Economic Update

Sydney | 17-09-20

September 2020

Outlook for Investment Markets

COVID-19 remains front and centre as the key to the investment outlook, as demonstrated by the impact of the recent resurgence in Victoria and the resultant business restrictions. At the moment, the consensus view is that both the global and local economies will gradually pull out of the COVID-19-induced recession, but it will be a long and slow haul, with ongoing risk of relapse. Given the ongoing uncertainty, extensive diversification and other defensive portfolio insurance will be central to good outcomes.

Australian Cash & Fixed Interest — Review

The Reserve Bank of Australia, or RBA, has continued to keep the cash rate at 0.25%, most recently at its 1 September policy meeting, and as a result, short-term rates are unchanged, with the 90-day bank bill yield continuing to trade close to 0.1%. Longer-term yields are also effectively unchanged, with the 10-year government bond yield a little below 0.9%. Formally, the Australian dollar is up 3.2% in overall value year to date, though it has been very much a game of two halves. The Aussie dollar plunged by 17.2% in the period of global financial volatility earlier this year, but has risen by 24.6% since its low point on 19 March.

Australian Cash & Fixed Interest — Outlook

Forecasters expect the RBA will keep the cash rate where it is for some considerable time. The bank has so far said it is not keen on cutting the cash rate into negative territory, but equally has also said that any eventual increase will be a long way off. Short-term rates will remain very low. Bond yields may move even lower again, as the RBA's preferred forms of post-COVID-19 policy support will be focused on keeping the three-year government bond yield at around 0.25% (and it has said it will buy more bonds as needed to achieve its target) and on providing cheap term funding to the banks. At its September meeting it increased its "term funding facility" (three-year money costing only 0.25%) to AUD 200 billion and extended its availability out to June 2021. The effect of these policies will be to keep sustained downward pressure on longer-term yields.

The currency, in the RBA's view, is roughly where it should be, or "broadly aligned with its fundamental determinants" as the bank put it, now that the previous safe-haven appreciation of the U.S. dollar had unwound and markets had priced in the strength of Australian commodity prices. The bank would like the dollar to be lower to help the economy recover, but it may not get its wish, and the currency could even continue its recent rise. The latest (early September) Reuters poll of foreign exchange forecasters sees it at US 74 cents in a year's time, up from its current USD 72.9 cents.

Australian & International Property — Review

Listed property has had a difficult year and continues to lag the performance of the wider sharemarket. In terms of total return the S&P/ASX 200 A-REITs index year to date has recorded a loss of 16.9% compared with the 9.6% loss from the S&P/ASX200 index.

The same pattern has been repeated overseas. The FTSE EPRA/NAREIT Global index in U.S. dollars has delivered a loss of 17.0%, a very large underperformance compared with the 3.6% total return from the MSCI World index. There has been little change to the regional outcomes: all major markets went backwards, though the eurozone did better than most (down 9.4%) while the U.K. (down 25.6%) and emerging markets (down 21.2%) fared worst.

Australian & International Property — Outlook

The reasons for property's underperformance are straightforward: a combination of largely COVID-19-related cyclical shocks have hit the retail and office subsectors, accelerating some structural challenges both sectors (particularly retail) were facing in any event, and the relatively robust performance of the industrial subsector has not been enough to offset the other sectors' issues.

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

On the retail front, the most obvious example was the large property devaluation announced by Scentre, the owner of the Westfield malls. A devaluation of some AUD 4 billion, 10% of the value of the portfolio, reflected both difficult trading conditions today—at its low point, Scentre was collecting only 48% of rent due in the June quarter, though that has improved to 80%—and subdued prospects over the longer haul. In offices, Dexus said that it expects weak tenant demand for the next 12 to 18 months, and while it was optimistic that longer-term white-collar office growth would pick up after that, there is still an outstanding question mark about the ultimate scale of remote working. Industrial, on the other hand, has done relatively well. Goodman Group's results showed that within its logistics properties, occupancy remained at 99.8%, rent collection was very high (99%) and the portfolio provided a rare example in current market conditions of positive property revaluation (a gain of 2.3%). Overall, it remains a sector facing headwinds, although again its dividend yield (4.6%) may find takers as investors look for pockets of income opportunity.

Investors are also wary overseas. Research from data firm Real Capital Analytics shows year to date the volume of real estate transactions has dropped sharply by comparison with last year, and that: "In addition to the thumping of transaction activity, the coronavirus crisis has taken a toll on liquidity worldwide. Market liquidity fell in 111 of 155 global commercial real estate markets in the second quarter of 2020."

