Economic Update

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Outlook for Investment Markets

Local and international markets have marked time in recent weeks as investors wait to see how the coronavirus outbreak will develop and what its ultimate impact will be. On the plus side, with supportive economic policies that have been put in place and anti-COVOD-19 measures like lockdowns and distancing, it is plausible that we are at or near the low point for the global economic cycle. On the downside, there is no certainty in what happens next, and even countries like Australia, which has been effective in controlling COVID-19, remain hostage to recurring outbreaks in areas that have not been managed well. Although uncertainty remains high, the best view is that the Australian economy will recover from the September quarter onwards. But even if everything goes as planned, it is likely to be late 2021 or early 2022 before the economy gets back to a pre-COVID-19 level of business activity.

Australian Cash & Fixed Interest — Review

Short-term interest rates remain very low, as the Reserve Bank has kept the target level for the cash rate at 0.25%, and 90-day bills are yielding 0.09%. Long-term interest rates have also remained low, and the 10-year commonwealth bond yield is currently 0.92%. The Australian dollar has been weak year to date, particularly against the yen (-9.1%) and U.S. dollar (-7.9%) and is down 5.1% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

It is very likely that short-term interest rates will remain at these very low levels until well into next year. The Reserve Bank has said it "will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 percent target band." Based on the Bank's own baseline forecasts, unemployment will still be 7.5% at the end of next year, so low interest rates are well embedded at least until then. Long-term rates will also remain low. The Bank is aiming to keep the three-year yield at 0.25%, which will help keep other longer-term yields low as well. To date it has been managing to achieve the target, despite high volumes of commonwealth bonds hitting the market: May 13's A$19 billion offer of 2030 bonds was the largest ever.

Ideally the Reserve Bank would like to see the Aussie dollar remain low or move even lower, as it would boost both domestic economic recovery and inflation (currently too low). At the moment, however, it has recovered from its earlier low levels thanks (as the Reserve Bank noted in its latest *Monetary Policy Statement*) to an easing in global financial market volatility and lower levels of risk aversion as the initial COVID-19 panic subsided. Calmer markets generally boost the Aussie dollar's value. While the outlook remains hostage to shifts in global sentiment, at the moment the consensus view is for a modest rise from current levels. The latest (May) Reuters survey of foreign-exchange forecasters expect the Aussie dollar to rise from its current 64.5 cents to $0.67 cents in a year's time.

Australian & International Property — Review

Current conditions have been very challenging for listed Australian property. The S&P/ASX 200 A-REITs Index has also taken a beating in both absolute and relative terms. It has recorded a capital loss of 28.2% compared with the S&P/ASX200's 19.1%.

Global property has also done very badly. Year to date the FTSE EPRA/NAREIT Global Index in U.S. dollars is down 31.0% in capital value, significantly worse than the 14.8% capital loss for the MSCI World Index. Unlike the wider equity market, where the U.S. market held up better than most, losses were significant across all regions, which is suggestive of common factors undermining investor sentiment towards the asset class.

Australian & International Property — Outlook

Recent surveys of the sector are only beginning to catch up with the scale of the setback caused by the pandemic. The March quarter Commercial Property Monitor from the

Royal Institution of Chartered Surveyors, or RICS, showed that, even in the early stages of the health crisis, rents and capital values were expected to fall over the coming year. Rents were expected to fall by 5.0% and capital values by 4.5%. Retail property was worst impacted, and secondary property in all subsectors was expected to do worse than prime property. Even weaker trading conditions since the March survey suggest that these forecasts may be on the conservative side. The asset class is confronted by an unpleasant mix of difficult cyclical trading conditions and potential longer-term structural change. The Reserve Bank of Australia's latest *Monetary Policy Statement* pointed out that, "A number of contacts in the Bank's liaison program have indicated that valuations of commercial property assets are expected to decline over the period ahead because of lost rental income and lower expectations of future rental growth. In turn, lower valuations may affect the viability of future projects, in combination with many firms expecting to reduce their long-term floor space requirements. This is likely to be most pronounced in the office and retail sectors, given the large-scale shift to working from home and the acceleration in the shift towards online retailing." It remains likely that the A-REIT sector will remain under pressure while these trends play out.

Global listed property is in the same position. The March global RICS Monitor was, somewhat alarmingly, titled "Pandemic Grips the Market," but the facts supported the description, and the survey, which captures both tenant and investor demand, showed "a worsening picture in pretty much all markets and negative readings nearly everywhere." Again, the gloom represented both the cyclical impact of COVID-19 and its potential longer-term effects. RICS said that a number of respondents mentioned "the scope for agile working to become more commonplace in the aftermath of the virus lowering the demand for office space in particular. Predictably, the acceleration in the structural trend towards e-commerce is also noted with increasing interest in prime logistics space viewed as a likely outcome." Some data suggest that the revaluation of property to reflect these challenges is already well advanced. Data from NAREIT, the U.S. trade body, shows that year to date the big American shopping malls have more than halved in value (down 51%) and the regional malls have been marked down even more (by 62%). On the other hand, the RICS survey shows that respondents still think property is expensive across the major markets: more than half of all respondents in France, Germany, Japan, and the U.S. think their local markets are expensive. It looks as if the rethink about property values may run on for some time yet.

