July 2020

Outlook for Investment Markets

After an initial strong recovery from the coronavirus sell-off, equities (globally and domestically) have made only modest progress in recent weeks, as investors have gone into wait-and-see mode on the next phase in the COVID-19 saga. It is still not clear how the global economy will play out. There are signs that the worst has passed and that fiscal and monetary policy almost everywhere is strongly supportive. However, even if COVID-19 is contained--a big *if* given recent experience in the U.S. and elsewhere--further progress is more likely to be gradual and possibly interrupted by new outbreaks, rather than a quick V-shaped recovery. Given the circumstances, portfolios will need to continue to hold healthy levels of downside protection, including bonds which, despite their very low yields, have been useful for capital preservation year to date. In Australia, the economy looks past the worst point (assuming the latest outbreaks, mostly in Victoria, can be brought back under control), but there will still be difficult trading conditions ahead for some time yet.

Australian Cash & Fixed Interest — Review

Short-term interest rates have remained very low, reflecting the target cash rate being held at 0.25% by the Reserve Bank of Australia--the 90-day bank-bill yield is only 0.1%. Bond yields also remain very low by historical standards; although the 10-year Commonwealth-bond yield is up from its COVID-19 low (0.62% on March 9), it is still below 1% (currently 0.88%). The Australian dollar has been rising in value in recent months and has now recovered the ground lost earlier in the year--it is up 0.7% in overall trade-weighted value year to date.

Australian Cash & Fixed Interest — Outlook

There is a very high likelihood that the Reserve Bank will keep the target cash rate at 0.25% for a considerable time, probably well into 2022. Returns from bank deposits will remain very low, as will bond yields. The RBA has said it is open to further monetary easing, which is understandable given its weak economy and lower-than-ideal inflation. In its latest (July 7) policy decision it said that it "is prepared to scale-up its bond purchases again and will do whatever is necessary to ensure bond markets remain functional and to achieve the yield target for 3-year AGS [Australian Government Securities]," which would cement in low-bond yields for longer.

On the currency front, year to date the evolution of the Aussie dollar against the U.S. dollar mirrors the world's equity markets, reaching a low in March and gradually recovering since then. The pattern of selling down when global risks are high and recovering when they are lower looks likely to continue to dominate the outlook. As with the equity markets, which have adopted a wait-and-see approach on its outlook, the Aussie dollar could do the same, and forecasters currently see little near-term change. If the global and local economies continue to recover in 2021 from the worst of the pandemic, or there are other positive developments, like a vaccine, then the Aussie dollar could well appreciate thereafter. Westpac Bank, for example, expects the Aussie dollar to appreciate to USD 76.0 cents by the end of 2021, up from its current 69.8 cents.

Australian & International Property — Review

Australian-listed property has been weak and has underperformed the wider equity market. Year to date the S&P/ASX 200 A-REITs Index is down 22.2% in capital value and down 20.6% including the value of dividend distributions.

The same is true of global-listed property. Year to date the FTSE EPRA/NAREIT Global Index in U.S. dollars is down 20.7% in capital value, substantially shy of the much smaller 2.7% capital loss for the MSCI World Index. All the major regions were under pressure, with the eurozone faring a bit better than most (down 16.3%), and the U.K., which has had difficulty controlling the virus, down more than most with a loss of 28.1%.

Australian & International Property — Outlook

Investors have clearly, and rightly, been concerned about the outlook for Australian commercial property. COVID-19 not only has had a cyclical impact (for example, through rent defaults or delays, especially for retail tenants) but has also created some new longer-term challenges (the impact of remote working on demand for office space) and aggravated some older ones (the impact of e-commerce on brick-and-mortar retail property).