NAREIT, the U.S. trade group for the American REITs, is surely right to point to the potential for becoming too pessimistic in reaction to COVID-19. It points out some subsectors have been doing very well: data centres, cell towers, and industrial and logistics property, have produced good returns, and this "21st century real estate" now makes up 40% of REIT market capitalisation, up from only 10% in 2010. And it is also possible that some of the alleged changes in the industry have been overhyped. NAREIT argues that "Many have speculated the pandemic could lead to a permanent shift away from housing employees in offices for many companies. However, as the work-from-home trend nears the six-month mark, many organisations are starting to see productivity and collaboration suffer. Additionally, heightened concerns about social distancing and personal space could increase demand for office space, as employees are spaced farther from each other and protective barriers are put in place. This may ameliorate some of the reduced demand for office space created by work-from-home arrangements." Even so, for the time being it looks more likely investors will remain cautious until there is clearer evidence on the COVID-19 endgame.

Australasian Equities — Review

Renewed COVID outbreaks have weighed on the Australian market, where prices have drifted lower in recent weeks. Year to date the S&P/ASX 200 index is down 11.7% in capital value (9.6% after allowing for the value of dividends). The weak financial sector (ex the A-REITs, down 23.6%) has been the biggest headwind, but the industrials (down 17.8%) have also done poorly. The stronger IT sector (up 18.1% year to date, despite the global IT sell-off in September) and a decent performance from the miners (up 6.0%) have not been enough of a counterbalance to the weakness elsewhere.

Australian Equities — Outlook

Australia escaped the original onslaught of COVID-19 relatively lightly: its GDP decline in the June quarter, while a substantial 7.0%, was rather less than the 9% or so experienced by the median OECD economy. It was however, enough to do serious damage to corporate earnings in the period to end June and to pose ongoing risks to improved profitability in the future. CommSec's half-yearly round-up of the latest reporting season showed that aggregate corporate earnings were down by 37% on a year earlier, and dividend payouts were down by 32%. CommSec said that "Clearly it has been the toughest year for some companies in living memory."

Since then, there have been mixed developments, while some parts of the country have been moving out of the

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

clutches of COVID-19, Victoria had a serious resurgence of cases, all against a background of strong fiscal and monetary policy stimulus. The net effect is that the economy is probably at or near stall speed.

Westpac, commenting on the latest (July) reading from the Westpac/Melbourne Institute leading index, said that "We expect the hard lockdown following the renewed virus outbreak to see the Victorian economy contract by 9% in the September quarter. That will offset the ongoing recovery we expect to be unfolding in other states as they continue to reopen, albeit at varying speeds. For Australia overall, we expect growth in the economy to be flat in the September quarter before lifting by 2.8% in the December quarter on the assumption that Victoria moves through Stage 4 to Stage 2 and the other states avoid 'second wave' outbreaks." Other data confirm little or no growth currently: the Commonwealth Bank's Composite Output index dropped into marginally contractionary territory in August, after signalling a growing economy in the previous two months.

Looking further forward, as in many other economies, the outlook is more likely to feature a slow recovery, potentially punctuated by Victoria-style relapses, rather than any quick "V-shaped" improvement. GDP is likely to drop this year–National Australia Bank thinks by 3.8%, Westpac is picking a similar size decline of 3.5%—and next year's recovery (if not derailed by more COVID-19) will not be strong enough to make back the lost ground. NAB is picking an anaemic 0.8% while Westpac has gone for a more optimistic 2.5%. Either way, unemployment will remain well above where it was before COVID-19 arrived.

It is not a strong backdrop for corporate profitability, and shares may well find it difficult to advance much from here. CommSec's assessment looks as realistic as any: it expected "sharemarket returns to be largely flat over 2020 due to supportive monetary and fiscal conditions," which would help offset the otherwise challenging prospects for improved company earnings.

International Fixed Interest — Review

Yields from global bonds continue to be pitiful: the yield on the J.P. Morgan Global Government Bond index is only 0.54%, and in some markets (notably Germany and Switzerland) the yield is negative (negative 0.36% in Germany, for example). But yields moving lower this ear, particularly in the U.S. and the U.K., mean that bond investors have enjoyed capital gains, and the asset class has continued to provide portfolio capital protection. Year to date the Bloomberg Barclays Global Aggregate index in U.S. dollars is up 6.1%. The strongest subsector by far has been long-dated U.S. Treasuries, where the long maturity amplifies the capital gain: year to date the Bloomberg Barclays Long Treasury index is up 22.1%.