Australasian Equities — Review

Australian shares have mirrored the world trend, partially recovering in the first half of April from March's COVID-19 low point, but treading water in more recent weeks as investors await the eventual impact of the pandemic. The scale of the earlier weakness, however, means that year to date the S&P/ASX200 Index is still down 19.1% in capital value. The large weight of the financials has been an issue because, unlike some other sectors, they have not rallied from their March lows—they are down 30.4% and investors reckon they will be on the frontline of the pandemic's damage. Consumer staples have held up relatively well, as would be expected, and are down only 3.5%; the globally popular IT sector has also done relatively well, with a small 3.9% loss.

Australian Equities — Outlook

The very worst of the immediate COVID-19 impact may be behind us, as lockdowns ease and business activity starts to recover, but business conditions remain very difficult. The latest business surveys have shown a pickup from the shocked levels they sank to in March, but business remains very weak. April's business survey from The National Australia Bank, for example, found that, "The improvement in confidence was broad-based but, like [business] conditions, it remains deeply negative across all industries and states. Forward orders fell again, suggesting that activity is likely to weaken further in the near term--in line with still weak confidence ... Cashflow ticked up in the month but only marginally and continues to suggest a significant deterioration." Official statistics everywhere are somewhat behind the curve, but the scale of the current setback was handily illustrated by the latest official job data, which showed that nearly 600,000 people lost their jobs in April alone.

The outlook remains challenging. Again, forecasters are typically showing a range of possible outcomes rather than a single view. The Reserve Bank in its latest (May 8) quarterly *Monetary Policy Statement* expects, in its baseline view where lockdown restrictions are mostly lifted by the end of September (such as the ban on large gatherings and border restrictions) that the economy will be in recovery mode for the second half of this year with further recovery next year: "Growth would then be stronger over 2021 as business and dwelling investment gradually recovered, although the level of GDP by mid-2022 would still be below the level expected at the time of the February *Statement*."

The reality for the equity market is that even with strong fiscal and monetary policy support it will be around two years before business conditions get back to the levels needed to support pre-COVID-19 share prices. Even then, the world may not be as it was. As the Reserve Bank put it: "It is quite plausible that the current economic disruption will have some long-lasting effects, not only because it will take some time to restore workforces and re-establish businesses but also because it could also affect mindsets and the behaviours of consumers and businesses. This could result in structural change in the economy." Dividends will be a more important attraction than they were before, given the likelihood of an extended period of exceptionally low bank deposit and bond yields. But it will be tough for local equities until the final COVID-19 bill is presented.

International Fixed Interest — Review

Bonds, as an overall asset class, have continued to protect capital through the pandemic's volatility. The Bloomberg Barclays Global Aggregate Index in U.S. dollars has managed a small 0.7% gain.

The outcome has however remained dependent on the U.S. bond market--the U.S. index was down 2.2%. It has also been very much dependent on the performance of the high-quality end of the asset class, particularly longer maturity U.S. Treasury bonds. The U.S. Long (20 years plus) Treasury Index has returned a remarkable 22.9% year to date due to the combination of longer-dated bonds producing larger gains when rates fall and the surge in demand for safe haven assets. The weak credit-quality end of the asset class, however, has been hit badly. The Global High Yield (low credit quality) Index is down 10.9% in U.S. dollars year to date, and the relatively risky emerging markets are down 5.6%.

International Fixed Interest — Outlook

As in Australia, central banks everywhere are on maximum policy-support settings. Their economies require very stimulatory monetary policies to help recover from the impact of COVID-19 and inflation--which was typically too low in the developed world even before pandemic--will also need an extended period of easy monetary conditions to get pushed back up to where central banks would prefer it to be.

We are likely to see an extended period of low short-term and longer-term interest rates. In the U.S., for example, the financial futures market expects the Fed to keep its current target range of 0% to 0.25% for the Fed funds rate at least until March of next year, and other major central banks are also likely to keep policy rates close to, or even below, zero.

Longer-term yields will also be kept low thanks to the aggressive quantitative easing bond-buying programmes of the big central banks. In the U.S., the Fed is committed to an open-ended programme of bond purchases, and other central banks have similar plans. The European Central Bank, for example, has committed to an additional EUR 870 billion (AUD 1.46 billion) of COVID-19 emergency asset purchases, and the Bank of England has a GBP200 billion (AUD 378 billion) programme. Although national Treasuries will be issuing vast amounts of bonds to finance their expansionary fiscal policies, which would normally send bond prices down and yields up, the central banks' buying and ongoing demand for safe haven assets are likely to keep the yields low. The U.S. forecasters in the latest (May) poll run by *The Wall Street Journal* are picking that the U.S. 10-year bond yield, currently 0.64%, will finish the year still below 1%, at 0.85%.

