Economic Update

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August 2020

Outlook for Investment Markets

The coronavirus continues to be the prime influence on the investment outlook. Unfortunately, the latest developments have been largely on the downside: Besides the local outbreak in Victoria, the daily number of global new cases continues to increase. At the moment, the consensus view among forecasters remains that 2021 will see a recovery in both the global and domestic economies, which could see the sectors previously most affected by COVID-19 lockdowns regain some lost ground, but risks remain tilted to the downside. Portfolio protection through extensive diversification and more defensive sectoral choices will have to remain a priority.

Australian Cash & Fixed Interest — Review

As universally expected, at its latest Aug. 4 policy meeting, the Reserve Bank of Australia, or RBA, kept its target for the cash rate at 0.25%, and other short-term interest rates consequently remain very low, with the 90-day bank bill yield at 0.1%. The bank also decided to resume buying Australian government securities, as the yield on three-year government bonds had been a little higher than its target 0.25%: As a result, the yield is now back very close to target, and other bond yields have been steady, with the 10-year government-bond yield at just below 0.9%. The Australian dollar has plateaued: After rising in overall trade-weighted value in May, June, and much of July, it has gone sideways more recently. For the year to date, it is up 2.2%.

Australian Cash & Fixed Interest — Outlook

At its Aug. 4 meeting, and again in its Aug. 7 *Monetary Policy Statement*, the RBA made it clear that it will be sticking with a cash target of 0.25% and a target three-year yield of 0.25% for some considerable time, "until progress is being made towards full employment and it [the bank's Board] is confident that inflation will be sustainably within the 2–3 per cent target band". In practice, going by both futures market pricing and commercial bank forecasts, that means out to the end of 2021 as a minimum, and returns from cash and bonds are likely to remain unusually low.

On the currency front, the RBA said in the statement that it did not see why the Australian dollar should move much: "The Australian dollar is now in a range that is broadly consistent with its fundamental determinants, namely the terms of trade and the differential between interest rates in Australia and rates in major advanced economies". Recent polls of forecasters have not been of much help–forecasters typically have been behind the curve, and by the time the poll has been published, the currency has already moved past where forecasters had expected it to go–but for what it is worth, currently the forecasters have the same view as the RBA and also expect little change. In the latest (August) Reuters poll, the median view is that the Australian dollar will be around U.S. 71 cents, close to its current 71.7 cents.

Australian & International Property — Review

The A-REITs have faced tough market conditions. The S&P / ASX 200 A-REITs Index for the year to date has lost 19.2% in capital value and delivered a total overall loss including dividends of 17.4%, significantly worse than the 7.4% overall loss from the wider Australian sharemarket.

Global listed property has produced similarly poor results. For the year to date, the FTSE EPRA / NAREIT Global Index in U.S. dollars has delivered a total overall loss including dividends of 17.6%, again well shy of shares in general. The MSCI World in U.S. dollars delivered a small positive total return of 2.8%. Losses were generally widespread, although the eurozone did a bit better than most (a loss of 8.7%) and the U.K. rather worse than most (down 22.6%).

Australian & International Property — Outlook

Whatever hopes investors may have had of a stabilisation or even improvement in the outlook for the A-REITs have taken a hit from the latest Victoria-centred COVID-19 outbreak. As an article in the *Australian Financial Review* on Aug 13 put it, "A high-rise building boom has made

Melbourne's CBD the largest in the country, surpassing Sydney, but there is barely a soul on the streets with the entire city in the grip of a fresh lockdown to combat a second wave of the deadly coronavirus". It has intensified the earlier COVID-19 impacts on retail properties and offices in particular, which were demonstrated in the latest round of earnings reports. In retail, going by the latest news from Scentre, Stockland, and Vicinity, mall values have dropped by some 10% during the first half of this year. In offices, the latest Property Council of Australia data show that the national vacancy rate has risen to 9.5% from 8.3%. The well-placed industrials sector, on the other hand, continues to do well as shown by the better than anticipated result from Goodman Group, which had a 12.5% increase in operating profit based on strong demand for e-commerce warehouse and distribution space. If the various COVID-19 impacts ease in the near future, the A-REITs may rally, but the more likely outcome for now is ongoing operating challenges and (ex industrial) low investor interest.

