

Economic Update

Sydney | 22-10-20

October 2020

Outlook for Investment Markets

The coronavirus continues to dominate the outlook. Here the Victoria-centred outbreak looks to have come back under control, but overseas there has been a resurgence in cases across a wide range of countries. The latest analysis is that the global economy will still recover in 2021, and there have indeed been some promising developments, notably China's resumption of robust economic growth, but risks remain tilted to the downside. Strong fiscal and monetary policy support will remain necessary: the world's central banks will be keeping interest rates very low for some time and the Reserve Bank of Australia is also likely to be even more supportive with its monetary policy, adding to the fiscal support from the Oct. 9 budget. Australia also looks as if it is headed for a better 2021, but it is early days in the recovery from the worst of the COVID-19 hit and investors will not know the true scale of the pickup for a while yet. In current risky conditions, extensive diversification and other defensive portfolio insurance remain a high priority.

Australian Cash & Fixed Interest — Review

Short-term interest rates remain very low, with the Reserve Bank of Australia continuing to hold the cash rate at 0.25%. The 90-day bank bill yield remains just under 0.1%. Longer-term yields have drifted a tad lower in recent weeks, with the 10-year Commonwealth bond yield now under 0.8% (currently 0.76%). It has been a very volatile year for the Australian dollar, which at first dropped sharply in the immediate wake of the COVID-19 outbreak but then recovered strongly through to early September. In recent days, however, it has weakened again, and year to date is now slightly down (by 0.5%) in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

In recent days market expectations have moved in favour of further monetary policy easing by the RBA. Market pricing and forecasters' views had been drifting in that direction in any event but got further stimulus after a

speech by RBA governor Philip Lowe on Oct. 15, which strongly indicated that further moves were being contemplated. It now looks likely that the cash rate will be cut to 0.1%, that the target three-year bond yield will also be cut to 0.1% from its current 0.25%, and that the RBA will take action to drive five- and 10-year bond yields lower as well through a programme of bond buying. The likelihood is that lower yields will be with us for an extended period: Westpac Bank, for example, expects that the cash rate will still be 0.1% at the end of 2022.

Before the RBA's policy intentions became clearer, currency forecasters in the most recent Reuters poll had been expecting the Australian dollar to appreciate by 3% against the U.S. dollar over the next year, based on a combination of a recovery in world growth helping commodity-backed currencies like the Australian dollar and on an expected weakening of the U.S. dollar. The recent weakness of the Aussie dollar in response to the RBA's likely moves suggests that the forecasts might now be out of date, and it would not be too surprising to see the dollar in a holding pattern for the next few months while analysts have a rethink.

Australian & International Property — Review

The A-REITs have had a hard time of it in both absolute and relative terms. The S&P/ASX 200 A-REITs Index year to date has recorded a capital loss of 14.5% and an overall loss, including dividends, of 12.5%. The corresponding figures for the wider share market are a capital loss of 6.8% and an overall loss of 4.5%.

Global listed property has fared equally badly. The FTSE EPRA/NAREIT Global Index in U.S. dollars has registered an overall loss, including dividends, of 19.0%, very substantially adrift of the 4.4% total return from the MSCI World Index. All major regions have shared in the pain, although the eurozone has not fared as badly as most (a loss of 12.2%). The U.K. has done a good deal worse with a loss of 26.8%.

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Australian & International Property — Outlook

The latest (December quarter) ANZ Bank/Property Council of Australia shows all too vividly the impact of COVID-19 on the sector. Although titled a “December quarter” survey, it was actually taken in September, in the early days of recovery and before the strongly stimulatory Australian Budget on Oct. 9.

At survey time, industry sentiment had improved a bit from the deeply depressed levels of June, but it was still strongly downbeat with the expected sectoral differences. The ANZ said that, “Not surprisingly sentiment remains weakest in the hard-hit tourism sector, although it is only marginally less negative in the office and retail sectors. It is strongest in industrial property, which was also the only sector where confidence is above the key 100 level.” Large majorities of respondents expected capital values to fall in the hotel, retail, and office sectors, although prices were expected to rise for industrial properties.

Conditions (excluding Victoria) are likely to have improved since the survey was taken, and the A-REITs may well have passed the point of maximum alarm about issues such as the threat of e-commerce to brick-and-mortar retail and the threat of remote working to demand for office space. Colliers, for example, in its latest *Capital Market Outlook 2021* report, noted that there is now a more balanced view being taken about office work, while in the retail space there are cutbacks and longer-term winners are being identified: “Capital will look to exclusively target assets underpinned by strong catchments with ideal property level fundamentals.” A combination of a comfortable yield pick-up relative to bonds, a gradual improvement in operating conditions, and a bottoming out of investor anxiety could see the sector better supported from here.

