QUARTERLY INVESTMENT REPORT FOR DECEMBER 2020

WATERWAYS CAPITAL

INVESTMENT OUTLOOK

The U.S. Food and Drug Administration, the European Commission and the World Health Organization authorised Pfizer's Covid-19 vaccine for emergency use in December, clearing the way for millions of highly vulnerable people to begin receiving the vaccine. Once a vaccine has been listed for WHO emergency use, the United Nations health agency said, it "engages its regional regulatory networks and partners to inform national health authorities on the vaccine and its anticipated benefits based on data from clinical studies to date."

Global financial conditions have remained accommodative, supported by substantial fiscal and monetary policy stimulus. Central banks have continued to emphasise that they will maintain the current easy stance of monetary policies for some time and provide further stimulus if required. Yields on long-term government bonds in the advanced economies have risen a little in response to the positive news on Covid-19 vaccines but have remained at very low levels. Central bank bond buying programs have provided an offset to the effect on yields stemming from the ongoing high level of government bond issuances necessary to fund stimulus programmes.

Equity prices in major markets again increased sharply during the December quarter and continued to be driven higher by some of the largest government stimulus ever, unlimited support from central banks and optimism about how quickly the economy is likely to bounce back next year as coronavirus vaccines become widely distributed. Investors have largely ignored the economic pain brought on by the virus, including pronounced unemployment and battered small businesses. The U.S. equity markets ended 2020 at all-time highs.

Investors are focused on the future and not about what is happening right now or what happened in the past. Goldman Sachs predicts economic growth of 5.9 percent in 2021 in the United Sates, the best annual increase since 1984. And the unemployment rate is expected to fall to 5 percent, according to the U.S. Federal Reserve, meaning 2 million more people could return to work in the United States. Corporate earnings are forecast to increase sharply in the second half of 2021, and importantly, analysts say, equities remain appealing for many investors because interest rates are so low, making them more attractive than other assets such as bonds.

As the extent of the coronavirus became clear in March, investors sent equity markets tumbling into a so-called bear market. But it turned out to be the shortest downturn in history. Since the U.S. equity market bottomed on March 23, the S&P 500 has risen 68 percent, shattering all-time records along the way. The rebound reflects Wall Street's optimism about 2021, but it also underscores the sometimes disconnect between equity markets and the economy.

It is worthwhile noting that households in most parts of the world have increased their savings significantly during 2020 as they spent less on dining out, travel and entertainment. There's "north of $1 trillion of accumulated savings in the United States," Richard Clarida, vice chair of the U.S. Federal Reserve, said at a Brookings Institution event in November. "This is the only downturn in my professional career in which disposable income actually went up in a deep recession." Economists predict that some of the accumulated household savings will be spent in 2021, creating a major tail wind for the global economy.

During 2020, the Australian dollar strengthened sharply against the U.S dollar and other major currencies. The main driver was an increase in the iron ore price of more than 70% to record highs on strong Chinese steel demand and ongoing supply disruptions in Brazil.

For now, the path forward for the economy remains uncertain and will depend in a large part on the success in containing the virus through successful vaccination rollouts. A full recovery is unlikely until people are confident that it is safe to reengage in a broad range of activities. The path forward will also depend on the policy actions taken at all levels of government to provide relief and to support the recovery for as long as needed.

Our investment philosophy has always been to focus on quality, in particular financially strong companies with plenty of cash and low debt as these companies can ride out the tough times. Even in extreme conditions such as those experienced in 2020, we expect the companies we are invested in to survive, and then to thrive again once we get to the other side in 2021 and beyond.