The overseas outlook is the same as for domestic markets, except writ larger. The latest (June quarter) survey of global commercial property run by the Royal Institution of Chartered surveyors, or RICS, showed that property professionals in virtually every overseas market expect significant declines in both rents and capital value over the next 12 months, with a predictable sectoral pattern: "a combination of cyclical weakness and structural change will continue to weigh particularly heavily on the retail sector as well as increasingly on offices. By way of contrast the reading for industrials/logistics has returned to positive territory at a global level but this masks significant differences at a country level with the US and Germany likely to be amongst the stronger performers".

In the midst of COVID-19, it is easy to become overpessimistic, but there are some positives. CBRE in its latest *Global Real Estate Market Outlook* expects that global gross domestic product will shrink by 5.2% this year but will rebound by 6.9% in 2021, which with a lag will feed through to commercial property values, and sustained low interest rates will also support property valuations. Some subclasses are well placed: Both CBRE and RICS mention data centres, and CBRE also picks healthcare and cold storage as potential options. And the recent setbacks mean that property is not as expensive as it had been: Some 40% of the RICS respondents believe property is now at fair value. But even on a relatively upbeat view, it looks as if it will be 2021 or beyond before global property will emerge from the current investor scepticism.

Australasian Equities — Review

COVID-19 has weighed on Australian shares with the Victorian resurgence leading to bouts of weakness throughout July. While share prices have improved in August to date, the recent modest recovery still leaves the S&P / ASX 200 Index well down for the year with a capital loss of 8.9% (reduced to a total return loss of 7.4% after including dividend income). The IT sector (up 18.0%) and consumer staples (up 11.0%) have done well, and the miners (up 9.0%) have benefited from higher world commodity prices, particularly gold and iron ore, but they have been outweighed by large falls for the industrials (down 19.4%), the A-REITs (down 19.2% as noted earlier), and the financials (down 18.5%).

Australian Equities — Outlook

The apparently quick recovery from the initial COVID-19 outbreak had always been somewhat misleading: It largely reflected a surge of pent-up spending and activity that had been repressed during the lockdown, rather than necessarily indicating a quick return to pre-COVID levels of business as usual.

The latest Victoria-centred outbreak has refocused attention on a more realistic and more unsettled outlook. The latest (Aug. 8/9) weekly consumer confidence survey from the ANZ Bank and Roy Morgan understandably found a setback to household confidence: "Now just 5% (down 1ppt) expect 'good times' for the Australian economy over the next 12 months (the lowest figure for this indicator since April 18/19) while an increasing majority of 55% (up 3ppts), expect 'bad times' (the highest figure for this indicator since April 11/12, 2020)".

Business confidence had also been weakening after the initial sugar rush of immediate lockdown recovery. National Australia Bank's July business survey found that while operating conditions had markedly improved from the depths recorded at the worst of the lockdown, they were still weak in absolute terms--a result also evident in the July Performance of Business Index from the Australian Industry Group. In addition, business confidence in the NAB survey had dropped back in the month, and forward-looking indicators were not encouraging. The survey was taken before the Victoria outbreak, and business sentiment has likely taken a further dive since.

In its Aug. 7, Statement on Monetary Policy, the RBA forecast that the economy would shrink by 6.0% in the year to December 2020 and recover by 5% in the year to December 2021, meaning that the economy will not be back to pre-COVID levels of output until sometime in 2022. The unemployment rate will hit 10% by the end of this year and will still be 7% at the end of 2022. Chances are that the outlook has weakened a bit further again, and the RBA governor said in post-*Statement* parliamentary evidence that "we should be prepared for a recovery that is uneven and bumpy. The recovery is also likely to be more drawn out than was initially expected despite the downturn being less severe than expected. There are a few factors at work here. The most obvious is the outbreak in Victoria".