Overseas, it is more difficult to be confident now that the trough of the cycle has been reached for property prices or investor sentiment. It was mildly encouraging that U.S.

commercial property prices, as measured by Green Street Advisers, stabilised in September at 10% below pre-COVID levels, with the usual sectoral pattern (industrial has actually risen by 2% since COVID-19, but accommodation like hotels is down 25% and shopping malls are down 20%). But in the meantime, the number of COVID-19 cases in the U.S. has continued to gradually rise, worsening operating prospects. The situation is worse again in several European countries, where there has been a sharp resurgence of new cases. In the U.K., retailers paid only 13% of the rent that was due for the final quarter of this year, according to property software company Re-Leased, and new lockdowns are in place or planned in several European countries. For now, apart from bottom-fishers who may reckon that beat-up mall and hotel valuations are beginning to look attractive, investors will likely continue shunning the sector.

Australasian Equities — Review

Australian shares have been doing well since the end of September--since then the S&P/ASX 200 Index is up 7.1%--but the recent strength has not been enough to make up the losses experienced earlier in the year, and year to date the index is still down by 6.8% in capital value and down by 4.5% including dividend income. Despite a stellar 43.5% capital gain for the IT sector, overall performance continued to suffer from the weak financials (down 17.3%) and the industrials (down 15.5%). The miners are modestly up (4.7%) for the year.

Australian Equities — Outlook

In Australia, the state of the business cycle took a knock with the Victorian outbreak. As the Commonwealth Bank said, its August composite activity indicator showed “business activity across Australia falling back into decline during August as the re-imposition of coronavirus disease 2019 (COVID-19) measures in parts of the country disrupted business operations and hit demand, with the service sector particularly affected.”

More recently, business activity looks to be picking up from the setback, although Victoria still lags. National

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Australia Bank's latest business survey reported "A modest improvement in September ... The improvement in conditions was driven by a rise in all three subcomponents – trading and profitability are in positive territory, likely reflecting improving activity as the economy opens up ... The impact of the virus remains evident in Vic where conditions are notably weaker than the other states. On the other hand, conditions are now above average in WA, SA and Qld pointing to an ongoing recovery in those states. NSW remains negative but also improved in the month."

There are two positive developments more recently still. First, the COVID-19 outbreak appears to be coming under control: At the time of writing, Victoria had just recorded a day with only one new case, raising hopes that retail and hospitality outlets might reopen before the previously scheduled Nov. 1, and New South Wales was also doing well with only two new community cases. There is still a long way to go, especially at the international border, but it is nonetheless good news.

The other was a supportive budget on Oct. 9, which offered a generous dose of supportive fiscal policy, spread across both households (income tax cuts) and businesses (a wide array of support, most notably immediate expensing of investment, subsidies to hire young people currently unemployed, and a further boost to an already ramped up infrastructure spend).

The impact of the budget is too recent to show up in business surveys, but it was captured in the latest (October) Westpac – Melbourne Institute consumer confidence survey. Westpac said that "This is an extraordinary result. The Index has now lifted by 32% over the last two months to the highest level since July 2018. The Index is now 10% above the average level in the six months prior to the pandemic."

Westpac credited the surge to the budget, plus containment of COVID-19, and likely further easing from the Reserve Bank. It is a useful combo, and hopefully will

support Australian shares into the next year, but, as everywhere else, the twists and turns of COVID-19 are not finished--unemployment is still expected to rise into the first half of 2021. Investors may have to wait a while for a more definitive read on the post-COVID outlook.

International Fixed Interest — Review

Even though bond yields had already fallen to very low levels, and the likelihood of further capital gains looked low, bonds have nonetheless kicked on and generated a useful contribution to portfolio performance. Year to date the Bloomberg Barclays Global Aggregate index in U.S. dollars is up 6.3%. The higher credit quality end of the asset class continues to perform best, with especially large returns from long dated U.S. Treasury bonds, but the riskier world of global 'high yield' bonds has returned only 0.7%.

International Fixed Interest — Outlook

There is no change to the outlook: central banks pretty much everywhere will be aiming to keep short-term policy rates and long-term bond yields at least as low as they are now (and could even drive them lower again) and are likely to stay on that supportive monetary policy course for an extended period.

In the U.S., for example, the Fed has recently said it is prepared to leave rates where they are even after inflation has risen back up to its preferred target level, and both the financial markets and the professional forecasters see it the same way. The Chicago Mercantile Exchange's FedWatch tool backs out the probability of Fed interest-rate changes from futures prices. At the moment it is saying that there is a 100% probability that the Fed will keep its target 0% to 0.25% Fed funds rate unchanged all the way out to September 2021 (which is as far as the tool goes). *The Wall Street Journal's* panel of professional U.S. forecasters goes further, out to the end of 2023, and the median pick in the latest (October) poll sees the Fed standing pat all the way.

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In the eurozone, the latest thinking is that the European Central Bank, after agreeing on an already massive EUR 1.35 trillion (AUD 2.25 trillion) package of monetary support, will go even further again at its December meeting to respond to the latest weakening of the eurozone economy. The Bank of England may also have to increase support to a COVID-battered U.K. economy.

