Economic Update

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Outlook for Investment Markets

The latest forecasts for the global economic outlook are pointing to gradual recovery, and growth assets have improved from their previous coronavirus losses. Markets, however, have remained choppy as investors waver between optimism about eventual recovery and renewed concerns about the final cost of the COVID-19 outbreak, as well as impending uncertainties (including second-wave infections). Investors will need to be realistic about the time it will take to get back to pre-outbreak conditions. On the plus side, monetary and fiscal policy everywhere is very supportive, and ongoing low-interest rates will help bonds preserve portfolio capital. In Australia, as elsewhere, there are signs that the very worst is past, but strong recovery in corporate profitability is still some considerable distance away.

Australian Cash & Fixed Interest — Review

With the Reserve Bank of Australia continuing to keep the target cash rate at 0.25%, other short-term rates have remained at very low levels, with the 90-day bank bill yield at 0.1%. Long-term interest rates are also unusually low, with the 10-year commonwealth bond yielding 0.9%. The Australian dollar has been volatile--at the peak of the COVID-19 global sell-off it fell as low as 57.4 U.S. cents, but it is now back up to 68.71 cents. Year to date it is down 2.0% in terms of its headline U.S. dollar rate and down 0.7% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

As with central banks overseas, the RBA is highly likely to remain committed to keeping interest rates very low until the impact of COVID-19 is over. The bank in the minutes of its latest (June 2) policy meeting said that "This accommodative approach would be maintained as long as required," and on the current outlook for economic activity and inflation this is likely to mean that the cash rate will be kept at 0.25% out to the end of 2021 (and possibly beyond). Bond yields are also likely to remain unusually low. The RBA has been very successful at keeping the three-year Commonwealth bond yield close to its target 0.25%, and again is likely to leave the target in place well into next year.

The outlook for the Aussie dollar is almost entirely hostage to investor-risk appetite. As the past few months have shown, during high-anxiety periods like the early onset of the COVID-19 outbreak, the Aussie dollar is sold down, but it does better when investors are more confident. The RBA, in its latest minutes, noted that "The Australian dollar over the course of this year had been closely correlated with global equity prices." Forecasts, such as Reuters early June poll of currency analysts, can consequently be blindsided by abrupt shifts in sentiment. Buoyed by temporary economic optimism, the Aussie rose in a few days as much as the consensus forecast in the Reuters poll had expected for the full year ahead. As discussed later in the International Equity section, the most likely scenario for the global economy is for gradual recovery over the next 18 months, which would be consistent with the Aussie dollar regaining some of this year's lost ground.

Australian & International Property — Review

Listed property has fared badly in COVID-19 conditions. The S&P/ASX 200 A-REITs Index has taken a capital hit of 20.1% year to date (19.6% including dividends), significantly worse than the overall market share's 12.5% capital loss.

Global listed property has also struggled. The FTSE EPRA/NAREIT Global Index in U.S. dollars is down 18.9% in capital value, compared with the 8.2% capital loss for the MSCI World Index. The losses were spread more or less uniformly across the major regional markets, although the U.K. market was weaker than most others, recording a 26.6% U.S. dollar loss.

Australian & International Property — Outlook

COVID-19 has had a major negative impact on two of the three main subsectors of the asset class, with retail and office landlords suffering significant interruptions to their

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rental income. In retail, which was challenged in any event before COVID-19, operating conditions have become very difficult. A survey of retail landlords run by Colliers found that 49% of tenants had asked for rent holidays, 73% of landlords expected rents to fall over the next year, and 79% of landlords expect retail property values to drop by between 0% and 20%. Office markets are also under pressure. A survey of property analysts by property consultancy Urbis found that "the value of the nation's office tower sector — currently estimated at $318bn — could fall by as much as 15 per cent over the next year because of the shift away from highly centralised CBD operations to stay-at-home work." It has not helped that a wide range of REITs have tapped the market to raise some AUD 4 billion in new capital to shore up their balance sheets, which has diluted rising share prices. The strength of industrial property, and perhaps in time the greater allure of property dividends in a world of very low returns from money in the bank, may ultimately give greater support to the REIT sector, but for now it remains under pressure.