While government bonds and high-quality corporate bonds look likely to hold their value, the lower-quality end of the asset class is likely to remain challenging. The ultimate impact of the COVID-19 outbreak remains unclear, but the more heavily indebted and marginal borrowers look most exposed. The financial markets continue to price in significant probabilities of default for less-creditworthy companies.

International Equities — Review

Following their sharp sell-off in February and March, world shares had regained roughly half the loss by the middle of April. Over the past month, however, shares have essentially gone sideways--for now, investors appear to be waiting to see how COVID-19 will play out.

Despite the April recovery, the scale of the earlier plunge means that all the major global share indexes are still well down year to date. The MSCI World Index of developed-economy share markets is down 14.8% in U.S. dollars. The outcome would have been significantly worse (a loss of 21.7%) without the relatively strong performance of the U.S. markets, where the S&P 500 is down by a relatively modest 11.4% and the Nasdaq, remarkably, has eked out a marginal 0.5% gain. Japan (Nikkei down 15.3%) and Europe (FTSE Eurofirst300 down 21.0%) were weak, with notably large falls in the U.K. (FTSE 100 down 23.1%) and in France (CAC down 28.4%).

Emerging markets have been weaker than their developed counterparts, and the MSCI Emerging Markets Index in U.S. dollars is down 19.2%. The big BRIC--Brazil, Russia, India, China—members are down by 16.8%, with only China holding up relatively well (Shanghai Composite down only 6.0%) and the others recording large losses.

International Equities — Outlook

The scale of the damage wrought by COVID-19 hardly needs stressing, but for the record, the April J.P. Morgan Global Composite PMI Index--which adds up a wide range of national-level survey data across manufacturing and services, has plunged. As J.P. Morgan said, "Companies across the world were hit hard by the impact of lockdowns, shutdowns and other restrictions in place to combat the spread of coronavirus 2019." The index is now "far below its previous low of 36.8 in November 2008 during the global financial crisis ... Rates of decline in output, new orders, new export business, employment and backlogs of work all registered new series records in April. All the nations for which April final data were available saw activity and new business fall to the greatest extent on PMI record, including the US, Germany, the UK, France, Italy, Spain, India, Brazil and Australia. Flash Composite PMI data for Japan also signalled the steepest drop in output and second-sharpest fall in new work received."

By sector, activity fell in each one except, unsurprisingly, healthcare services, with transportation and recreation the worst affected by the lockdowns and other preventative measures.

The same picture emerged from the Organization for Economic Cooperation and Development's suite of leading indicators, which attempts to predict the near-term outlook for the major economies. The OECD said that "Composite leading indicators (CLIs) in most major economies collapsed by unprecedented levels in April as containment measures for Covid-19 continued to have a severe impact on production, consumption and confidence."

It may be, though, that the very worst of the impact is around now, and that the outlook from here--however unsettled--will start to reflect the gradual easing of lockdown restrictions. One small positive signal is that China, which was first into the storm, is showing some signs of coming out the other side. The OECD estimates that "In China ... where containment measures have already been eased, the CLI for the industrial sector is tentatively pointing towards a positive change in momentum, with April's CLI and a large upward revision for March both pushing the CLI upwards." The data is partly incomplete for April, so the improvement is not definitive, but some turn for the better in China has also been detected in the latest (April) Caixin PMI surveys (one of the surveys that feeds into the J.P Morgan Global Index). For Chinese services it found that, "Despite the current challenging climate, optimism toward the 12-month outlook picked up to a three-month high amid hopes of a recovery in conditions once the pandemic situation improves."

Even if the global economy gradually turns for the better, the impact of the setback likely will have ongoing consequences for likely corporate profitability. In the U.S., for example, data company FactSet estimates that corporate profits at the companies in the S&P 500 dropped in the March quarter by 13.6% on a year earlier--the drop was especially large for consumer discretionary stocks (down 50.1%) and the financials (down 43.5%).

From here, things are expected to get worse for some time yet. According to the analysts' forecasts collected by FactSet, the year-on-year decline in profits will be 40.6% in the June quarter, 23% in the September quarter, and 11.4% in the December quarter. 2020 will see profits fall by 19.7%.

The analysts expect profits to come back strongly in 2021, with a 26.9% increase, and are consequently upbeat about the prospects for the S&P 500, which they see rising by 11.4% over the coming year. But several of commentators have questioned this level of optimism; if the S&P 500 does indeed rise to that extent, it would essentially be back to the levels just before the pandemic. It is difficult to believe that the outlook is no worse than it was then, or that there will not be some permanent casualties along the way.

A recent issue of *The Economist* magazine noted the contrast between still-poor operating conditions and financial-market optimism, and argued that, "A one-month bear market scarcely seems enough time to absorb all the possible bad news from the pandemic and the huge uncertainty it has created. This stock market drama has a few more acts yet." It looks like a reasonable conclusion.

Performance periods unless otherwise stated generally refer to periods ended May 15, 2020.

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