

ESCALA
PARTNERS

October 2020

MONTHLY AGENDA - TIME FOR SMALL TO SHINE?



Time for small to shine?

One of the interesting features of the equity market in October is the relative outperformance of small companies over their larger counterparts.

If we are correct in our view that the trough for this economic cycle is in, then the outperformance we have seen this month is just the beginning. There is a strong historical precedent, looking back over the past 90 years and 14 recessions, for small companies to outperform large at this point in the cycle. The outperformance is longer and larger following major market meltdowns such as what we experienced earlier this year.

Is the trough in for this cycle?

The economic data released over recent weeks and months suggests the economy has bounced back considerably from the low recorded for April. This can be seen in Chart 1 below where we show what the data are telling us for consumption, production and employment.

It is estimated that consumer spending surged by almost 40% in the third quarter amid the economy reopening and the triple-digit rise in auto sales. Strong demand, low interest rates and depleted stock has also supported housing activity. Home builder sentiment has increased to its highest level since records began in 1985.

The rebound in industrial production has not been as extreme as it has been for consumption, but lean inventories will promote stable factory-output going forward.

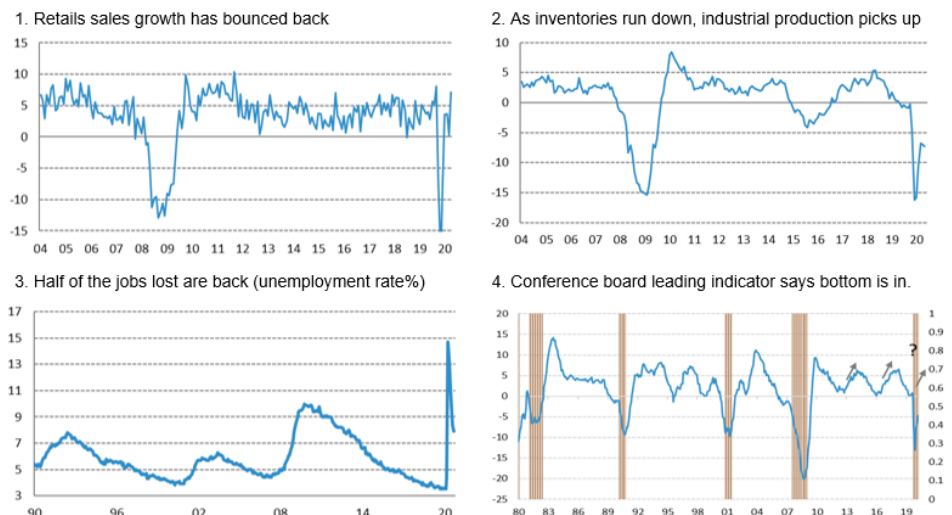
Business fixed investment has also recovered sharply, again to a smaller degree than consumption. It is estimated business investment rebounded by 17% in the third quarter following a 27% drop in the second quarter.

The recovery is continuing in the labour market, albeit at a slower pace as uncertainty rises in line with a rise in new COVID-19 cases.

Also shown in Chart 1 is the Conference Board Leading Economic Indicator (d). This indicator, published by the Conference Board, a non-government organisation, is an aggregation of 10 separate indicators that when brought together provide a reading on where economic growth is headed to next. The brown bars are the months when the US was in recession.

This indicator shows a bottom was hit in April this year. Since that time the leading indicator has been improving. If history is any guide, this suggests that the trough is in for this recession.

Chart 1: US economic data suggests the trough in the cycle is in



Source: Bloomberg, as at 22/10/20



The earnings season is also providing encouraging signals that companies have turned the corner. Not only have most beaten analyst forecasts, they're more optimistic about the future.

This month, 52 companies, including Verizon and Procter & Gamble, have raised their financial outlooks and only six have cut them. The net improvement as a percentage of the total reached 63%, the highest since Bloomberg started compiling the data in 2000.

History tells the story

Empirical research dating back to 1933 shows that US small cap stock indices tend to outperform large cap stock indices in the 12 months following the trough in the US economic cycle (Chart 2).

This has been the case across all 14 recessions studied with just one exception, that being in June 1938 when small caps had a one-year holding period return of 27.6% versus 30.7% for large.

This tendency for small companies to outperform following a trough is the opposite in the year prior to the business cycle peak, where small caps tend to underperform large companies.

