuing with a 'Participate & Protect' mantra for our multi-asset portfolio investors. Participate and protect facilitates participation in potential market upside to a limit and protection by limiting losses on the downside. The inflation regime remains uncertain so we continue to seek innovative solutions to insulate funds' real returns. As markets have priced the risk of inflation into fixed income values, our actively managed strategies with low duration and a preference for inflation linked bonds over nominal bonds has been rewarding and remains appropriate for all our multi-asset portfolios.

After an extensive research process, baskets of companies with attractive thematic characteristics (eg companies with high and sustainable dividend yields) have been introduced into our multi-asset portfolios. The investment team has also been researching candidate asset classes and strategies such as global listed infrastructure which provide an additional source of return and help insulate the portfolios from inflation risks.

MLC's investment process is ideally suited to deal with an uncertain future

Rather than basing portfolio decisions on a single future, we attempt to understand the many ways in which the future may unfold and the trade-offs between risk and return that each future may entail. A continuation of the current environment is only one of many scenarios that could unfold. By understanding how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad, we can adjust their asset mix to manage possible risks and take advantage of potential return opportunities. This careful analysis means our portfolios are prepared for the range of outcomes that may occur, including having adequate diversification, being risk-aware and being positioned for a range of future market environments.

Important information