Economic Update

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Outlook for Investment Markets

While equity markets have generally recovered from their coronavirus-affected lows in late March, the prognosis for the world economy remains uncertain. While forecasters are typically running with a range of scenarios, most agree that their baseline or best-guess scenario is for a serious setback to world trade and gross domestic product this year followed by a recovery next year. The shape and speed of the recovery remains very uncertain, however, with fund managers inclined to believe it may be a more gradual affair rather than a rapid return to normality. In the interim, equity markets will continue to be confronted by generally downbeat economic and financial news, even as more countries succeed in bending the curve of new infections. On the plus side, bonds have preserved capital and prices are likely to be supported by ongoing central bank buying. In Australia, the decline in new cases is good news, but there is still a long way to go before the full extent of COVID-19's impact becomes apparent.

Australian Cash and Fixed Interest — Review

Like everywhere else, monetary policy has been used vigorously to help offset the impact of COVID-19. The cash rate is 0.25%, 90-day bank bills are yielding only 0.15%, and the 10-year commonwealth-bond yield is only 0.862%. A lower exchange rate has also helped the overall easing in monetary conditions. The Australian dollar is down 6.6% in overall value since the start of the year, with especially large falls against the two main currencies regarded as relative safe havens--it is down 10.0% against the yen and down 9.2% against the U.S. dollar.

Australian Cash and Fixed Interest — Outlook

Currently there is a very strong consensus that the target cash rate will be kept at 0.25% over the next year. The Reserve Bank has committed to it and has said that the target will not be raised "until progress is being made towards full employment," and inflation gets back up to 2% to 3%, which is likely some time away. This is also the view of both the futures market and the economic forecasters. Apart from providing ongoing support to the post-COVID-19 economy, the cash rate would need to be kept very low as inflation looks very likely to be well below what the Reserve Bank would like.

Long-term interest rates are also likely to remain unusually low for an extended period. As part of its quantitative easing programme, the Reserve Bank has committed to keeping the yield on three-year commonwealth bonds at 0.25% (as long as is necessary to get unemployment down and inflation up). And with over AUD $46 billion of bonds purchased already, it is very likely to be able to do so (currently the rate is indeed very close to 0.25%). At some point, the huge supply of new government bonds (as part of anti-COVID-19 fiscal policy support) may require higher yields to find homes with buyers, but that still looks to be a long way away.

The outlook for the currency remains, even more than usual, hostage to the global unfolding of the COVID-19 outbreak. Currently investors are in a strongly risk-averse mood and currencies like the Australian dollar have had little appeal to global investors who have preferred to stay closer to home. As the outbreak is better contained, it may be that peak pessimism diminishes and appetite for risk picks up. The low point for the Australian dollar could be behind us. There is still a very wide range of views, but the average pick in the latest (early April) Reuters' survey of foreign-exchange forecasters is that the Australian dollar will stabilise around U.S. $0.63 over the next six months and pick up to $0.66 in a year.

Australian and International Property — Review

Listed Australian property has had a difficult time through the COVID-19 period. The A-REITs have significantly underperformed the wider market, with the S&P/ASX 200 A-REITs Index suffering a capital loss of 25.2% compared with the S&P/ASX 200 Index's 17.9%.

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Global property has also been out of favour. The FTSE EPRA/NAREIT Global Index in U.S. dollars has lost 25.6% in capital value, worse than the 14.5% capital loss for the MSCI World Index. Losses were similar across most of the main regions, ranging from the Asia Pacific's 22.2% loss through to the U.K.'s 29.2% loss.

Australian and International Property — Outlook

Operating conditions have become very difficult for property owners. The latest (June quarter) ANZ/Property Council of Australia survey, which added some special questions about COVID-19, found that it was already having a serious impact on 35% of property businesses. Over the next three months it is expected to have a serious impact on 52% of them. The impact was expected to be particularly severe for hotel, tourism, and leisure properties, but all sectors reported sharply lower expectations for capital growth, with hotels and an already pessimistic retail sector in the worst shape. Even the relatively resilient industrial sector turned pessimistic about capital values. Respondents expected cap rates to increase, again depressing valuations, and, realistically, given the sector's various issues, also expected debt availability to worsen over the coming year. As the Reserve Bank of Australia said in its April Financial Stability Review, "In the period ahead, declines in both sales volumes and valuations are likely, reflecting the weakness in the rental market and a repricing of risk by institutional investors." And it looks likely that the REIT sector will remain weak until all the ramifications of COVID-19 have played out.

Global listed property faces all the same challenges. The retail sector has been hit by a double whammy. Its own businesses have faced reduced revenues as shoppers have been in lockdown and tenants have been unable to pay rents. A survey by the U.S. trade body NAREIT found that U.S. shopping centres collected only 46% of their normal rent in April, while its existential threat from e-commerce has surged as people, perforce, have turned to online retail channels. The impact on the retail REIT subsector has been dramatic. In the U.S. the prices of shopping centre REITs have effectively halved (down 49.6% year to date) and regional shopping malls have fared even worse (down 59.3%). Offices, while not as badly shaken (down 23.2% in the U.S.), also face the prospect that enforced remote working through COVID-19 lockdowns may permanently impact the demand for office space. Industrial property everywhere has been a beneficiary of the e-commerce demand for warehouses and logistics. The U.S. industrial REITs are down only 2.1%--and there are other pockets of good performance (big data has led to strong performance by data centres)--but the few bright spots are unlikely to counterbalance the bigger picture in coming months.