In addition to the more cyclically sensitive structure of the small cap indices, it could also be argued that small cap companies tend to be more financially levered than large and have higher interest expenses relative to earnings. This would explain their relative underperformance when interest rates are rising and relative outperformance when interest rates are falling.

Chart 2: Market return 12 months following a trough in the recession

Recession trough	Small cap return (%)	Large cap return (%)	Small cap outperformance (%)
March 1933	296.5	98.8	197.7
June 1938	27.6	30.7	-3.1
October 1945	6.3	-3.7	10.1
October 1949	38.4	34.7	3.7
May 1954	56.7	40.8	15.9
April 1958	57.5	36.4	21.0
February 1961	22.7	14.8	7.8
November 1970	18.1	16.9	1.2
March 1975	68.1	27.2	40.9
July 1980	69.7	20.5	49.2
November 1982	47.2	27.9	19.3
March 1991	39.6	16.0	23.7
November 2001	-4.8	-15.1	10.4
June 2009	23.5	14.4	9.0
Average	54.8	25.7	29.1

Source: Lorne E. Switzer, "The behaviour of small cap vs. large cap stocks in recessions and recoveries: Empirical evidence for the United States and Canada"

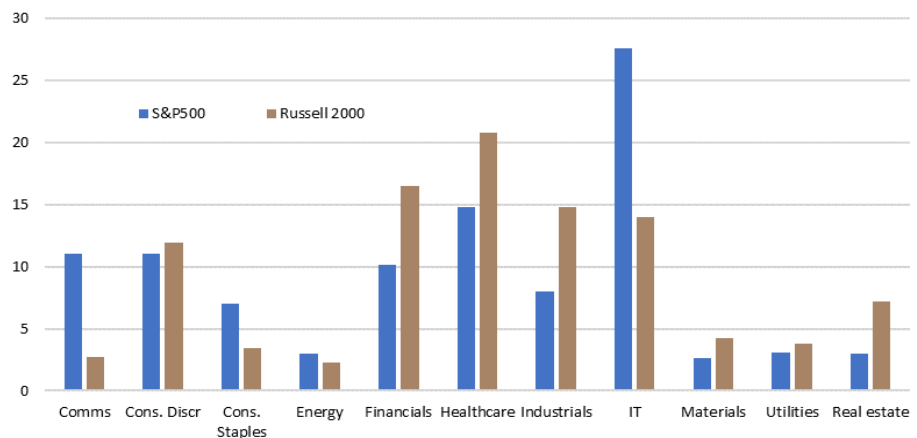


Sensitive to the cycle

The structure of the small cap indices necessarily makes them very sensitive to the economic cycle.

As can be seen by the chart below, compared to the large cap S&P500 Index, the small cap Russell 2000 Index has a higher weight in financials, real estate, and materials. These are considered “Cyclical” sectors as they tend to respond the most to the economic cycle. By comparison, the S&P500 has a much higher weight in the technology and communications sectors compared to the Russell 2000 Index. These sectors tend to be less dependent on where we are in the economic cycle.

Chart 3: GICS Sector Weights in Large vs Small Cap Indices (%)



Source: Bloomberg

Small caps and major market meltdowns

More specifically, history shows that after major market meltdowns, small companies tend to outperform large over longer periods of time.

The chart below shows the performance of small cap indices (blue bars) versus large cap (brown bars) over two previous market meltdowns – the dot.com meltdown in the early 2000s (Panel A) and the GFC meltdown (Panel B).

The comparison is made for global, Australian and US markets over 1, 3 and 5-year time periods.

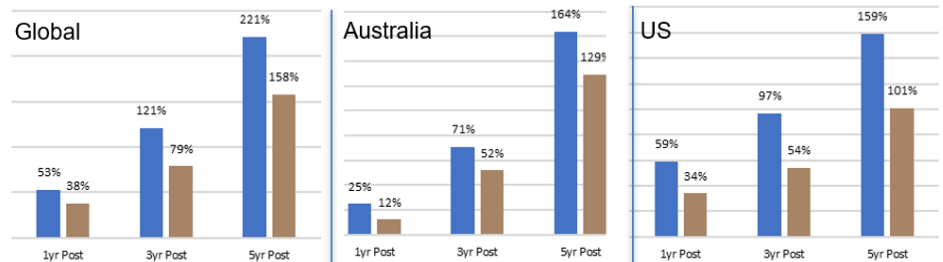
With just one exception, in Australia after the GFC on a 5-year basis, small cap stocks outperform large cap stocks over 1, 3 and 5-year periods following the meltdown.

