2020 calendar year in review

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Despite the devastating health, social and economic consequences of COVID-19, most asset classes recorded positive returns for the year.

2020 was a year that challenged us all but ended with hope

The emergence and rapid spread of COVID-19 pushed the global economy into a deep recession and led to substantial market falls early in 2020. In the absence of a vaccine until very late in the year, restrictions on social mobility and business activity were implemented in many countries to control the spread of infection and minimise fatalities. To support households and businesses and sustain the functioning of financial markets, central banks and governments implemented co-ordinated policy measures on a massive scale. As a result, the breadth and depth of the economic decline was not as severe as initial forecasts and encouraging signs of recovery emerged in the second half of the year. This contributed to a remarkable rebound by many share markets following their deep falls in the March quarter, particularly the US share market which was driven by a handful of tech company giants and finished the year up by 17.8%. However, many economies and industries have not fully recovered. Public health policy failures in many countries such as in Europe, the US, UK and Japan saw an acceleration in new virus infections, requiring the reintroduction of lockdown measures. Confirmation of the successful development of a number of vaccines in November helped sustain markets through to the end of the year but the logistical challenges of making the vaccines available to vast numbers of people around the world shouldn't be underestimated.

Table 1: Asset class returns in Australian dollars – periods to 31 December 2020

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	0.4%	1.3%	1.5%	2.4%
Australian bonds	4.5%	5.4%	4.6%	5.6%
Global bonds (hedged)	5.1%	4.6%	4.6%	5.9%
Australian property securities	-4.0%	5.8%	7.4%	11.3%
Global property securities (hedged)	-13.7%	0.1%	2.9%	7.2%
Australian shares	1.4%	6.7%	8.7%	7.8%
Global shares (hedged)	11.0%	8.6%	11.3%	11.0%
Global shares (unhedged)	5.9%	10.6%	10.9%	12.3%
Emerging markets (unhedged)	7.8%	6.7%	11.5%	6.6%

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.

The economic impact of COVID-19 was severe but moderated as the year progressed

The economic and health shock caused by the spread of COVID-19 occurred early in 2020 with the 'virus crisis' proving to be the worst economic downturn since the 1930s Great Depression. Infection rates grew alarmingly in the first half of the year, forcing governments to impose limitations on personal mobility and business activity that had dire economic consequences. In the US, the Federal Reserve Chair Jerome Powell commented that the US economy had entered a "downturn without modern precedent"**.**

The economic downturn was most evident from June quarter economic statistics. In the US, the unemployment rate surged from 4.4% to 14.7% by April and US retail sales that month also fell a record 14.7% due to the massive job layoffs and business shutdowns. These US statistics were replayed across the global landscape with the June quarter decline in global Gross Domestic Product (GDP) the deepest since World War 2.

In Australia, fiscal policy measures such as the "JobKeeper" and "JobSeeker" support programs and relative success in virus containment meant the Australian impact was mitigated, but GDP still fell by 6.3% over the year to June. This followed the March quarter GDP fall of -0.3%, thereby bringing to an end an almost 30 year period without a recession. Perhaps encouragingly, the Reserve Bank of Australia (RBA) Governor Dr Philip Lowe suggested on 28 May that Australia's economic downturn "will not be as severe as earlier thought" but that "much depends on how quickly confidence can be restored". That optimism did prove to be somewhat premature as a worrying second wave of infections in Victoria in the second half of the year required draconian lockdown restrictions.

Global economic conditions improved in the second half of the year as moderating infection rates allowed many economies to gradually re-open and relax social mobility restrictions. In the US, roughly half of the 22 million jobs that were lost in March and April were regained by year end. After peaking at 14.7% in April, the US unemployment rate edged lower to 6.7% in November but remains around double the pre-pandemic level. China's economy rebounded strongly following the -6.8% GDP contraction in the March quarter with 3.2% annual growth in the June quarter and then 4.9% in the September quarter. Massive fiscal and monetary stimulus enabled China's industrial production to grow 6.9% in the year to September, which was a remarkable recovery from the -13.5% fall in January and February.