This will not be a congenial period ahead for corporate profits. The Credit Suisse analysts, for example, think earnings per share will drop by 20% this year, with only relatively modest increases of 6% in 2021 and 5% in 2020. As with other equity markets, dividend income in a zero interest rate world will provide some support, and the IT stars may also continue to shine, but the end-year profit reporting season is looming as a reality check on underlying corporate performance.

International Fixed Interest — Review

Bonds have continued to provide useful portfolio insurance through recent market volatility. For the year to date, the Bloomberg Barclays Global Aggregate Index in U.S. dollars is up 5.6%. For most of the year, the overall outcome has been heavily reliant on higher U.S. bond prices, but the gap is narrowed in recent weeks: Ex the U.S., the index is up a useful 4.5%. As one would expect in unsettled markets, the riskier end of the asset class has underperformed, with global high-yield (low credit-quality) bonds up by only 0.6%.

International Fixed Interest — Outlook

In the near term, the outlook is for central banks everywhere to maintain very low short-term and longer-term interest rates, as it looks as if the world economy will need ongoing monetary policy support at least through all of 2021 and arguably beyond. Even if the global economy were to pick up faster than currently seems probable, central banks are likely to wait some considerable time before removing the current levels of stimulus – partly for fear of imperilling the early stages of recovery and partly because inflation is likely to be too low for their liking. Most central banks, with the partial exception of the Fed in the U.S., had been struggling even before COVID-19 arrived to get inflation up to the 2% level they typically target, and their job has got harder since.

In the U.S., for example, it is highly likely that the Fed will keep its 0% to 0.25% target range for the federal-funds rate for the foreseeable future. The Chicago Mercantile Exchange's 'FedWatch' tool, which backs out probabilities of Fed moves from futures market prices, is signalling a 100% probability of no change out to March 2021 (which is as far out as the tool currently extends). The median forecast in the latest (August) *The Wall Street Journal* poll of U.S. forecasters is for the fed-funds target to be kept where it is all the way to the end of 2022. The forecasters expect the 10-year U.S. bond yield to rise gradually from its current 0.73% to 1.1% by the end of next year, but it would not be surprising if even this modest rise did not eventuate: Forecasters had been mistakenly picking higher bond yields even before COVID-19 struck, and they are even more likely to be wrong now.

In this environment, where government yields are kept unusually low, the main investor risk is that the hunt for pockets of outstanding yield will push prices to levels that do not compensate for the underlying credit risk. It is all very well for Alphabet, the AA-plus rated parent of Google, to be able to issue 10-year bonds on a yield of only 1.1%, as it did this month. Whether companies on the BBB borderline of investment grade should be able to issue bonds at an average yield of 2.4% (the latest reading from the ICE Bank of America index) is another matter.

Other indicators also suggest that investors may be letting their guard down when it comes to having an appropriate wariness of default risk. When COVID-19 hit, yields on sub-investment-grade spiked to more than 10% above the 10-year U.S. Treasury yield (again on ICE Bank of America calculations). Currently, it has dropped back to a 5.2% spread over Treasuries. This is lower than the spread that prevailed in the tech wreck of 2001-02 or through the global financial crisis. Bonds are likely to be needed for capital protection in coming months while COVID-19 continues to play out, but the focus will need to stay on the high-quality end of the asset class.

International Equities — Review

Rather remarkably, despite the crushing COVID-19 setback to global business activity, world shares are slightly ahead for the year, with the MSCI World index of developed economies up for the year to date by 1.3% in U.S. dollars. Australia-based investors, however, have not felt the benefit, as the 2.4% appreciation of the Australian dollar against the U.S. dollar has more than outweighed the share price rises.