The same trends are evident overseas. Industrial property, while taking its own cyclical knocks, is best placed as structural changes work in its favour. Colliers, in its latest U.S. industrial market outlook, said that "Post COVID-19, there will be increased demand for industrial capacity due to the growth of e-commerce, increased inventory levels to maintain safety stock inventory, and a growing use of 3PL [third party logistics] providers." On the other hand, the future role of offices is under the microscope. Colliers' latest U.S. office report said that "The most lasting impact to the office sector resulting from COVID-19 could come from firms reassessing their space needs and the flexibility of their lease agreements. If it is proven that some business functions can be run successfully through remote working, tenants may decide not to house such operations in their office space once we reach the new normal. Additionally, firms could move to a more distributed labor strategy, rather than locating all functions in one central office." It is not all doom and gloom, though--as the U.S. trade group NAREIT points out, beyond the immediate cyclical difficulties "Most REIT-owned properties are of high quality and their tenants often are financially more secure than those in many privately-owned properties, which may help shield both the tenants and also the REITs themselves from some of the economic damages caused by the pandemic." In the meantime, however, investors may well remain on the sidelines.

Australasian Equities — Review

Australian shares have tracked the global equity market. Prices had been steadily recovering from their post-COVID-19 lows in mid-March, but weakened in recent days following a downbeat economic outlook from the Fed in the U.S. Year to date the S&P/ASX200 Index is down 12.5% in capital value. The financials (negative 20.6%) and the A-REITs (negative 20.1%) have fared the worst, while IT (positive 5.2%) and consumer staples (positive 0.4%) have done the best. The miners have also been relatively resilient with a small 1.3% loss.

Australian Equities — Outlook

The good news is that lockdowns are beginning to lift and the COVID-19 medical toll was kept low. But the bad news is that the economy, though just past the very worst, is still in weak shape and has a long way to go to return to pre-COVID-19 levels.

National Australia Bank's May business survey for example found that "Business conditions saw a broad-based improvement in the month but remain deeply negative – at a level last seen coming out of the GFC. The services sectors remain weakest, but all sectors continue to see negative conditions. Business confidence increased further from its low point in March, but remains weak with a current reading last seen around the trough in the 1990s recession. The increase in confidence was also broad-based across the economy but all industries continue to expect a deterioration in conditions."

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The same picture, of some improvement from the very worst of lockdown conditions, emerged from the Commonwealth Bank of Australia's latest (May) index of the performance of the services sector. It found that "The easing of some restrictions in May helped boost activity at some businesses, though this was only sufficient to see a softening in the overall pace of decline. Activity fell at a slower rate than in April, but the pace of contraction was still the second-fastest in the survey history."

It helps that consumers appear to be feeling more upbeat. The latest (May) Westpac/Melbourne Institute Index saw a big rebound: as Westpac said, "Confidence has clearly been buoyed by Australia's continued success in bringing the Coronavirus under control, which has in turn allowed for a further easing in social restrictions over the last month." And it is also good news that the COVID-19 impact does not now look as bad as first feared. The Treasury now thinks the peak unemployment rate will be more like 8% than its previous (April) forecast of 10%.

But despite these signs of recovery getting underway, it will still be a long time before corporate profitability will be back to pre-virus levels. Credit Suisse, for example, thinks earnings per share for the ASX200 companies will drop by 19% this year, but will recover by only 3% in 2021, and it will be 2022 before there is a more significant (11%) improvement. Investors will need to be realistic about what is likely to be a tortuous path back to normality.

International Fixed Interest — Review

Bonds have again proved their portfolio value in protecting capital, with the Bloomberg Barclays Global Aggregate Index in U.S. dollars up 2.8% year to date. In a climate where investors have been prioritising safety, global government bonds have done best with a 3.3% return, while global corporate bonds have returned 2.0%. The U.S. market has again been the main driver of the positive return—for example, the U.S. the Global Aggregate would have been up by only 0.7%. Lower-quality assets continue to struggle, with the Bloomberg Barclays Emerging Markets down 1.2% and the Global High-Yield (such as, low-credit quality) index down 4.5%.

International Fixed Interest — Outlook

While the global economic outlook remains uncertain, one element looks more dependable--to a high degree of likelihood, the major central banks will be keeping interest rates very low for an extended period.

After the Fed's latest monetary policy meeting on June 10, for example, the Fed Chair Jerome Powell said that "We're not thinking about raising rates. We're not even thinking about thinking about raising rates." Forecasts made by the 17 officials attending the meeting showed that every single attendee expected the current 0% to 0.25% target level for the Fed funds rate would be maintained throughout 2020 and 2021, and all but two thought it would be kept unchanged in 2022 as well.

Monetary policy is also likely to keep interest rates very low in the eurozone. The European Central Bank at its June 4 policy meeting substantially increased the scale of its pandemic emergency purchase programme, which keeps bond yields low, and said that it "expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon." On the ECB's own projections, inflation will still be well below 2.0% in 2022, so again eurozone interest rates will remain very low for the next two years. The Bank of Japan and the Bank of England will also be in the same position of having to provide an extended period of vigorous monetary policy support.