Australasian Equities — Review

Australian shares have followed the global COVID-19 pattern, dropping sharply from mid-February to late March, before staging a partial recovery in more recent weeks. Year to date the S&P/ASX 200 Index is down 17.9% in capital value and down 16.9% in total returns. The financials, which will be exposed to business defaults and the costs of debt relief, have been particularly weak, and are down 28.0%. But weakness is pervasive across most subsectors, with the industrials down 20.6% and the miners down 13.0%. Consumer staples are the only resilient sector, with prices up slightly by 2.3%.

Australian Equities — Outlook

The latest state of business sentiment, which now reflects the full impact of COVID-19 and the lockdowns, is, unsurprisingly, dire. The latest (March) business survey run by National Australia Bank, for example, found that: "Business confidence saw its largest decline on record and is now at its weakest level in the history of the NAB business survey ... the decline in forward orders and business conditions imply a large fall in GDP in the next 6 months ... The timing of a recovery is extremely uncertain at this point ... For now, more businesses expect it to get worse before it gets better. It could well be that conditions fall to the lowest level since the 1990s recession in coming months – but we will be closely watching the survey for a turn in business confidence

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which may take some time to recover following an economic shock of this magnitude."

In current conditions point forecasts remain highly speculative, but the current view is that there will be a V-shaped recovery, with quite a sharp fall in activity this year followed by a reasonably rapid recovery next year. The International Monetary Fund, for example, expects that the Australian economy will shrink by 6.7% this year, followed by 6.1% growth in 2021. Even on this relatively optimistic view, unemployment still would be markedly higher in 2021, at 8.9%, than it was pre-COVID-19 (it was 5.2% in March, before the pandemic began).

Business conditions even on a relatively optimistic assessment are likely to remain difficult for the rest of this year, despite substantial fiscal support--the AUD $130-billion JobSeeker wage subsidy scheme alone is worth some 6.5% of GDP. Treasury estimates that without the scheme, unemployment would have hit 15% in the June quarter, but even with it kicking in, unemployment is likely to reach 10%. In these difficult conditions, there will be unsavable casualties, like Virgin Australia, for example, who had just gone into voluntary administration at the time of writing. In time, the equity market will start factoring in a 2021 turnaround, but the coming few months are more likely to see it having to absorb a stream of very poor news.

International Fixed Interest — Review

Bonds have done their portfolio-protection job year to date. The Bloomberg Barclays Global Aggregate Index in U.S. dollars has eked out a small 0.7% gain, protecting capital as equity markets slumped.

The outcome depended on the U.S. bond market (the U.S. index was down 2.1%) and on the strong performance of higher-quality assets like government bonds, which gained 1.7%, compared with the 1.7% loss for global corporate bonds. Lower-credit quality corporate bonds recorded a large loss of 10.7%, and the relatively risky subsector of emerging-markets debt lost 7.4%.

International Fixed Interest — Outlook

The outlook for monetary policy everywhere is essentially the same: both short-term and longer-term interest rates will be kept at extremely low levels for an extended period of time--at least until the COVID-19 outbreak is controlled and some normality has returned. But, in all probability, it will take longer. Many economies will be experiencing lower inflation for some time after the immediate COVID-19 impact, and unemployment will be higher than ideal. In these circumstances, central banks everywhere will have a strong incentive to keep a stimulative monetary policy well into 2021 and possibly into 2022. Any reappearance of COVID-19 would also extend the period of very low interest rates and other forms of monetary stimulus.

In the U.S., for example, Fed chair Jerome Powell said on April 9 that the Fed is "committed to keeping rates at this low level until we are confident that the economy has weathered the storm and is on track to achieve our maximum-employment and price-stability goals." He also said that the Fed would continue to use its emergency lending powers "forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery." Powell's use of the words "confident" and "solidly" imply support beyond any immediate upturn.

The U.S. forecasters in the latest (April) poll run by *The Wall Street Journal* now expect that the Fed will keep its current 0% to 0.25% target cash rate at least until the middle of next year. They also expect the U.S. 10-year bond yield to remain below 1.0% this year, and for it to rise only gradually to 1.4% by the end of 2021. Other central banks will be following similar policies, which means that bond investors can expect stable government-bond prices, albeit at the cost of pitiful running yields. According to the J.P. Morgan Global Government Bond Index, yields are negative (currently negative 0.19%) across the asset class, with positive yields only available by taking on duration risk in long-dated bonds.

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While government bonds will remain solid, the low-quality end of the asset class is in serious trouble. According to the ICE Bank of America Index, which tracks the spread between the yield on U.S. bonds with a credit rating of CCC or lower and the yield on U.S. Treasuries, low-grade borrowers were paying around 10% more than the U.S. government before COVID-19 erupted. At the peak of the equity sell-off, the gap had blown out to 19.6% and is still high at 16.3%. Year to date the index has lost 18.8%. More corporate distress is likely, and the outlook for the high-yield subsector remains hazardous.