In many cases the outperformance was substantial, particularly over the 5-year time periods. In the five years after the GFC, the Russell 2000 Index (the US benchmark index for smaller stocks) outperformed the S&P500 by just over 40%. The outperformance was even greater after the dot.com meltdown at almost 60%.

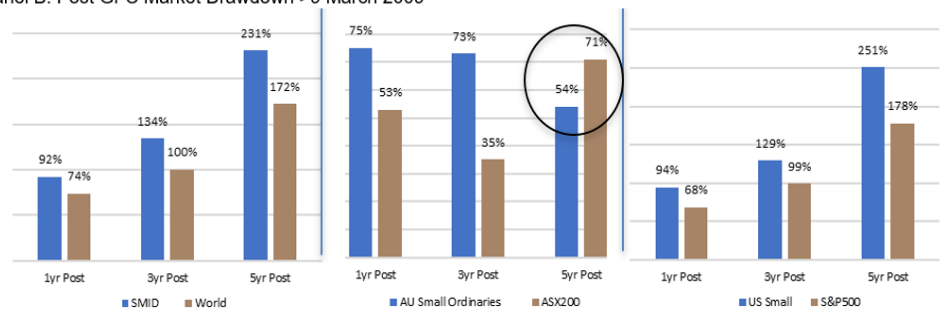


Chart 4: Longer term performance of small versus large after major market meltdowns

Panel A: Post Dot.Com Market Drawdown > 9 October 2002



Panel B: Post GFC Market Drawdown >9 March 2009



Source: Bloomberg

Investment implications

Timing, as they say, is everything.

Officially, the US recession has not yet been declared over. The Business Cycle Dating Committee (part of the National Bureau of Economic Research) are the official arbiter of when recessions begin and end in the US.

They are not exactly a responsive lot. It took the Committee until September 2010 to declare that the US recession following the GFC officially ended in June 2009. By then, the US equity market had risen by 30%.

Historically, recessions end soon after the equity market reaches a bottom. Over the past 14 recessions (dating back to 1933), the trough in the recession was hit, on average, 3.5 months after the market trough. The longest lag was 6.5 months in the 1933 recession and the shortest was 1.5 months in the 2001 recession. In the current cycle, the market trough was in March this year - seven months ago.

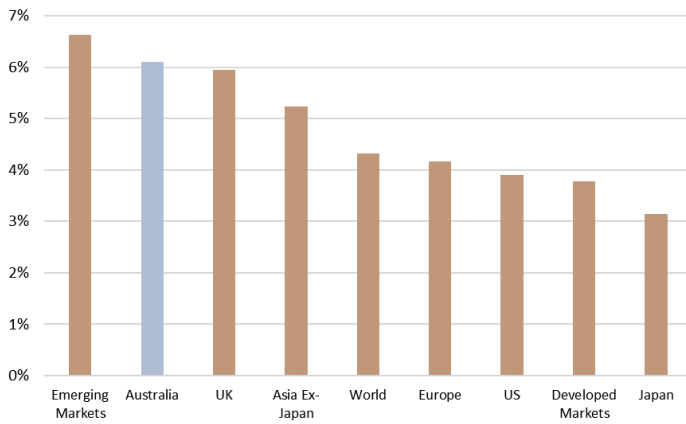
Our view is we are close to, if not already, out of recession in the US. If this is the case, history shows small cap stocks tend to outperform large. For this reason, we advocate an allocation to small cap funds within both Australian and international equity portfolios.