ECONOMIC OVERVIEW

AUSTRALIAN ECONOMY

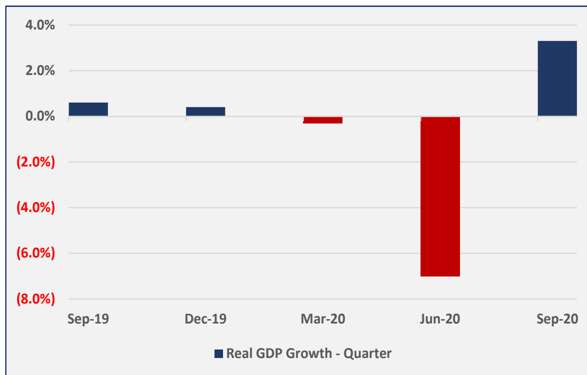
In the December quarter, the Australian economic recovery has gained reasonable momentum, aided by the lifting of restrictions in Victoria. Expectations for GDP growth have been upgraded by economists, and employment has also recovered faster than anticipated. In November, the unemployment rate decreased to 6.8%. However, there continues to be a significant amount of spare capacity in the labour market and the economy more generally. Ongoing fiscal and monetary support will therefore be required for a considerable period.

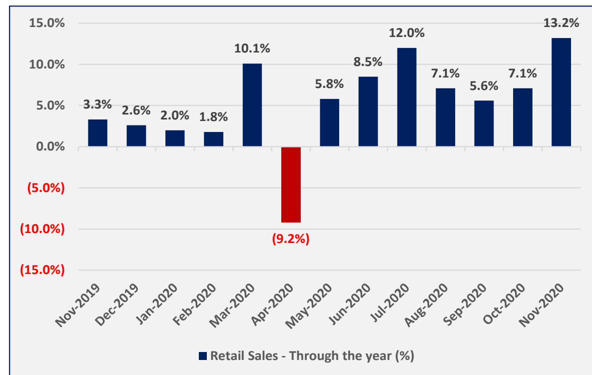
On the positive side, a rebound in household consumption is well under way following a record contraction in April. Retail sales rose 13.2% in November compared with November 2019. High household savings are also likely to support consumption in the period ahead.

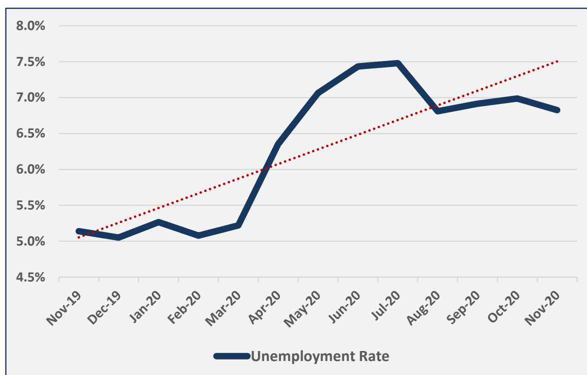
Conditions in the domestic housing market are improving. However, an important factor in housing market conditions has been the slowdown in population growth because of the closure of international borders; this has been more consequential in Australia than in many other economies. The decline in net overseas migration has affected conditions in the rental market in particular, with rents falling and rental vacancy rates in inner-city Sydney and Melbourne around their highest levels in many years.

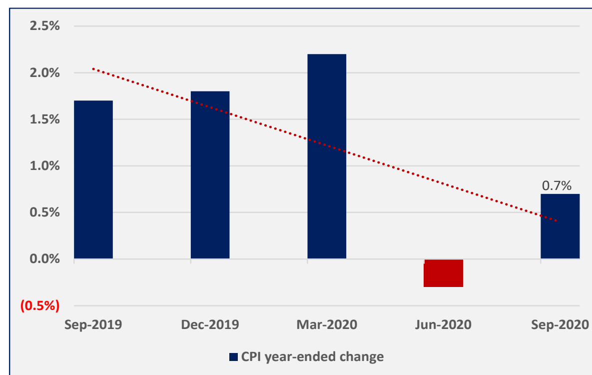
The Reserve Bank of Australia remains committed to not increasing the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth would have to be materially higher than current levels. This would require significant gains in employment and a return to a tight labour market. Given the outlook for inflation, the RBA does not expect to increase the cash rate for at least 3 years.