However, the pace of the global economic recovery has been uneven with economic indicators in many countries remaining below where they were a year ago. India's GDP is 7.5% smaller than it was last year, Japan's GDP has shrunk nearly 5%, Italy's GDP by 5% and the US by 3%. A major concern in the remaining months of a traumatic 2020 was the sharp rise in virus infection rates in key economies such as the US, Japan, Germany and the UK and the emergence of a new highly infectious COVID variant. The re-introduction of restrictions is likely to compromise the economic recovery, with Europe and the UK particularly vulnerable given lockdowns starting in November.

Compared to many countries, Australia was fortunate. Despite the economic impact caused by Victoria's infection outbreak, Australia's economy managed to record a solid recovery in the September quarter with real GDP growing by 3.3%. Consumer confidence at year end was above pre-COVID-19 levels (as indicated by the Westpac Melbourne Institute's Consumer Sentiment survey) which surged in December to the highest result since 2010. The Mid Year Economic and Fiscal Outlook released in December forecasts the 2021-21 budget deficit, while still massive at $197.7 billion, will be smaller than expected due to the rebound in the economy and surge in the price of iron ore. Unemployment fell to 6.8% in November and around 80% of the 1.3 million people who lost their job or were stood down are now back at work. However, many Australian households will continue to be disadvantaged as unemployment is expected to remain at an average 6.25% into the middle of 2022 and the underemployment rate also remains too high. According to the RBA, this will likely require the cash rate to remain at current low levels of 0.1% for at least three years.

Global shares collapsed in the March quarter, followed by a remarkable rebound

For the year to 31 December, global shares returned 11.0% on an Australian dollar hedged basis. This was higher than the 5.9% return for global shares on an unhedged basis as the Australian dollar appreciated in value against some major currencies.

Share investors had to endure extraordinary market gyrations during the calendar year. It is likely that the positive returns numerous share markets managed to record for the year are greater than what many investors thought could be possible given the serious economic consequences of the global spread of COVID-19.

The calendar year began strongly as markets, having already recorded large double-digit returns in 2019, extended this positive momentum well into the first quarter. However, the rapid global spread of COVID-19 and the declaration by the World Health

Organisation of a global pandemic resulted in sharp and substantial falls by share markets in March. For example, the S&P500 Index fell by 9.5% on 12 March, its largest one day fall since the October 1987 crash.

However, global share markets staged an astonishing recovery in the June quarter as many economies relaxed social distancing measures (perhaps prematurely), raising expectations that the economic dislocation will be temporary. In the June quarter, the US S&P500 Index rebounded by 20.4%, pushing its one-year return of 6.9% back into positive territory. In Europe, Germany's DAX Index increased by 23.9% and the French CAC Index gained 13.5% while in Asia, Japan's Nikkei Index returned 18.0%.

The September quarter was another positive one for the global share index as encouraging economic data began to emerge in parts of the world. However, individual market returns were more varied than in the June quarter with some like the UK and French markets losing ground due to fears worsening infection rates could derail or delay the anticipated economic recovery. The US share market continued to lead, rising by 8.8% despite the failure of Congress to agree on further fiscal support measures.

Market confidence received a further boost in November when encouraging vaccine trial results were announced by Pfizer, Moderna and AstraZeneca. Pfizer said initial results found its vaccine was 90% effective in preventing COVID-19 among volunteers who had no prior infection while Moderna's trials indicated 95% effectiveness. One of AstraZeneca's trials returned a 90% effectiveness. These encouraging test outcomes helped global share markets finish the year on a more positive note, outweighing concerns caused by the acceleration in new virus infections across the world, especially Europe, the UK, the US and Japan.

Most major share markets closed out the calendar year with positive returns. The US share market was by far the best performer, rising by 17.8% (in local currency terms) although it was very narrowly led by the tech and online shopping giants such as Facebook, Apple, Microsoft, Google and Amazon. It wasn't until news of the positive vaccine results in November that the performance of sectors more exposed to the economic cycle began to improve. European market returns were soft in comparison with Germany's DAX Index increasing by 3.5% while the French CAC Index fell -5.0% in the year. The dire economic consequences of COVID and worsening health crisis as an aggressive, more infectious strain of the virus emerged late in the year contributed to the -11.6% return by the FT100 Index. China's return to work earlier than most countries helped the MSCI China Index to increase by 18.0%. Japan's Nikkei Index (18.3%) also performed well.