Asset Class View

Australian Equities

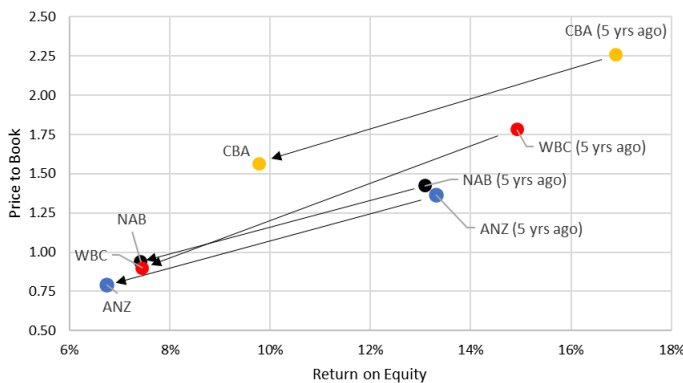
Chart 5: Forward EPS Revisions: September/October



Source: Bloomberg

There has been an increasingly optimistic outlook for the Australian equity market over the last two months on the back of an expansionary Federal Budget, dovish Reserve Bank and easing of restrictions in Victoria as the second wave of COVID19 cases was brought under control. This has been reflected in an improved earnings outlook, with upgrades in the Australian market ahead of all key developed markets since the beginning of September.

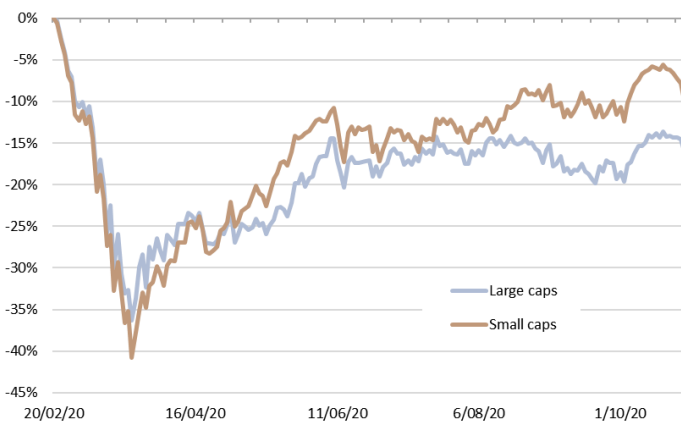
Chart 6: Major Banks: Change in Price to Book and ROE



Source: Bloomberg

The full year earnings season for three of the major banks is getting underway, with the focus likely to be on bad debts, capital levels, net interest margins and volumes. There will also be keen interest on asset quality as a large number of borrowers transition from a loan repayment holiday through the COVID crisis, although the full extent of losses is unlikely to be revealed until 2021. Currently, three of the four majors trade at a discount to book value, although as the chart illustrates, this is reflective of the lower return on equity across the sector.

Chart 7: Australian Equities: Large and Small Cap Performance



Source: Bloomberg

As is typical in a correction, domestic small cap stocks fell more than their large cap counterparts through the sell off in markets in February/March this year. In the recovery phase, however, small caps have outperformed significantly, reflecting the greater leverage to an improvement in economic conditions. We have a constructive view on small caps as the domestic economy reopens, combined with ongoing supportive fiscal and monetary conditions.



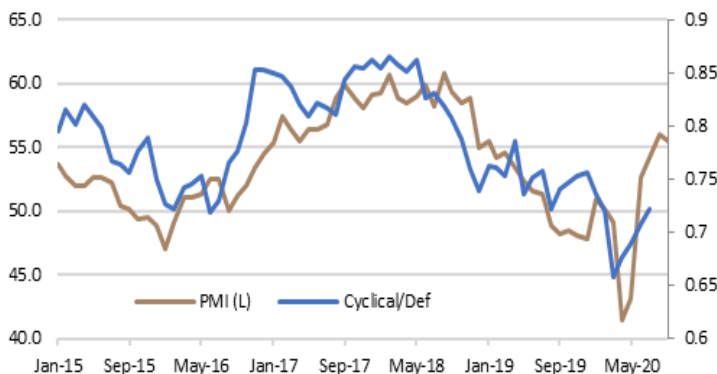
Chart 8: Emerging markets erase 2020 losses



Source: Bloomberg

The MSCI Emerging Markets Index of stocks has shown a burst over the last month and stands at the cusp of hitting a two-year high. China's role in that can't be discounted - an economic rebound without a worrying flareup in Covid-19 cases isn't currently happening in many places. But can it all hold up if the EM-to-developed-market demand loop is broken by rising Covid-19 case counts in the U.S. and Europe? Before that question is answered, a main U.S. political hurdle must be cleared. It has less to do with who will be in the White House and more to do with who is controlling Congress. If Senate Republicans have the power to eschew stimulus on account of its eye-watering price tag, China sentiment will be insufficient to offset the pain.