International Fixed Interest — Outlook

The big event of the past month was the Fed's review of how it plans to go about running monetary policy in future. The main points were that both U.S. employment and U.S. inflation risked turning out too low; that there was room to push harder against unemployment given that pushing unemployment down did not appear to risk sparking off too-high inflation; and that periods when inflation has been too low (as it has been in both the U.S. and elsewhere) would need to be balanced with periods when it will be a bit too high, if on average the target rate of 2% is going to be hit over the longer term.

As Fed chair Jerome Powell put it on 27 August, "if inflation runs below 2 percent following economic downturns but never moves above 2 percent even when the economy is strong, then, over time, inflation will average less than 2 percent. Households and businesses will come to expect this result, meaning that inflation expectations would tend to move below our inflation goal and pull realized inflation down. To prevent this outcome and the adverse dynamics that could ensue, our new statement indicates that we will seek to achieve inflation that averages 2 percent over time. Therefore, following periods when inflation has been running below 2 percent,

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

Some of the changes were not especially easy to follow—chair Powell admitted a change to how the Fed views employment, drawing a distinction between "shortfalls" and "deviations," "may appear subtle"—but many people got to the same broad conclusion the RBA did. The RBA said the Fed "would now pursue a flexible average inflation target and increase the emphasis placed on achieving maximum employment. Most commentators had concluded this implied the Federal Reserve would maintain a stimulatory monetary policy stance for longer than initially thought and until inflation was moderately above 2 per cent for a time."

For investors, the likelihood is now stronger than ever that very supportive monetary policy will keep U.S. bond yields very low for some considerable time, and the policy lesson is likely to spread. Other central banks are likely to find themselves thinking along similar lines. For now, bonds look likely to repeat their protective role. Ultimately the Fed's new tolerance for a period of inflation above 2% will do no good at all to bond yields, and there may be periods of bond market indigestion (and temporarily higher yields) when even the balance sheets of the Fed and the European Central Bank may struggle to accommodate the forthcoming torrent of new government bonds. But at the moment those risks look well down the track.

International Equities — Review

The good news is that, towards the end of August, world shares, as measured by the MSCI World index of developed markets in U.S. dollars, had made back all the COVID-19 losses and had narrowly gone past their pre-COVID peak: on 2 September the index closed 2.4% above its previous peak set in February.

The bad news is at that point, the previously hot market for tech stocks, which had been making a disproportionate contribution to overall market gains, suffered a sharp relapse. The New York Stock Exchange publishes an index called the FANG+ which tracks the collective performance of 10 of the tech giants, and between 2 September and 8 September it slumped by 13.6%.

A partial tech recovery more recently has helped world shares back into slightly positive territory for the year. The MSCI World index in U.S. dollars is up 1.6% year to date, although Australian investors do not yet have much to cheer about: the 4.0% rise of the Australian dollar against the U.S. dollar means a local investor holding the World index basket is down 2.3% year to date.

The U.S. continues to do the heavy lifting, with the S&P500 index up 4.7% and the tech-oriented Nasdaq up 23.2%: ex the U.S. the MSCI World is down 6.2%, with European markets (other than Germany) doing especially badly. Emerging markets are up 2.6% on the MSCI index, but again performance is heavily attributable to one market (China) which has offset large losses in Brazil, India and Russia.

International Equities — Outlook

The extent of the COVID-19 setback to the world economy has become somewhat clearer. At time of writing, for the 35 OECD-member economies that have reported June quarter GDP data, the average quarter on quarter decline was a 10.6% fall in output. The simple average was exaggerated by some very large falls indeed, notably the U.K.'s 20.4% decline, but even the median fall of 9.1% represented a severe shock to the global economy.

That was then, and the world has moved on, with more recent indicators showing that world business activity has recovered from the initial lockdowns and other COVID impacts. Infection rates have eased in some countries, restrictions have been loosened, and pent-up demand has boosted companies' revenue. The J.P. Morgan Global Composite indicator of world business activity for August found: "Expansions have been signalled in each of the

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

past two months, following a five-month sequence of contraction."

It has helped that China, the economy that first ran into serious COVID trouble, is coming out the other side in decent shape. The Caixin China General Composite index, one of the indexes that feed into the J.P Morgan overall global index, was strong in August. Caixin commented that "the recovery of the manufacturing and services sectors from the epidemic remained the main theme of the economy. Supply and demand both expanded. The gauges for orders, purchases and inventories all remained strong." Since the Caixin survey was published, other data have confirmed the upturn, notably August's retail sales.