Our share market also recovered to record a positive return for the year, but only just

Australian shares as measured by the ASX200 Accumulation Index (the index) returned 1.4% in the year to 31 December. While this modest return outcome for the year may look disappointing compared to the 23.4% return by the index in 2019, recording a positive return is a considerable achievement considering the complexity of the last 12 months and the significant challenges Australian companies have experienced caused by the economic slowdown.

The start to the new year was promising with our market reaching a new all-time high in February. However, the arrival of COVID-19 on Australian shores and rising infection rates forced the Federal and State governments to implement measures designed to contain its spread. This resulted in a sudden and substantial decline in economic activity with some industries such as hospitality, travel and gaming forced into a sudden closure. The share market's response was savage with the index falling -20.7% in March, one of its worst monthly performances on record.

Despite the wide range of supportive policy initiatives introduced by Federal and State governments as well as action by the RBA, the outlook for the economy was highly uncertain. Business sentiment plunged, prompting many companies to reduce, defer or cancel dividends in order to preserve capital. Some companies came to the market to raise capital to tide them over until the economy recovers.

The profit reporting period in August/September highlighted the adverse impact the economic slowdown was having on specific industries while others were beneficiaries. Supermarket operators Woolworths, Coles Group and Metcash enjoyed growth in sales as households stock-piled food and other essentials. 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. In contrast, industries including airlines, airport infrastructure, tourism, education, casinos and hospitality were deeply impacted.

Industry sector returns varied with some managing to record good gains for the year. The best performer was Information Technology (57.8%), emulating in part the performance strength of the US technology companies. Resource-based sectors experienced mixed fortunes. Miners such as BHP, Rio Tinto and Fortescue Metals Group performed well as the iron ore price increased 70.3% due to strong demand by China and ongoing supply issues in Brazil, leading to market expectations of higher earnings and dividends. The 24.6% rise in the gold price was another contributor to the 18.2% rise by the Materials index.

However, Energy was our market's worst performing sector, falling -27.6%. This reflects the -21.5% fall in the price of oil (Brent crude) over the year. Aside from the collapse in global demand caused by the economic contraction, oil market conditions were also compromised by the initial failure of OPEC and Russia to agree on production cutbacks.

The Financials ex-AREIT index returned -6.3%, underperforming the market. The weaker economy created challenging operating conditions for the banking sector with numerous customer support measures such as the deferral of household and business loan repayments contributing to lower bank profits. Dividends were reduced or suspended altogether, partly as a result of limitations imposed by the prudential regulator APRA on banks' dividend payouts. This restriction was removed late in the year, which led to a rebound in bank share prices in the final weeks of the year.

The Real Estate Investment Trust (REIT) sector also performed poorly for much of the year (-4.0%) due to the dominance of retail-based property landlords in the index. Not surprisingly, conditions for retail operators were very challenged through much of the year due to lockdown measures and initial consumer caution in response to the considerable economic uncertainty. Industrial property owners like Goodman Group exposed to the growth in the digital economy and online retail sales did well. The outlook for commercial/office properties remains uncertain as the trend to working-from-home may be permanent for many industries.

Fixed income markets became unstable but eventually recovered

2020 was a year of solid positive returns from fixed income assets, with annual performance numbers showing almost no sign of the extreme volatility and panic unleashed by COVID-19 lockdowns in March. The strong recovery since April was underpinned by the powerful combination of massive monetary and fiscal support from governments and central banks. The approval of a vaccine in November opened up the prospect of a return to normality much sooner than feared. While these forces delivered strong performance for both government and corporate bonds, they have also pushed interest rates (yields) down to record low levels, reducing return expectations for the next few years. One measure of the scale of the recovery and policy support provided to markets is the quantity of debt outstanding with negative yields, which ticked up to a record US$18 trillion in December, including US$1.5 trillion of corporate bonds.