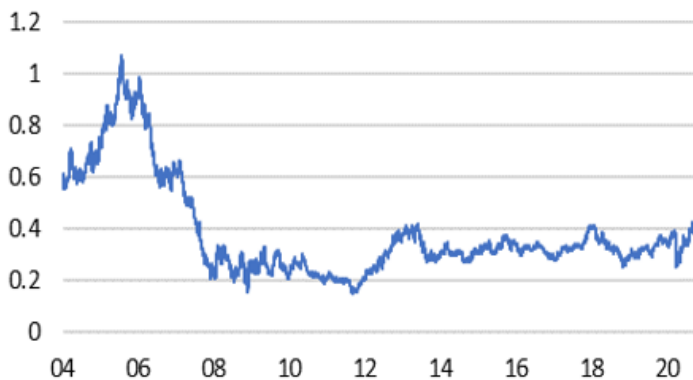
Chart 9: Cyclical stocks vs Manufacturing sentiment



Source: Bloomberg

The cycle appears to be turning in the US. The best measure of manufacturing sentiment is the Index of Purchasing Managers. Whenever this index is above the 50.0 level it suggests manufacturing activity is expanding. Below the 50 line implies contraction. Since April, the PMI has rebounded strongly to be sitting comfortably above 50. Historically a close relationship can be observed between this index and the ratio of cyclical to defensive stocks. This may help explain why small cap stocks have done so well recently.

Chart 10: Homebuilders ratio vs S&P500



Source: Bloomberg

The housing market is one of the strongest areas of the US economy thanks to historically low interest rates and a pandemic-spurred desire for single-family homes. U.S. pending home sales reached a record in August, with prices rising on low inventories. The S&P 500 Homebuilding Index has recovered the most from its 52-week low among sectors, up almost 170%, and hit a fresh intraday high this month.

The strength of the housing market bodes well for further gains, as the boom in builder orders continues. Homebuilders are one of the best-performing S&P 500 sectors this year, and the ratio between the Homebuilders Index and the S&P500 is close to the highest since 2007.



Asset Class View

Fixed Income

Chart 11: US yield curve steepening (bpts)



Source: Bloomberg

The dynamic between U.S. stocks and Treasury yields is once again in focus. Both are rising due to a belief in stimulus-driven reflation. Steeper yield curves tend to be indicators of a pickup in economic activity. Yet once yields rise and curves steepen to key levels, a fresh stocks selloff awaits as valuations become more challenged.

The notion of near-term, highly expansive U.S. fiscal policy steepened the yield curve to as much as 151bps, a level not seen since August 2017.

Chart 12: Reserve Bank loads up on bonds (\$b)



Source: Bloomberg

Australia's 10-year yields are higher than "almost everywhere in the world," Governor Philip Lowe observed on the 15th October. Lowe signalled a package of new measures could be forthcoming at the November policy meeting including the option to buy bonds further out the maturity spectrum from State and Federal Governments. That unleashed speculation that the central bank would announce a plan to purchase bonds at the longer end of the curve as soon as next month, in addition to announcing a rate cut to 0.1%. Such a move would push the RBA balance sheet well beyond the current \$300b level.

Chart 13: Foreign ownership of the US Treasury market (%)



Source: Bloomberg

The US has a trade deficit which means it needs to rely on the kindness of foreigners to help fund it.

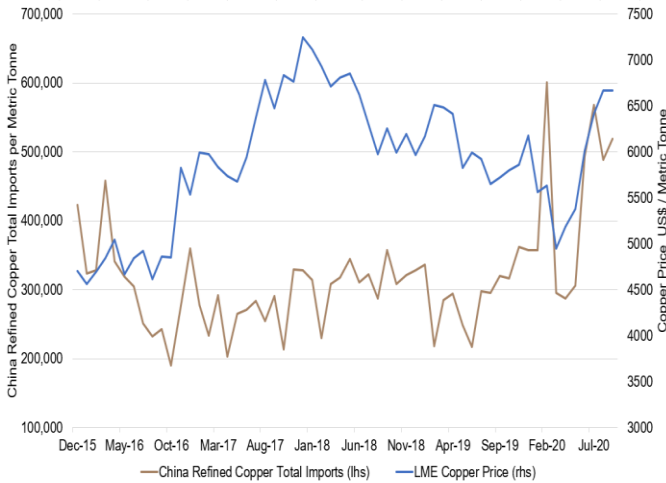
To lure foreign buyers to finance the deficit, U.S. assets need to be attractively priced. With rates suppressed by the Federal Reserve (implying bonds are expensive) and strong demand for U.S. stocks driving valuations in that market higher, the dollar is left as the main channel for adjustment. This chart shows how foreigners remain sanguine about buying US bonds even with the weakness in the currency year-to-date.