The latest (September) quarterly property survey by the ANZ Bank and the Property Council of Australia showed the impact of the issues currently in front of the sector. Although sentiment was up from the depths of the June readings, it remained strongly pessimistic. Expectations about capital values had been particularly depressed in June for hotels and retail properties. This latest September update showed that expectations remained low, but now offices have joined the mix as well, clearly feeling the heat of the threat from remote working and other changes to former employment processes. Even in the strong industrial-property sector--where in June respondents had been optimistic about future capital appreciation--confidence has dropped and respondents do not expect change in industrial values. Other indicators confirmed difficulties ahead: respondents expect debt-finance availability to worsen, and they expect cap rates (the interest rates used to value property) to rise even as interest rates in general are expected to fall. Cap rates are expected to rise most (and so cause greater revaluation losses) for secondary-grade property. With the numerous other surveys of difficult operating conditions (JLL, for example, found that shop vacancies in malls in June had risen to a 20-year high), it is hard to be optimistic about the near-term outlook for the A-REITs.

Overseas markets face the same issues. In the U.K. market, for example, where listed property prices have been especially weak, early indications from the Royal Institution of Chartered Surveyors' latest (June) commercial property survey are showing that "rents will remain under some pressure for most segments of the real estate market over the next three months and with a few notable exceptions, this trend could persist into the early part of next year reflecting cyclical as well as structural challenges." REIT prices have also weakened in the U.S. as COVID-19 cases have surged to new record levels. NAREIT, the U.S. industry trade group, said that "news of more rapid growth of new cases, especially across the Sunbelt, is leading to a reconsideration of the prospects of reopening right away or being able to do so fully, rather than in slow stages." And there are the structural issues that COVID-19 has brought (or intensified). A global survey of office property markets by CBRE in June, for example, found fundamental changes. Pre-COVID-19, 63% had expected no full-time remote working at their companies, and only 37% had expected some usage. Post-COVID-19, the figures have been transformed: now 70% expect some remote working, and only 10% expect none (the other 20% are unsure). Though there may be some tactical opportunities in industrial property, and in countries that manage to re-open relatively quickly, the sector will likely face ongoing headwinds for some time yet.

Australasian Equities — Review

Like many other equity markets, Australian shares have continued to recover from their earlier COVID-19 sell-off, but the bulk of the recovery took place in April through to early June and there has been little subsequent net movement in recent weeks. The recovery has not been robust enough to gain back the earlier COVID-19 losses, and year to date the S&P/ASX200 Index is still down 9.7% in capital value (down 8.4% after including dividend income). The large weight of the financials continues to drag on the overall outcome, with the sector down 18.4%; on the plus side, the star sectors have been IT (up 16.4%) and consumer staples (up 6.9%). Against a background of a severe shock to world trade, the miners have done better than many might have expected and are up 6.1% year to date.

Australian Equities — Outlook

The outlook is one of near-term recovery that is going better than originally feared, but longer-term challenges remain to be confronted.

Several recent indicators have pointed to a near-term rebound from the lockdown-induced setbacks to business activity; but at the same time there have been questions raised over the longer-term prognosis. Employment rebounded massively in June, for example, but it is noteworthy that the number of full-time jobs actually declined and the bulk of that return-to-work consisted of part-time jobs. The big surge in employment was not enough to prevent a rise in the unemployment rate to 7.4%, and forecasters think there is worse to come before unemployment peaks.

The June National Australia Bank business opinion survey also contrasted the immediate bounce with the longer-term outlook. It found that "the rebound has been significant," but it also found that "conditions remain deeply negative and well below average – reflecting the fact that activity still has some way to go before a full recovery can be declared. Unsurprisingly the services sector continues to show the weakest outcomes, but of some concern are construction and manufacturing which also remain weak – pointing to second round impacts on industries that were not directly impacted by lockdowns. Notably, retail has risen to be close to the top of the pack in terms of conditions – a significant turnaround from persistently weak outcomes prior to the current pandemic. While there has been a very large and fast rebound in the business survey over the past two months, the survey points to ongoing weakness in the sector which will need to see ongoing support until activity levels and capacity utilisation return to normal."