The overseas outcome has, however, been heavily dependent on one market (the U.S.) and, within that market, on one sector (IT). Ex the U.S., the MSCI World Index is down by an intuitively more realistic 6.1%. Within the U.S., the S&P500 Communications Services and Information technology Index is up 19.4%, but ex those sectors the S&P500 is down by 3.2%. The importance of the tech companies is also shown by the remarkable performance of the Nasdaq index, which is up 23.1% for the year to date.

Other developed economies have been considerably weaker. Japan has been relatively resilient, with the Nikkei index down by only 1.7%, but European shares have generally been weak. While German shares are down only slightly (DAX down only 1.9%), overall European equities are down by 11.0% (on the basis of the FTSE Eurofirst 300 index). The U.K. has been especially weak: GDP dropped by 20.4% in the June quarter, a larger fall than in most other developed markets, and the FTSE 100 index is down 18.0%.

The emerging markets are slightly down for the year to date, with the MSCI Emerging Markets Index down 1.7% in U.S. dollars. The key Brazil, Russia, India and China markets (the 'BRIC' group), however, were up slightly, by 0.6%. The marginal gain was entirely due to stronger Chinese shares, offset by large losses in the other three BRIC markets.

International Equities — Outlook

The recent domestic pattern of an initially rapid recovery from the first COVID-19 outbreak, followed by a plateauing and risks arising from new outbreaks, is mirrored overseas.

The J.P. Morgan global composite indicator, for example, which tracks the latest business surveys across a wide range of economies, found that "The global economy continued to recover in July, with the latest PMI [purchasing managers index] data signalling further gains in the indices tracking output and new orders". But as

J.P. Morgan commented, "To fully recoup the losses experienced earlier in the year will still take some time, particularly if COVID-19 restrictions are reintroduced in key pockets of the global economy and supply chains during the coming weeks and months". As it has happened, there have been new restrictions, including, for example, new quarantine restrictions between the U.K. and France. New cases in the U.S., while a bit lower than previously, are still over 50,000 a day, and globally the pace of infection is still increasing, with something like 260,000 new cases a day in mid-August, compared with 215,000 in mid-July and 130,000 in mid-June.

While the consensus view is still that the world economy will recover in 2021, the speed and scale of recovery now look less promising. Reuters' latest (July) global poll of more than 500 economists around the world found that the world economy is now expected to shrink by 4.0% this year, compared with the 3.6% that had been expected in the previous June poll, and the outlook for 2021 is now for growth of 5.3%, a tad less than the 5.4% expected previously. If the COVID-19 cases continue to increase, containment is ineffective, and a vaccine remains over the horizon, then the Reuters economists' worst-case scenario would come into play, with a 6.5% global setback this year and only a 2% recovery in 2021.

It is possible that, despite the uncertain global outlook, continued outperformance by U.S. equities might carry along the overall asset class. Currently, American corporate profits are under pressure: The analysts polled by data company FactSet believe earnings in the June quarter will be some 34% down on a year earlier and will still be lower than last year in both the September and December quarters. But they are looking to a strong 26.5% bounceback in profits in calendar-year 2021. They expect the S&P500 to rise to 3,626, which was an expected 8.3% gain from its level at the time of the FactSet survey (7.5% from its level at time of writing). One question mark is whether economic policy management in the U.S. will provide the stimulus necessary for this to happen: Proposals to keep existing support going, notably the extra unemployment benefit payments that expired on July 31, and to spend more to support the likes of battered state and local government budgets are currently stalemated in Congress.

Investors are currently relying on COVID-19's effects abating, fiscal and monetary support coming to the party at the scale required, and the U.S. sharemarket (and its IT sector in particular) continuing to outperform. That may all come to hand, but many investors may well want to put extra protection including diversification and more defensive equity sectoral allocations into the mix in case it doesn't.

Performance periods unless otherwise stated generally refer to periods ended Aug. 13, 2020.

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