Key Australian Economic Indicators

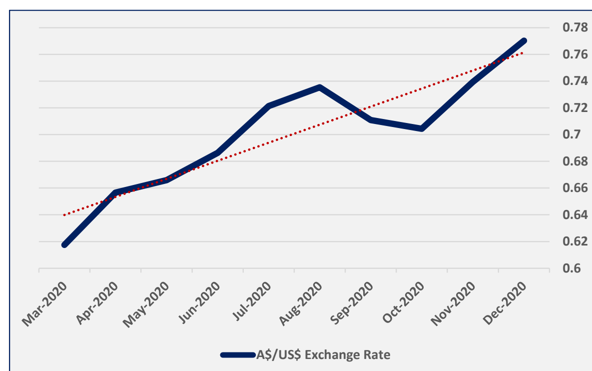








November	Change in Dwelling Values		
	Month	Quarter	Annual
Sydney	0.4%	0.3%	3.7%
Melbourne	0.7%	(0.4%)	(0.9%)
Brisbane	0.6%	1.5%	3.2%
Adelaide	1.3%	3.4%	5.3%
Perth	1.1%	1.9%	0.8%
Hobart	1.4%	2.9%	5.6%
Darwin	1.9%	4.7%	5.9%
Canberra	1.9%	3.3%	7.0%
National	0.8%	1.1%	3.1%



UNITED STATES ECONOMY

Economic activity has continued to recover from its depressed second-quarter level. The substantial reopening of the U.S. economy led to a rapid rebound in activity, and real GDP rose at an annual rate of 33 percent in the third quarter. In recent months, however, the pace of improvement has moderated.

Household spending on goods has been strong and has moved above its pre-pandemic level. In contrast, spending on services remains low, especially in sectors that typically require people to gather closely, including travel and hospitality.

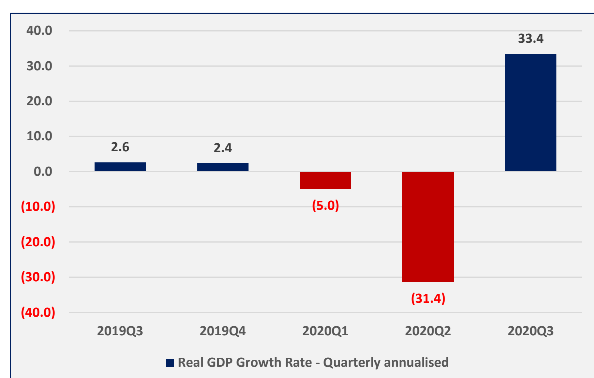
The housing sector has fully recovered from the downturn, supported in part by low mortgage interest rates. Business investment has also picked up.

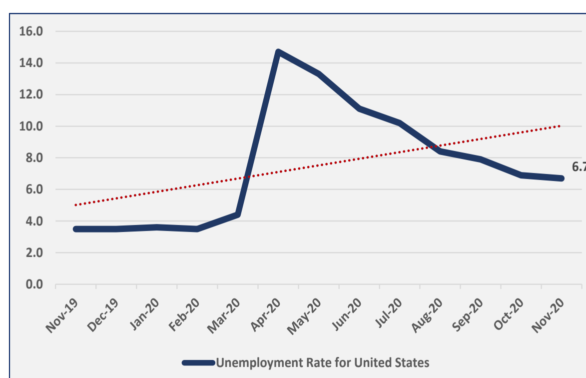
The recovery has progressed more quickly than generally expected, and forecasts from the U.S. Federal Reserve for economic growth have been revised up.