At some point improved economic conditions will reduce the need for the current degree of monetary policy stimulus, however, it doesn't appear that will be happening anytime soon. The latest (June) view of the U.S. forecasters polled by *The Wall Street Journal,* for example, sees only a very gradual increase in the 10-year U.S. Treasury bond yield from its current 0.7% to 1.4% by

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the end of 2021 and 1.8% by the end of 2022. Bonds look likely to help preserve portfolio capital for some time to come. The lower-credit quality end of the asset class is also likely to continue to underperform. Although market pricing of lower quality corporate debt has improved compared with the immediate post-COVID-19 spike in credit spreads, prices are still signalling an appropriate wariness of default risk.

International Equities — Review

After their sharp fall in February through to mid-March, world share prices recovered steadily through April and May and into early June. In recent days, however, prices have dropped back on a more downbeat assessment of the post-COVID-19 global economic outlook.

Year to date the MSCI World Index of developed markets is down 8.2% in U.S. dollars. The loss would have been a significantly larger 13.4% without the relatively strong performance of the U.S. markets--the S&P 500 is down 5.9% and the Nasdaq Index is ahead for the year with a 6.9% gain. The Japanese market has also been relatively resilient, with the Nikkei down 5.7%. European markets, however, have been very weak: the FTSE Eurofirst300 Index has lost 14.9%, weighed down by the poor performance of the U.K. (FTSE100 down 19.1%) and France (CAC down 19.0%).

Emerging markets have continued to underperform relative to the developed world, with the MSCI Emerging Markets Index down 11.5% and its core BRIC--Brazil, Russia, India, China--markets down 10.0%. A relatively modest fall in China (Shanghai Composite down 4.3%) has been outweighed by large falls in the other BRIC economies.

International Equities — Outlook

Up to early June, investors had been optimistic about early recovery from COVID-19, and had been especially cheered by the May jobs report in the U.S. Forecasters had expected another 8 million jobs to have been lost, on top of the 20.7 million lost in April. The actual outcome, a gain of 2.5 million jobs, was at first sight a major positive surprise, as was the fall in the unemployment rate from 14.7% to 13.3%.

Subsequent analysis, however, showed that the numbers were not as obviously positive as they had appeared, given the statistical difficulty of classifying people as employed or unemployed in a labour market in turmoil. Optimism took a further knock when the Fed published its latest forecasts--it now expects the unemployment rate to take a long time to come down to previous levels. The Fed expects the unemployment rate to be 9.8% at the end of this year, and 5.5% in 2022. It expects U.S. gross domestic product to be 6.5% lower at the end of this year than at the end of 2019.

Private-sector forecasters have a similar view. The consensus view in the latest (June) poll of forecasters run by *The Wall Street Journal* is that the American unemployment rate will be 9.6% at the end of this year and 5.7% at the end of 2022.

A more realistically cautious view of the global outlook is also evident in the latest forecasts from the World Bank and the OECD.

The World Bank's baseline forecast is that the world economy will contract by 5.2% this year. The Bank said that "This would be the deepest global recession since World War II, and almost three times as steep as the 2009 global recession," with the developed economies suffering worst (a 7.0% drop in GDP compared with a 2.5% decline for emerging markets). The bank's forecast of 4.2% global GDP growth means that world GDP will still be lower at the end of next year than it was pre-COVID-19.

The OECD has two equally likely scenarios: "One scenario in which a second outbreak occurs in all economies towards the end of this year ... and an alternative scenario where the second outbreak is avoided." Neither makes for pleasant reading: "In the 'double-hit' scenario,

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global GDP is projected to decline by 7.6% this year and remain well short of its pre-crisis level at the end of 2021; in the 'single-hit' scenario, world GDP is projected to decline by 6% this year, but will have almost regained the pre-crisis level at the end of 2021." The OECD said that "The crisis will cast a long shadow over the world and OECD economies. By 2021, it will have taken real income per capita in the majority of OECD economies back to 2013 levels in the double-hit scenario and to 2016 levels in the single-hit scenario."

The takeaway is that if all continues to go along the lines of the World Bank's base forecast or the OECD's "single hit" scenario, world business activity will have got back to pre-COVID-19 levels at the end of 2021. FactSet's latest (12 June) round up of share analysts' expectations for U.S. profits shows the same expected outcome: a 21.4% drop in profits at the S&P 500 companies this year, followed by a 28.6% rise in 2021, which means that profits at end of 2021 will be only slightly (1.1%) above levels at the end of 2019. At this point, a gradual 18-month return to where equity markets were before the virus outbreak is a plausible outlook. Investors will need to remain realistic about the speed and extent of corporate recovery.

Performance periods unless otherwise stated generally refer to periods ended June 12, 2020.

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