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# Rising Bond Yields and Implications for Australian Equity Portfolios

Our weekly view on Australian Equities.

11 March 2021

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# Rapid Rise in Bond Yields

The rapid rise in long bond yields during 2021 has challenged the market narrative around the persistence of low-interest rates. Australian 10-year bonds yields have moved up +100bps to 1.9%.

This is a dramatic rise in such a short period and sharper relative to prior bond market sell-offs over the last 10 years.

The RBA has responded to the rise in long bond yields by expanding its version of QE and recommitting to low interest rates out to 2024.

Australian equities have struggled for direction in 2021 so far. The S&P/ASX 200 index is up ~1.5% YTD, in-line with the MSCI World Index, but below the highs reached in mid-February. The headline performance of the index masks the significant performance divergence between sectors. Cyclical exposed sectors have performed strongly, whilst more defensive and high growth sectors have under-performed.

## Factors behind the rising bond yield

1. COVID-19 Vaccine – The rollout of the vaccine will provide a pathway for a return/resumption of more normal levels of economic activity.

2. Additional global fiscal stimulus – This needs to be financed by the bond market which in turn will push up bond yields.

Read: The Coming Global Growth Revival.

3. Early signs of rising prices (inflation) - rising commodity and oil prices, rising shipping/transportation costs, product shortages (i.e. semiconductors, building products), minimum wage increases in the US from key companies.

## Recent episodes of rising yields

Recent periods of rising yields in Australia have challenged the adage that bonds and equities move in an inverse relationship. In the three most recent episodes of bonds rising in yield by +50bps, we have seen bond yields rise in tandem with equities.

In all three periods, the rise in Australian bond yields was part of a global phenomenon, not driven by Australian specific factors per se.

It's important to note real interest rates have been falling or remained negative in all three episodes.

Exhibit 1: Bond market moves vs. equities

| | Taper Tantrum | Synchronised Global Growth | COVID-19 Reflation |
|---|---|---|---|
| Date | May-Dec 2013 | Sept-Dec 2016 | Nov 20 - Mar 21(?) |
| Length | 7mths | 4mths | 4mths |
| Starting 10Y Bond Yield | 3.00% | 2.00% | 0.80% |
| Finishing 10Y Bond Yield | 4.50% | 2.80% | 1.90% |
| Movemment (bps) | 150 | 80 | 110 |
| Speed (bps per mth) | 21 | 20 | 28 |
| S&P/ASX-100 Index Performance | 10% | 10% | 12% |
| Top Performing Sector* | Materials [+9%] | Materials [+10%] | Materials [+15%] |
| Worst Performing Sector* | A-REIT [-13%] | A-REIT [-12%] | Utilities [-19%] |
| 12mth ASX-100 Return | 7% | 11% | ? |

*Source: Refinitiv, Wilsons. *Relative performance to S&P/ASX 200.*

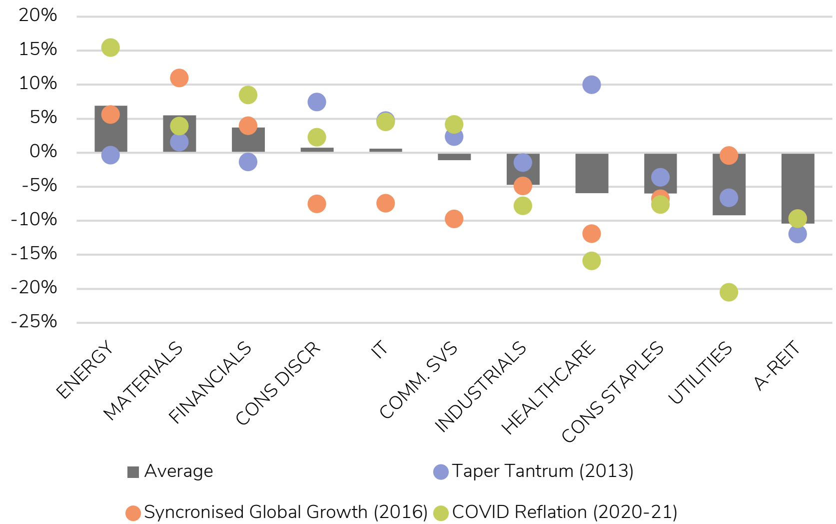
## So, how does the current period compare to the 'taper tantrum' in 2013 and the period 'synchronised global growth' acceleration in 2016?