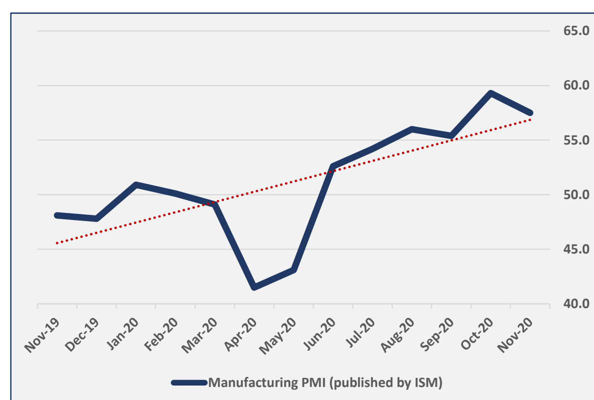
In the labour market, more than half of the 22 million jobs that were lost in March and April have been regained as many people returned to work. As with overall economic activity, the pace of improvement in the labour market has moderated. Job growth slowed to 245,000 in November, and while the unemployment rate has continued to decline, it remains elevated at 6.7%. Participation in the labour market remains notably below pre-pandemic levels.

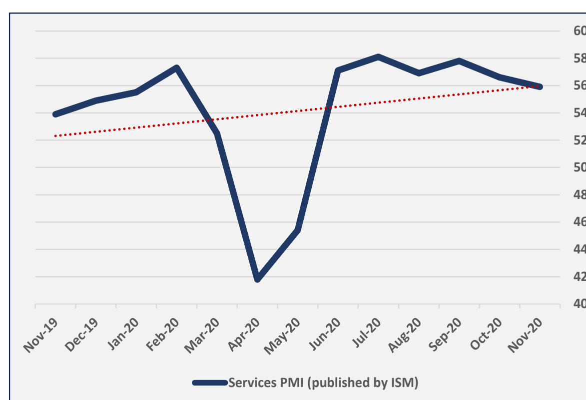
Looking ahead, the U.S. Fed projects the unemployment rate to continue to decline; the median projection is 5% at the end of next year and moves to below 4% by 2023.

Key United States Economic Indicators







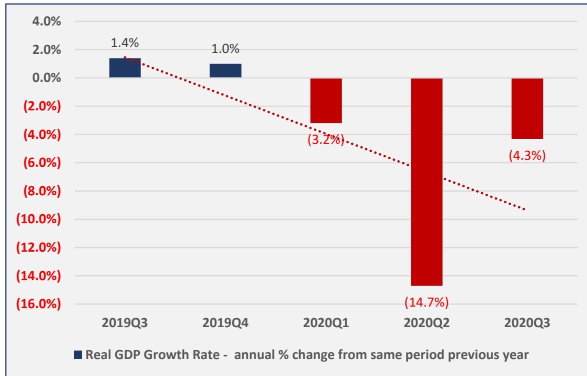


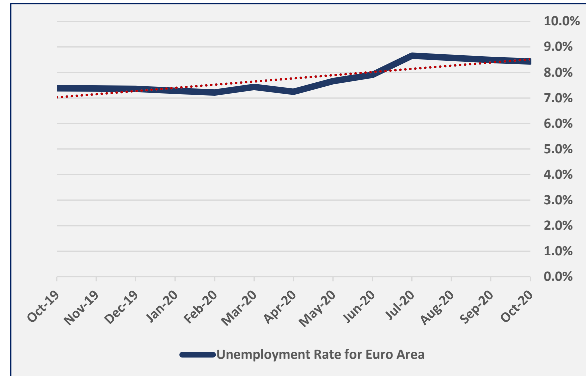
EUROPEAN ECONOMY

Following a sharp contraction in the first half of 2020, euro area real GDP rebounded strongly and rose by 12.5 per cent, quarter on quarter, in the third quarter, although remaining well below pre-pandemic levels. The second wave of the pandemic and the associated intensification of containment measures observed since mid-October are expected to result in a renewed significant decline in activity in the fourth quarter, although to a much lesser extent than observed in the second quarter of this year.

At its December meeting, the ECB decided to keep the key ECB interest rates unchanged. In addition, the ECB decided to increase its bond purchases under the pandemic emergency purchase programme by €500 billion to a total target of €1,850 billion.

Key Euro Area Economic Indicators





CHINESE ECONOMY

China was the first major economy to show a recovery from the damage caused by the coronavirus pandemic in 2020, largely due to a series of stimulus measures.