Relative to the rest of the world, fixed income markets in Australia weathered the storm well, allowing for some significant disruptions in March. Initially, government bonds performed well as concerns around the virus started rising. But in mid-March the concern turned to panic. Riskier markets started to freeze up as investors rushed for cash by selling whatever assets they could. This led to some wild swings in government bond prices, forcing the RBA to step in to preserve market functioning by slashing the cash rate to 0.25%, committing to direct purchases of government and semi-government bonds while also specifically aiming to keep the three-year government bond yield at 0.25% (which entails the RBA buying as many bonds as it takes to maintain that price). These measures were effective in restoring some calm to government bond markets, although it took some time for credit markets to 'unfreeze'. Since then, there was a gradual return to more normal market conditions, although ongoing elevated unemployment and weak growth prompted the RBA to cut its short-term interest rate even further to 0.1% in November. Following the volatility in March, the 10-year government bond yield was range-bound, trading between 0.7% and 1.0%, ending the year around 0.9%.

In the US, the Federal Reserve (the Fed) also cut their cash rate from 1.75% to their lower bound of 0.25% in March as the scale of the crisis became clear. Yields on higher credit risk investments rose at the fastest pace in history, compared to government bond yields. Initially this widening of "credit spreads" was driven by fundamental concerns around corporate defaults, and then exacerbated by leveraged investors being forced to sell out of portfolios at the worst time. Credit spreads on US investment-grade bonds rose from a low of 0.9% in mid-February to a peak of 3.7% by late March while high-yield spreads peaked above 10%.

In response, the Fed and the US government rapidly began rolling out support programs, initially with those that were successfully deployed during the GFC and then entirely new ones. Broadly speaking, these came in three flavours: expanded unemployment insurance and cash grants to individuals; lending programs for businesses to allow them to retain workers and survive the lockdown period; and, support for markets through asset purchase programs (ie. quantitative easing) and liquidity provisions. While previously the Fed had limited its asset purchases to Treasuries and Agency securities, this time it committed to buying corporate bonds as well, even including those recently downgraded below investment grade rating. The programs were effective in restoring market functioning and sparked a recovery in asset prices.

Companies took advantage of the backstop provided by the Fed to raise record amounts of new debt over the following months, but despite that, credit spreads continued to compress. While certain parts of the credit markets (especially those sectors most impacted by the virus) still show some signs of distress, for investment-grade companies spreads are back to where they started 2020, if not tighter. Fears of GFC-level corporate default rates among companies below investment grade also haven't materialised, although some industries like retail, hospitality and energy continue to see elevated distress levels.

Europe entered the crisis in a weaker position than the US with cash interest rates still firmly in negative territory and high debt levels in the peripheral countries. Several long-standing fault lines were highlighted again, most notably the weakness of Italy as reflected in a rapidly widening spread between the yield of Italian government bonds relative to Germany's. Without the room to cut interest rates further, the European Central Bank focused its response on asset purchasing programs as well as relaxing bank regulations to allow lending to companies and individuals. In addition, much needed fiscal support came from the new European Union (EU) pandemic recovery fund which provides loans and grants to the weaker EU countries. In the end, results were similar with a strong recovery in risk assets as investors became comfortable that the worst of the crisis was behind them and the search for yield recommenced.

In terms of index performance, global government bonds delivered 4.9%, with investment-grade corporate bonds higher at 6.7% over the year in Australian dollar (hedged) terms. Australian bonds (4.5%) slightly underperformed global bonds (5.1%). High-yield bonds suffered a 15% fall in March but recovered to deliver a return of 3.5% (hedged) for the year to 31 December, outperforming floating rate bank loans (2.8%). Australian inflation-linked bonds returned 4.7%, in line with nominal bonds.

Geopolitical issues unfolded as the year progressed

As in past years, markets had to contend with a range of geopolitical issues. Some were new while others like Brexit were all too familiar.