International Equities — Review

World share prices fell very sharply between mid-February and late March. From its Feb. 12 peak, the MSCI World Index of developed markets in U.S. dollars dropped by over a third (34.2%) before bottoming out on March 23. Since then the index has rallied and is up by 25.9% from its low, but the earlier loss still dominates the year-to-date outcome, with investors suffering a 14.5% capital loss.

Relatively resilient U.S. markets have helped to cushion the loss: The S&P 500 is down by *only* 11.0%, and the Nasdaq by only 3.6%. Other major markets have fared markedly worse. In Europe, the FTSEurofirst 300 Index is down by 19.4%, with Germany (down 19.8%), France (24.7%), and the U.K. (down 23.3%), all suffering large setbacks. Japan's Nikkei Index is also down by 15.9% year to date.

Emerging markets have suffered worse again, in an environment where investors have shunned the riskier end of an asset class. The MSCI Emerging Markets Index is down 19.9% in U.S. dollars, with the key BRIC economies--Brazil, Russia, India, and China--down 16.6%. Within the BRIC bloc, using the MSCI single-country indexes, China had a modest drop (5.7%), but there were substantial declines in the other members, with India down 26.1%, Russia down 32.3%, and Brazil down a massive 47.4%.

International Equities — Outlook

Even though the COVID-19 outbreak appears to be peaking in several countries as health measures are in place to help bend the curve of new infections, forecasters are still very unclear how the world economy will behave in coming months.

Nearly all the big forecasters have opted to run with scenarios rather than point forecasts. As the World Trade Organisation said when it released its scenarios, "These should be viewed as explorations of different possible trajectories for the crisis rather than specific predictions of future developments. Actual outcomes could easily be outside of this range, either on the upside or the downside."

The WTO opted for two scenarios: "A relatively optimistic scenario, with a sharp drop in trade followed by a recovery starting in the second half of 2020 and ... a more pessimistic scenario with a steeper initial decline and a more prolonged and incomplete recovery." Even on the more optimistic reading, world trade suffers a major shock this year, dropping by 12.9%, before bouncing back strongly next year with a 21.3% rebound. World GDP drops by 2.5% this year but comes storming back in 2021 with 7.4% growth.

The more pessimistic scenario, however, makes for grim reading. World trade drops by nearly a third (31.9%) this year and does not make up the lost ground in 2021, rising by only 24%. World GDP declines by 8.8% this year and again does not make good the loss in 2021, with only a 5.9% recovery.

The IMF has also stressed the difficulty of trying to figure out what happens next. In its latest (April) *World Economic Outlook* update it said that, "There is extreme uncertainty around the global growth forecast. The economic fallout depends on factors that interact in ways that are hard to predict, including the pathway of the pandemic, the intensity and efficacy of containment efforts, the extent of supply disruptions, the

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repercussions of the dramatic tightening in global financial market conditions, shifts in spending patterns, behavioural changes (such as people avoiding shopping malls and public transportation), confidence effects, and volatile commodity prices."

In IMF's baseline forecast, "the pandemic is assumed to fade in the second half of 2020, allowing for a gradual lifting of containment measures." On that basis, the IMF thinks that world GDP will drop by 3% this year, before recovering by 5.8% next year--qualitatively that is very similar to the WTO's optimistic scenario. The advanced economies bear the brunt of this year's setback, with GDP dropping by 6.1%, while emerging and developing economies escape with a relatively minor 1.0% drop in GDP.

The IMF also ran with three alternatives, all worse than its baseline. In the worst of them, it takes longer than expected to get the 2020 outbreak under control, which is then followed by another outbreak in 2021. In that case, world GDP would take a larger hit this year, dropping by about 6%, and there would be no recovery in 2021.

The global fund managers surveyed by Bank of America Merrill Lynch, or BAML, in April are on board with the idea that 2020 is looking bad. Virtually everyone (a net 93%) thinks there will be a global recession this year, which is a record level of pessimism, even higher than in the depths of the GFC. They are less convinced, however, by scenarios of a quick recovery--57% picked a gradual U-shaped recovery, and 27% picked a W-shaped recovery with a double-dip recession. Only 15% currently think a quick V-shaped recovery is in the cards. Their biggest fear (mentioned by 57%) is a second wave of the virus, and their other big worry (mentioned by 30%) is a systemic credit event, where some large institution or market unexpectedly falls over.

In very unsettled conditions, portfolio diversification remains the key defence. Investors may also find it worthwhile to emulate the BAML managers who are building extra protection into the equity portion of the portfolios by favouring defensive sectors like healthcare, consumer staples and utilities, and underweighting sectors seen as cyclically riskier, including energy (given plunging world oil prices), materials, industrials, and banks. The BAML managers also have a very strong preference for premium names--by wide margins they prefer high-quality earnings to low-quality earnings and large caps over small caps.

Performance periods unless otherwise stated generally refer to periods ended April 17, 2020.

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