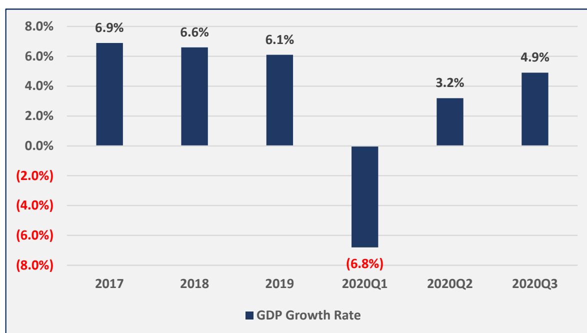
China unleashed a flurry of stimulus measures, including increasing the issuance of special treasury bonds to fund infrastructure investment by local governments and tax cuts that lifted the fiscal deficit ratio to a record high of 3.6% of GDP. In addition, the People's Bank of China provided extra liquidity to the market, driving down interest rates, while also providing special assistance to struggling small and medium-sized companies.

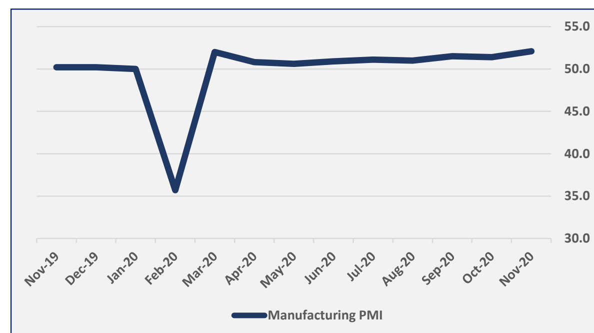
China's economy contracted by 6.8 per cent in the first quarter of 2020 after the coronavirus shut down large swathes of the country. It was, however, the first major economy to show a recovery, with growth rates of 3.2% in the second quarter and 4.9% in the third. China is now expected to be the only Group of 20 nation to show a positive economic growth rate in 2020, predicted to be 1.9% by the IMF and 2.0% the World Bank.

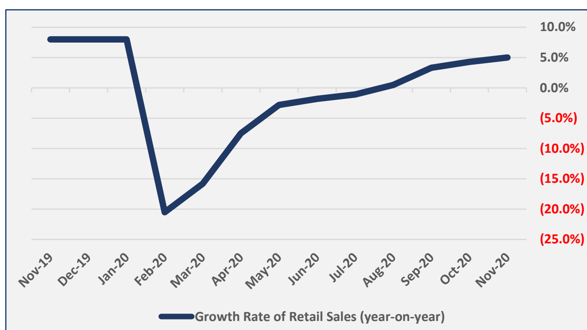
Its growth rate is expected to increase sharply in 2021 due to both the continued strong recovery and the low 2020 base for comparison. The IMF expects China's GDP growth to be 8.2% next year, while the Organization for Economic Co-operation and Development places it at 8%.

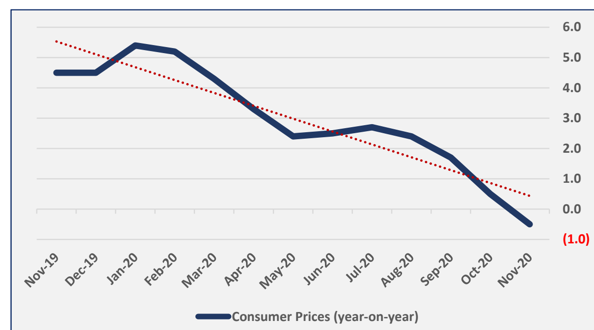
It should be noted that the sharp increase in government borrowings due to stimulus measures, adds pressure to the country's already high public debt level.