### We see several similarities:

- Bond yields can rise by well over 100bps. In the absence of core inflation breakout, bond yields will not keep rising in a straight line, particularly with the cash rate anchored at zero.
- A combination of both the rise in the yield and the speed at which the yield rises is important. The current COVID-19 reflation period has seen bond yields rise much faster than in prior episodes. In our view, it is the speed of the bond yield move that is the more powerful force in driving the equity market rotation rather than actual movement in the bond yield.
- Cyclical sectors – Materials, Energy, Financials (50% of the market) do particularly well when bond yields are rising. Materials have been the best performing sector across all three periods. This is simply down to investors wanting to position into sectors with the strongest exposure to the recovery.
- The worst performing sectors against rising yields have historically been A-REITs, Utilities and Consumer Staples (13% of the market). All three have minimal earnings leverage to an acceleration in global growth.
- The underperforming sectors typically underperform by a greater amount than the sectors which outperform – this is a function of relative sector weights and the weight of money.

The index composition in Australia is a key reason why the market can keep rising while bond yields are rising. The heavyweight sectors of Materials/Energy and Financials far outstrip the index weight of the defensive sectors.

Exhibit 2: Sector performance in periods of rising yields – a familiar pattern in the tails




*Source: Refinitiv, Wilsons. Relative performance to S&P/ASX 200.*

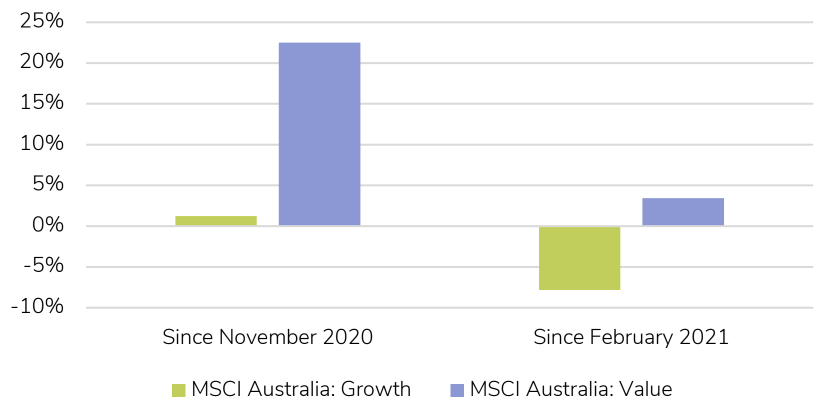
## Value vs. Growth in periods of rising bond yields

Another way to look at the impact of rising bonds yields on the equity market is to split the market into 'Value' vs 'Growth' buckets. The two buckets' performance has been stark since news of the COVID-19 vaccine broke in November 2020. Value has outperformed growth for 4 consecutive months; this comes after a long period of relative underperformance.

The February results season saw more earnings upgrades to Value stocks than Growth. Both technology and healthcare sectors saw earnings downgrades (unusual vs prior result seasons), reinforcing the negative sentiment towards these growth-oriented sectors.

Read: Higher Conviction in the Cycle.

Exhibit 3: Value has outperformed Growth strongly since November 2020




*Source: MSCI, Refinitiv, Wilsons.*

## Australian Equity Focus List

We have written extensively in recent months on the risk of rotation to portfolios. For the best part of 9 months, we have been repositioning the Wilsons Australian Equity Focus List further towards the cyclical/value exposures given our increasing confidence in the cycle. We now sit at around 70% exposure to Australian and Global cyclicals.