While there are people beginning to worry about the longer-term inflationary consequences of ultralow interest rates for long periods of time, for the next few years providing support to the world economy will continue to trump all other concerns. Bonds, somewhat remarkably, could even eke out some further modest capital gains as central banks increase their efforts. While yields will remain tiny, bonds look like continuing to provide effective portfolio protection. One area to remain wary of, however, will be the low credit-quality end of the spectrum: COVID-19 has recently taken a turn for the worse overseas, which is likely to take a toll on the credit spreads attaching to weaker borrowers.

International Equities — Review

Although world share prices have eased back over the past week, investors are slightly ahead year to date, with the MSCI World Index of developed markets in U.S. dollars up by 2.5%, although Australian investors experienced roughly half of the gain eroded by the Aussie dollar's 1.1% appreciation against the greenback. As has been the case all year, the outcome has been heavily reliant on the U.S. market, where the S&P 500 is up 6.1% and the Nasdaq is up 27.9%. Without the U.S. contribution, the MSCI World Index is down 7.1%. European shares have been especially weak, with the FTSEurofirst 300 down 12.7% (in euros). The U.K. market has struggled with both COVID-19 and Brexit, and the FTSE 100 is down 22.0% (in sterling).

Emerging markets are slightly up year to date, with the MSCI Emerging Markets up 1.1% in U.S. dollars. The core BRIC (Brazil, Russia, India, China) components are up 5.1%, entirely due to stronger Chinese shares, which have

outweighed a small loss in India and large losses in Brazil and Russia.

International Equities — Outlook

There have been some constructive developments in the global economy. World economic activity has picked up strongly from the COVID-19 setback, and the latest (September) J.P. Morgan Global Composite Index (which adds up a very wide range of national business surveys) showed that the world economy continued to grow, albeit at a slightly slower rate than in August. It was encouraging that international trade--as measured by the new export orders component of the index--ticked over from slight contraction in August to slight expansion in September.

It has also been helpful that China has emerged from the other side of its COVID-19 outbreak and is providing significant support to world economic activity. China's GDP in September was 4.9% up on a year earlier, and year to date Chinese GDP is up 0.7%, meaning that China has made good on the earlier COVID-19 losses. And in a global equity market so dependent on U.S. shares, it helps that forecasters are still upbeat about the prospects for U.S. corporate profits. The analysts polled by data company FactSet expect that profits for the S&P 500 companies will have dropped by 17.1% in 2020, a loss exaggerated by the weakness of the energy sector but also reflecting large COVID-19 impacts on sectors such as consumer discretionary. For 2021, however, they continue to expect a strong rebound of 24.6%, which would take profits back above pre-COVID levels.

The latest (October) forecasts from the IMF also expect ongoing growth. The IMF reckons that world output will have shrunk by 4.4% in 2020 but will recover by 5.2% in 2021. Its latest assessment is that 2020 has turned out a bit better than initially thought, but the scale of the bounceback is also not quite as large. Emerging markets are expected to be a strong contributor with 6.0% growth forecast, but the advanced economies in 2020 will grow more slowly--their expected 3.9% growth will not be

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robust enough to make back the 5.8% drop in output in 2020.

The IMF's view is their best guess at a central scenario, but as they point out it is subject to large uncertainty. There are some things that could go better than expected--fiscal policy support could be increased further and a vaccine might arrive early--but there is also a longer list of things that could derail the baseline view, including further COVID-19 outbreaks, premature removal of monetary or fiscal policy support, the financial impact of COVID-19 insolvencies, and renewed trade tensions. The recent re-imposition of tight lockdowns in several European countries, and the still-rising number of global new COVID-19 cases, suggest that the IMF is right to focus on the downside.

The latest (October) Bank of America Merrill Lynch survey of global fund managers shows a similar degree of caution. On the plus side, they see little chance of a renewed global recession, have slightly reduced their cash allocations, and remain net overweight to equities. But the managers surveyed also said they continue to expect a slow rather than a quick recovery from COVID-19. Although they are hopeful about early development of a vaccine--they pick the first quarter of next year as the most likely time--they still rate the evolution of COVID-19 as their top investment risk.

They are also worried about the U.S. election, which is their second-highest risk. By a wide margin--74% of them picked it--the worst investment outcome would be the uncertainty that would result from a contested election, and they think it is entirely possible (61% expect a challenge to the result). By region, they continue to like eurozone equities, presumably on relative valuation grounds, though whether their large overweight allocation will survive the latest resurgence in COVID-19 cases remains to be seen, and they also like U.S. equities. U.K. equity allocations remain deeply underweight, which is not a surprise given the twin issues of a "hard" Brexit and a virulent level of COVID-19 cases.

Guarded optimism, along the professionals' lines, looks like a reasonable stance, but the high levels of economic and political uncertainty, and in particular the latest surge of COVID-19 cases across a range of economies, suggest that portfolios will still need to carry extensive insurance, through diversification and defensive within-sectoral allocations, against risks eventuating. The IMF, for example, looked at an alternative scenario where poor progress is made and COVID-19 isn't contained until 2021: In that scenario, world growth would be only 1.5 to 2.0% in 2021. That would not be well received in the equity markets.

Performance periods unless otherwise stated generally refer to periods ended Oct. 19, 2020.

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