Key Chinese Economic Indicators









FINANCIAL MARKETS OVERVIEW

Equity Markets

The U.S. equity markets ended 2020 at all-time highs, closing off a soaring comeback despite a deadly pandemic. The S&P 500 index finished the year up more than 16 percent, and the tech-heavy Nasdaq gained 43.6 percent. Adding those gains to 2019 gave the S&P and Nasdaq their best two-year runs since 1998 and 1999, the height of the dot-com boom.

Wall Street's resurgence has been driven by the largest federal government stimulus ever, historic support from the Federal Reserve and optimism about how quickly the economy is likely to bounce back next year as coronavirus vaccines become widely distributed. Investors have largely ignored the pain on Main Street, including pronounced unemployment and battered small businesses.

All the major equity markets rose sharply in the December quarter. The S&P 500 rose 11.7%, the Nasdaq Composite increased by 15.4% and Australia's ASX 200 ended the quarter 13.3% higher.

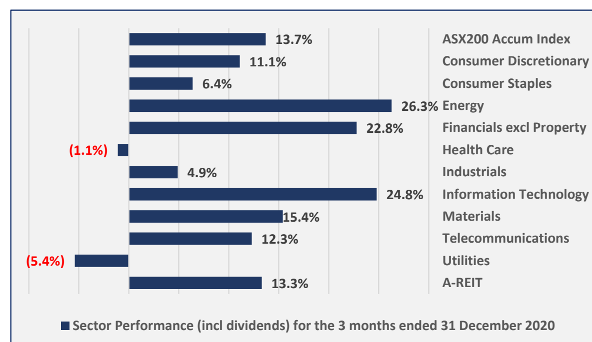
Index Performance*	3 Months	6 Months	12 Months	FYTD
ASX 200	13.3%	11.7%	(1.5%)	11.7%
S&P 500	11.7%	21.2%	16.3%	21.2%
Nasdaq Composite	15.4%	28.1%	43.6%	28.1%
FTSE 100	10.1%	4.7%	(14.3%)	4.7%
DAX	7.5%	11.4%	3.5%	11.4%
MSCI Europe	15.3%	20.0%	3.1%	20.0%
Nikkei 225	18.4%	23.1%	16.0%	23.1%
Shanghai Composite	7.9%	16.4%	13.9%	16.4%
A-REIT	11.8%	19.3%	(8.0%)	19.3%

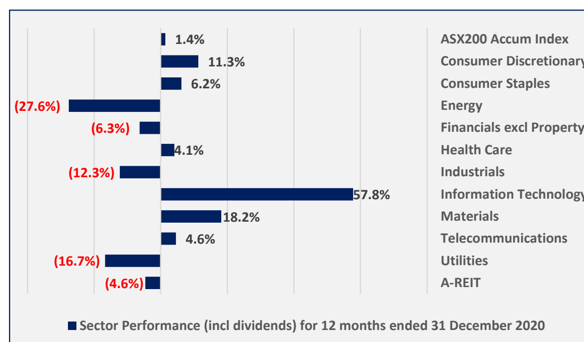
** Excluding impact of currency movements*

The ASX 200 Accumulation Index (including dividends) increased 13.7% in the quarter and the A-REIT Accumulation Index rose by 13.3%. For the calendar year 2020, the ASX 200 Accumulation Index ended 1.4% higher, and the A-REIT Accumulation Index dropped by 4.6%.

Returns including Dividends	3 Months	6 Months	12 Months	FYTD
ASX 200 Accumulation Index	13.7%	13.2%	1.4%	13.2%
A-REIT Accumulation Index	13.3%	21.2%	(4.6%)	21.2%

During the December quarter, the Energy sector recovered some of the sharp declines during the first nine months of 2020 and was the best performing sector, increasing 26.3%. The Utilities sector was the worst performer declining 16.7% (including dividends). For the 12 months ended 31 December, the Information Technology sector was the best performer returning 57.8% including dividends, and the Energy sector was the worst performer declining 27.6%.