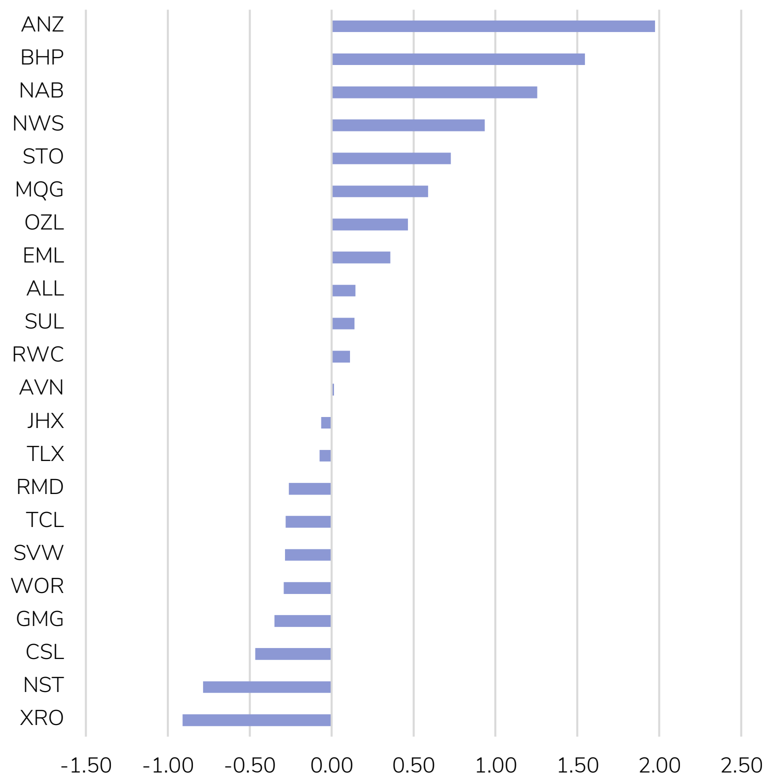
Read: Acting with Conviction.

Pleasingly, from a performance perspective the Focus List has continued to outperform the market. Exhibit 4 shows the performance contribution across the Focus List so far this calendar year.

By number, the majority of positions have positively contributed to performance this year. Just as importantly, the relative weightings between each of the stocks have been part of the story – with positive contributors contributing more than the tail of negative contributors.

The Focus List's overweight positions across cyclical sectors like Financials, Materials, Energy and selected more value-orientated companies like NWS have paid off.

Exhibit 4: Summary Focus List performance contribution in 2021




*Source: MSCI, Refinitiv, Wilsons. Weighted contribution to performance CYTD.*

## So where to from now?

Our view is that a low inflation economic recovery can take place over the next 12-24 months. It's unlikely that rising bond yields will rise so far that it will unravel the case for equities.

Read: Bonds and Equities – Is the Honeymoon Over?

Whilst we don't know how far bond yields will rise in the short term – we would note that the rise has been unprecedented in its speed relative to other episodes over the last 10 years. This suggests that further rises in bond yields could be moderate as investors wait to see how further developments play out.

The market is unlikely to be so black and white in discriminating between so-called COVID-19 winners and losers. Stock specific characteristics are likely to be a more significant factor in performance – particularly companies which can show a **relative acceleration** in earnings growth from here. Indeed some traditional "bond proxies" have been significant COVID losers and may see a significant earnings rebound as the economy re-opens/recovers (e.g. selected REITs, Utilities and Infrastructure).

We are likely to see companies upgrade earnings as activity reaccelerates, particularly cyclical exposed companies across Financials, Materials and select Industrials sectors where we have significant exposure.

This is where both the healthcare and technology sectors are challenged near-term from a relative performance perspective – as both sectors decelerating levels of earnings growth (despite strong secular drivers) – against relatively high valuations in FY21.

Whilst rotation swings in markets are never permanent; ultimately its companies that can show sustained above-market earnings growth that will help drive portfolio outperformance in the long-term. This current period of rotation is likely to create opportunities for the Focus List to revisit long-term growth plays that are currently unloved. Names like **Brambles** (BXB), **Carsales** (CAR), **CSL** (CSL, Focus List – recently down weighted), **Dominos** (DMP), **Next DC** (NXT), **ResMed** (RMD, Focus List), **Seek** (SEK), and **WiseTech** (WTC) within the S&P/ASX 100.

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### Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com