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 with a majority of Electoral College votes. 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. Control of both houses increases the likelihood of further stimulus measures and the successful delivery of President-elect Biden's legislative agenda.

Despite the extent of political polarisation in the US and after months of partisan policy gridlock, the Republicans and Democrats finally reached agreement on a fiscal stimulus bill just before Christmas. While much less than markets were hoping for and considerably less than the US$2.7 trillion stimulus package implemented in March, the US$900 billion stimulus plan provides much needed support to American households and businesses as the pandemic and the economic pain it is causing continued into 2021.

The Brexit saga continued to unfold through the year. After securing parliamentary agreement early in 2020 for the withdrawal, the terms of Britain's exit from the EU was finally agreed between Brussels and London and ratified just days before the 31 December deadline. While the agreement means there will be no tariffs or quotas imposed on trade between Britain and the EU from 1 January 2021, the terms of the 1,200+ page agreement which cover living, working, trade and a multitude of issues between them are complex and may present unexpected challenges ahead.

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, more recently coal. The exports affected so far amount to around $22 billion in value. In response, the Australian government referred China's decision to impose high tariffs on Australian barley for adjudication to the World Trade Organisation. Exports of iron ore to China have not be 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 remain defensively positioned while looking for attractive risk-reward opportunities

Leading up to the crisis created by COVID-19, risk management had been prioritised in managing the MLC multi-asset portfolios – the MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios. They had been defensively positioned for some time as the potential reward for taking risk looked unattractive to us. Share market valuations looked stretched, as did parts of the fixed income universe.

The MLC Inflation Plus portfolios protected investors' capital from the substantial market dislocation early in the year due to their elevated holdings of cash, a low exposure to Australian shares, derivatives-based portfolio protection, unhedged global shares and a range of alternative managers and strategies. The MLC Horizon portfolios gained a great degree of defensiveness through their allocation to the MLC Inflation Plus portfolios. The MLC Index Plus portfolios benefited from their investment in the Real Return strategy (a scaled down version of Inflation Plus) and actively managed fixed income.

Looking ahead, our management of MLC portfolios pivots around the continued presence of COVID-19. Despite the development of vaccines and potential roll-out across the globe in 2021, the pandemic remains unbeaten and economies can't return to normal until it is. The investment environment remains complex and challenging.

A significant portfolio challenge we are managing for investors relates to the poor return potential of many standard traditional asset classes used to build portfolios. With interest rates close to zero across the globe and likely to remain there for an extended period, perhaps years, the potential for above inflation returns, from fixed income and cash, looks poor. This increases the reliance on shares as a source of return and requires us to look beyond traditional investment exposures if stated fund objectives are to be achieved. Share markets could continue to be underpinned by the massive funds flow from central bank quantitative easing policies. However, share market valuations aren't cheap, especially as the continued presence of COVID-19 could undermine the anticipated economic and corporate earnings recovery that market pricing already reflects.

To address this important issue, we have focused on developing a series of portfolio strategies that fulfil the dual objectives of 'participate and protect'. The whole 'participate and protect' approach is aimed at finding or creating exposures that can deliver a reliable source of return in an environment where that type of return is not available from traditional low risk sources. For example, we initiated investments in Chinese shares and emerging markets via derivative based instruments including swaps and options which enable the portfolios to benefit when the markets rise, preserving some of the upside while limiting the impact of market falls. A new position in Chinese government bonds was introduced while the gold exposure was hedged to protect portfolios from a steep fall in the price of gold.

The investment team are investigating ways that the 'participate and protect' approach could be extended to include building baskets of companies with attractive thematic characteristics (eg high and sustainable dividend yields) that are aligned with fund objectives. In addition, extensive research has been conducted on candidate asset classes and strategies.

A strategic review of Horizon and Index Plus portfolios' benchmark asset allocations was completed during the year, resulting in a higher weighting to hedged global shares and, for most funds, a lower exposure to Australian shares. These changes were made to improve portfolio diversification and increase access to a much deeper opportunity set available within global shares compared to the Australian share market which remains highly concentrated.

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.

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