While this is all positive, there are still a number of risks and uncertainties which make the investment outlook problematic. One is that the improved levels of economic activity have not lifted all boats equally. The J.P. Morgan data, broken down by sector, show that while most industries are growing again, activity levels are still falling in the tourism, recreation and transportation sectors, and little respite is likely in the near term. There are also likely to be some ongoing adverse impacts even as the shorter-term business cycle improves. As noted earlier in the property sections, for example, the old world of the commute to the job in the office has likely changed, and while there are winners from the process (Zoom being the outstanding example), there is an ecosystem of businesses linked to the old pre-COVID ways of doing things that are going to find the going difficult.

Another issue is that the while the COVID outbreak may be easing in some high-profile countries such as the U.S. and China, globally the outbreak is still on the increase. Figures compiled by the *New York Times* show there are around 270,000 new cases a day globally, a figure which has been creeping up in recent weeks. India in particular is recording over 90,000 new cases a day, and its rate of infection is growing.

There is also the issue of fiscal policy support running out or being pared back. Many countries, including Australia, initiated large and expensive programmes of temporary job and income support, and these are now threatening to wind down. As J.P. Morgan noted, "Jobs may face renewed pressure later in the year as government support schemes fade and company restructuring programmes are implemented."

Global fund managers are understandably relieved with the progress so far, but also recognise the outstanding risks. The September fund manager survey run by Bank of America and Merrill Lynch found 58% of them think a new bull market is underway for global equities. But equally they are rather wary of a quick "V shaped" return to where we were pre-COVID: only 20% subscribe to a V scenario, with a large majority (61%) thinking there will be either a slow, extended "U-shaped" recovery or a "W-shaped" recovery with recovery punctuated by recurrent COVID outbreaks. A second round of COVID remains the biggest risk (nominated by 30% of the managers), followed by the bursting of a tech bubble (22%). By a wide margin, the managers regarded overweight allocations to tech as the "most crowded" trade with, implicitly, the greatest risk of a disorderly unwinding if sentiment were to change.

For investors, the global equity outlook is guardedly optimistic, and on top of a gradual in improvement in business activity, ongoing monetary policy support means that equities will continue to enjoy relative valuation attractions compared with cash or bonds. But risks (COVID and otherwise) have not gone away, and asset class performance has been overly dependent on a narrow spectrum of markets and sectors. Diversification, with some focus on relatively defensive sectors, remains highly advisable.

Performance periods unless otherwise stated generally refer to periods ended 14 September 2020.

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.

Copyright, Disclaimer & Other Information

This report has been issued and distributed by Morningstar Australasia Pty Ltd ABN: 95 090 665 544, AFSL: 240892 and/or Morningstar Research Limited, subsidiaries of Morningstar, Inc.

To the extent the report contains any general advice or 'class service' this has been prepared by Morningstar Australasia Pty Ltd and/or Morningstar Research Ltd, without reference to your objectives, financial situation or needs. Please refer to our Financial Services Guide (FSG) for more information including our conflict management procedures at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest.

Copyright

© The material contained in this document is copyright of Morningstar, Inc., its licensors and any related bodies corporate that are involved in the document's creation. All rights reserved. Except as permitted by the Copyright Act 1968 (Australia) or Copyright Act 1994 (New Zealand), you may not reproduce, transmit, disseminate, sell or publish this information without the written consent of Morningstar, Inc.

Trademarks

Morningstar and the Morningstar logo are registered trademarks of Morningstar, Inc.

Disclaimer

All care has been taken in preparing this report. However, please note we base our financial product research on current information provided to us by third parties (including financial product issuers) which we cannot necessarily verify. While we use all reasonable efforts to obtain information from reliable sources, we do not guarantee the data or content contained herein to be accurate, complete or timely. To the extent that our research is based on information received from other parties, no liability is accepted by Morningstar, its affiliates nor their content providers for errors contained in the report or omissions from the report. Morningstar determines its ratings on information disclosed to it by financial product issuers and on past performance of products. Past performance is no guarantee of future performance.

More Information

If you wish to obtain further information regarding this report, licensing and our services, please contact us on:

Morningstar.com.au subscribers
Tel: 1800 03 44 55
Email: help.au@morningstar.com

Advisers/Institutions/Others
Tel: +61 2 9276 4446
Email: helpdesk.au@morningstar.com

For further information on our analysts and research methodologies, we recommend you visit www.global.morningstar.com/au/researchdocuments

© 2020 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782.