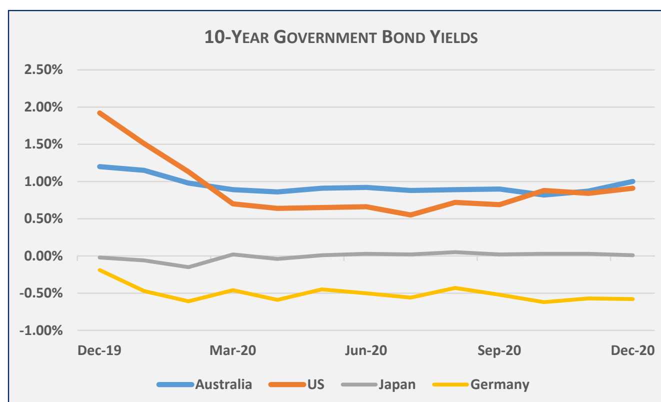


Mid- and Small-cap companies outperformed Large-cap companies in the December quarter and over the last 12 months.

Index Returns including Dividends	3 Months	12 Months
ASX200 Accum Index	13.7%	1.4%
ASX20 Accum Index	15.2%	1.5%
MidCap50 Accum Index	16.9%	17.0%
Small Ords Accum Index	13.8%	9.2%

Bond Markets

With the outbreak of the coronavirus, central banks worldwide announced several actions to support households and businesses, and to keep markets functioning. These actions included the reduction of official interest rates to effectively zero, and the implementation of unlimited bond purchase programs (quantitative easing). As a consequence, global government bond yields fell quite sharply.



After the falls during the March quarter, bond yields remained relatively steady given the continued intervention in bond markets by central banks.

Since the end of 2019, the Australian 10-year government bond yield fell from 1.20% to 1.00% and the US 10-year Treasury yield has fallen from 1.92% to 0.91% with both touching lows in March of 0.61% and 0.50% respectively.

Currency Markets

During the December quarter, the AUD strengthened by 8.4% against the US dollar and against all other major currencies. Over the last 12 months, the AUD strengthened by 9.9% against the U.S. dollar and also strengthened against other major currencies.

The main driver of the strong Australian dollar was the higher iron ore price. During 2020, the iron ore price increased by more than 70%.

Currencies	FX Rate				Change		
	31-Dec-20	30-Sep-20	30-Jun-20	31-Dec-19	3 Month	6 Month	12 Month
A$/US$	0.7702	0.7108	0.6863	0.7006	8.4%	12.2%	9.9%
A$/Euro	0.6269	0.6058	0.6111	0.6254	3.5%	2.6%	0.2%
A$/CNY	5.0298	4.8425	4.8523	4.8876	3.9%	3.7%	2.9%
A$/JPY	79.45	74.99	73.94	76.16	5.9%	7.5%	4.3%
A$/GBP	0.5657	0.5538	0.5586	0.534	2.1%	1.3%	5.9%

Commodity Markets

Iron ore outperformed all commodities in 2020, increasing in price by more than 70% to record highs on strong Chinese steel demand and ongoing supply disruptions in Brazil.

Oil prices turned negative for the first time ever in April as demand seized up during the global coronavirus lockdowns but have recovered since then, though not back to pre-covid levels, amid hope that vaccines will restore consumption.

After soaring earlier in the year, gold prices have retreated from a record of $2,069.50 an ounce reached in August, dragged down by signs of improvement in the global economy. Investors tend to buy the metal when nervous about holding riskier assets such as stocks or corporate bonds. Important to investors' gold outlook is the direction of what are known as real yields, or the returns on bonds when adjusting for inflation. With the real yield on the benchmark 10-year Treasury note sitting around minus 1%, the cost of holding gold (which pays no yield) instead of government bonds is relatively low. A strong economic recovery could spur a climb in real yields and hurt the value of gold. Significant moves in real U.S. Treasury yields have been paired with inverse moves in gold prices since the 2008 financial crisis, according to data from JPMorgan Chase, which found for every 0.25-percentage point increase in real 10-year Treasury yields, gold has moved $80 an ounce in the opposite direction.