One complication has been the resurgence in COVID-19 cases. The July Westpac Bank/Melbourne Institute survey of consumer confidence said that "Sentiment has been rocked by the resurgence in Coronavirus cases over the last month. After averaging about ten a day through late May and early June, new cases have lifted significantly, running at close to 200 a day in the July survey week. These increases have been almost exclusively in Melbourne prompting the state government to reinstate lockdowns for the city and several regional areas, and the closure of Victoria's state borders – measures that were announced in the first half of the survey week ... It is of some concern that the survey pre-dates the news of a significant cluster of cases in Sydney which emerged last weekend – a day after the end of the survey."

The latest forecasts suggest that over the next two years the Australian economy will go backward. For National Australia Bank, the economy will shrink this year by 1.8% and recover next year by 1.6%; for Westpac, the pattern will be more dramatic, with a 4.2% decline this year and a 3.0% recovery next year. The reality is that the expected economic recovery in 2021 does not currently look like it will make up the hit from 2020. The same outlook is seen in, for example, Credit Suisse's forecasts for earnings per share at the ASX200 companies, which are expected to be down 20% this year, but only limited recovery is expected in 2021 (up 4%) and 2022 (up 8%).

With underlying profits under pressure, dividends are likely to be cut. As a recent CommSec report said, "future payments are much less assured as companies assess the right strategies for their circumstances. Certainly, analysts and investors expect a similar drop off in dividend payments to that of the global financial crisis as shown by the 12-month forward estimated dividend per share for ASX 200 companies," which equates to something like a 30% cut to dividends.

Assuming new lockdowns work as intended, getting back on top of the recent infection resurgence is likely to give some support to the market, but the longer-term impacts of COVID-19 will be tough on future performance.

International Fixed Interest — Review

Once again bonds have acted to protect portfolios through the difficult COVID-19 conditions. Year to date the Bloomberg Barclays Global Aggregate Index in U.S. dollars is up 4.1%. As in the equity markets, investors have had to be fully exposed to the U.S. market to reap all the benefits—ex the U.S. index was up by a smaller 1.9%. The higher-risk end of the market continues to underperform, with the Bloomberg Barclays Index of global high-yield (low-credit quality) bonds down by 2.7%. Emerging-markets bonds have lagged the developed economies, but they are at least now slightly in the black for the year with the Bloomberg Barclays Emerging Markets Index up 0.9%.

International Fixed Interest — Outlook

The outlook for global bonds remains the same. The major central banks are committed to supporting the big economies to recover from the COVID-19 setback, and beyond the immediate need to get economies back on track they will be preoccupied with getting inflation back up to where they would prefer it to be. Inflation had generally been too low for the central banks' liking even before COVID-19 struck, and the post-COVID-19 spare capacity in the global economy means that inflation is likely to move lower again until global recovery finally takes hold and, eventually, starts to increase pressure on wages and other prices.

The huge supply of new government bonds, as governments everywhere turn to expansive fiscal policy to help combat COVID-19, might cause investor indigestion and buyers might start to ask for higher yields to keep buying. This may be why the latest (July) poll of U.S. economic forecasters run by *The Wall Street Journal* is pointing to a gradual increase in bond yields. The consensus in the July poll is that the U.S. 10-year Treasury yield will rise from its current 0.63% to 0.85% by the end of this year and to 1.25% by the end of next year.

However, there is as yet little sign that investors are finding the new supply difficult to absorb. The most recent (early July) auctions of new 10-year and 30-year bonds by the U.S. Treasury, for example, had investors still very keen to buy the issues. The 10-year bonds were oversubscribed, with investors bidding for 2.6 times the USD 29 billion of securities allotted. Demand was equally robust for the 30-year issue, where investors bid for 2.6 times the USD 19 billion issued.

Eventually more normal economic conditions will re-emerge, central banks will begin to ease back from their highly supportive monetary policy settings, and investors will begin to feel a less pressing need to hold safe haven capital-preservation assets like bonds. But more normal conditions still appear to be some distance away. The latest forecasts showed the Fed, for one, is likely to stay on its current easy-money course at least through all of 2021 and most likely well into 2022. Bonds also will likely continue to play a useful portfolio-insurance role for some time, with the main qualification being default risk at the lower-credit-quality end of the spectrum as the COVID-19 cycle makes trading conditions difficult for more marginal issuers of corporate debt.