Asset Class View

Alternatives

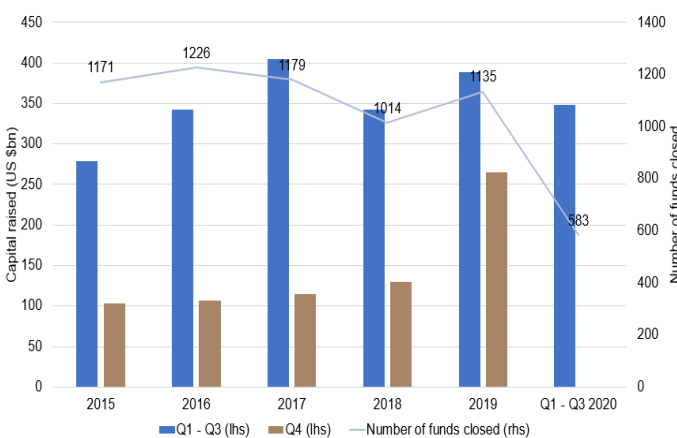
Chart 14: Copper demand rises on clean energy developments



Source: Bloomberg

With decarbonisation now gaining significant traction with governments across the world many of the initiatives are likely to be relatively copper intensive. Copper is a key component for many renewable power generation projects such as wind and solar farm construction, related grid infrastructure, battery storage, and electric vehicle (EV) manufacturing. The Chinese government has set many ambitious targets such as 25% EV penetration by 2025 and has pledged to raise wind power generation by 50GW p.a. through 2025. As a result, Chinese imports of copper in recent months have surged to well above their long term average levels whilst prices remain elevated at \$6,672 per metric tonne, up 34% from their lows in March. Citibank now see price hitting \$7,000 by Q2 2021.

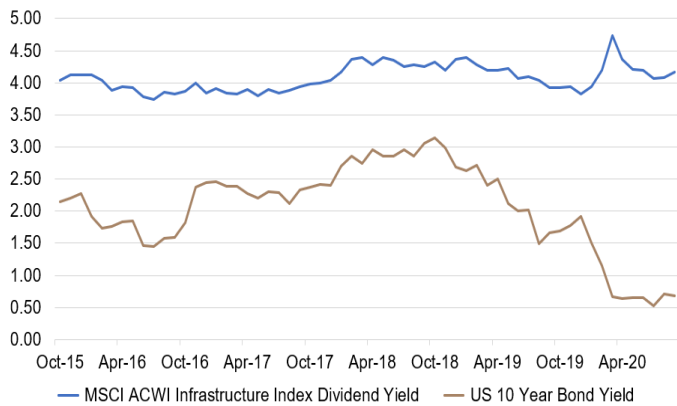
Chart 15: Q3 Private Equity fundraising activity picks up



Source: Private Equity International

Investor appetite for private market alternative investments remains strong despite the pandemic. After a slow start to the year given the heightened investor uncertainty activity picked up in the third quarter bringing the amount of capital raised year to date for 2020 to \$348.5bn, although down from \$388.3bn over the same period in 2019. The number of funds closing this year is down significantly on previous years as investors focus their attention and capital on the largest players in the market. The 10 largest funds that were closed year to date have accounted for almost 30% of all capital raised. The majority of private equity investors surveyed recently by Preqin stated they intended to increase their allocation to the largest private fund managers in their portfolios.

Chart 16: Infrastructure dividend yield spread over bonds widens



Source: Bloomberg

With bond yields sitting close to historic lows investors searching for yield are forced to look further out the risk spectrum to achieve the same level of return. Infrastructure is one area where dividend yields have remained relatively stable in recent times. The sector is also exposed to some of the biggest secular growth stories of our time from renewable energy, 5G and improvements in data infrastructure as well as the aging populations in developed nations all requiring significant investment. The spread of the MSCI All World Infrastructure Index dividend yield over US 10 year bond yields has widened to 349bps from 118bps in October 2018.



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