International Equities — Review

World equities have continued to regain the ground lost after the outbreak of COVID-19, though most of the recovery occurred in April and May and progress has been more limited through June and July. Year to date the MSCI World Index of developed markets is now down by only 2.7%. Performance continues to be heavily dependent on the U.S. market, where the S&P 500 is now all square for the year (down -0.2%) and Nasdaq is up by a remarkable 17.1%. Ex the U.S., the MSCI World Index is down 9.2%. Europe has been the weakest of the major markets, with the FTSE100 in the U.K. down 16.6% (in GBP) and the CAC40 Index in France down 15.2% (in euros).

Emerging markets have continued to underperform the developed economies, with the MSCI Emerging Markets Index in U.S. dollars down 5.3%. Many investors will, however, be focused within the overall asset class on the core BRIC—Brazil, Russia, India, China—economies, which have slightly outpaced the developed economies year to date, with a 1.7% loss. A 15% surge in Chinese share in early July helped the BRIC outcome, with the other three members still showing significant year-to-date losses.

International Equities — Outlook

The outlook remains uncertain. On the plus side, recent indicators show that the low point for the global economy, in terms of speed of decline of GDP, was in April--the J.P. Morgan Global Composite Purchasing Managers' Index, or PMI, improved in May and again in June. Even at its new improved level in June, however, it is signalling that global output is still dropping, albeit much more slowly than before. It is promising that a few sectors (banks, real estate, construction materials, and telecommunication services) have resumed outright growth rather than slower rates of decline.

But the outlook beyond the peak of the pandemic remains unclear. The IHS Markit June global business outlook, which appeared after the J.P. Morgan data, was not encouraging. Markit said that "The latest business outlook survey highlights some of the devastating longer-term impacts of the COVID-19 pandemic on the global economy. The prospects for the world's workforce appear especially bleak, with firms not looking to hire over the coming year amid a gloomy outlook for corporate profits ... With firms seemingly in survival mode amid a lack of confidence around future profitability, these data are suggestive of a long, drawn out economic recovery rather than a quick snap back to pre-COVID volumes once the immediate health crisis has passed."

There was a somewhat more upbeat read from the most recent evidence, which comes from a special survey IHS Markit carried out across companies in 12 major countries in June, asking whether output had risen or fallen since the start of the pandemic, and when the companies' expected losses would be fully recouped. The results were that "of the 62% of firms that are waiting (and still expect) to recover their lost output, the average recovery time is five months."

IHS Markit itself was somewhat wary of the expected quick turnaround: "The survey reveals a surprisingly short anticipated path to recovery for companies on average, which will help ferment expectations of a v-shaped recovery for many markets," adding that "such optimistic expectations are encouraging, but setbacks along the way, such as that currently being seen in the US, seem likely. Persistent weak demand and ongoing social distancing measures until an effective treatment or vaccine for the coronavirus are available will also be a challenge for firms."

Fund managers' current take on the outlook is also sceptical about the quick improvement foreseen by the companies polled in the IHS Markit June survey. In the latest (July) Bank of America Merrill Lynch, or BAML, fund manager survey, only 14% of fund managers expected a quick V-shaped recovery, well behind the more likely options of a protracted U-shaped gradual improvement (the top pick, by 44%), or a second outbreak-interrupted W-shaped recovery (chosen by 30%).

With the outlook still uncertain, perhaps the best approach is to do what the big BAML fund managers are doing: They see COVID-19 as by far the biggest investment risk and are consequently playing it relatively safe. They are long cash and bonds, and within equities they favour healthcare, technology, and the U.S. market (although they recognised that too many of them may be doing the same thing and felt that U.S. tech stocks were the "most crowded" trade). They are avoiding the energy sector, the U.K., banks, and industrials.

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

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