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Economic Update

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Outlook for Investment Markets

Risk assets have had a strong November to date, partly due to some resolution of the political uncertainty around the U.S. elections and, more recently, a strong response to news of a possible COVID-19 vaccine. But just as markets may have initially overreacted on the downside to the emergence of COVID-19, now there is a risk they may be overoptimistic about a vaccine. It is yet to be approved, will take time to deploy, and in the meantime the scale of new COVID-19 cases has got dramatically worse in the U.S. and a number of European economies. There are still cyclical bumps in the road ahead, and it is not surprising that earlier this month the Reserve Bank of Australia, or RBA, has provided further monetary policy support to help with what is likely to be an extended period of post-COVID-19 recovery.

Australian Cash & Fixed Interest — Review

The RBA lowered the target cash rate from 0.25% to 0.1% at its most recent monetary policy meeting on 3 November, and as a result, the 90-day bank bill yield is now effectively zero (currently 0.03%). The 10-year Commonwealth bond yield has edged up a bit in recent days: it had ended October at 0.84% but got just over 1.0% on 11 November, and is currently 0.9%. The Aussie dollar has also risen, from USD 70.3 cents at the end of October to USD 72.3 cents now. Year to date it is slightly stronger, with a 0.5% rise in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The RBA's cut to the cash rate was only one part of a package of further monetary policy stimulus. The bank is likely to keep its strongly stimulatory stance in place for some time. In the more optimistic climate following news of a potential COVID-19 vaccine, forecasters are likely to rethink how long monetary policy will have to remain in ultra-supportive mode, but for now, the best call looks to be that the cash rate will stay where it is at least out to the end of 2022.

The recent rise in local bond yields has been part of a global phenomenon, where yields have risen in response to the possibility of an early vaccine: one line of thinking is that a better outlook for growth suggests that inflation may not stay as low as previously expected, which tends to put upward pressure on bond yields. But the recent uptick in yields is unlikely to last. The RBA has lowered its target yield for three-year bonds from 0.25% to 0.1%, and has also announced a AUD 100 billion war chest to buy five- to 10-year bonds over the next six months. Westpac Bank's view that the 10-year yield will be held around the 0.8% mark over the next year fits well with the RBA's likely bond buying plans.

The rise in the Australian dollar is also very likely a response to the vaccine news: the Aussie dollar tends to do better in "risk on" markets when investors are more optimistic. Currently the big bank forecasters think the rally has further to run, and possibly quite a bit further—National Australia Bank, for example, expects USD 78 cents by the end of next year and Westpac Bank expects USD 80 cents. One issue, however, is that the RBA would be unlikely to welcome appreciation of that order–it would make both its growth and inflation targets harder to achieve–and some further but more modest appreciation, perhaps to the mid-70s, may be a more realistic call.

Australian & International Property — Review

The global equity rally in November had a large effect on the A-REITs, with the S&P/ASX 200 A-REITs index up by 12.3% month to date. The scale of the earlier COVID-19 setback, however, means the A-REITs even after this rally are still down by 7.9% year to date (down 5.8% including distributions).

Global listed property also benefited strongly from the wider global equity rally in November, with a month to date capital gain of 10.8% for the FTSE EPRA/NAREIT Global index in U.S. dollars. As with the A-REITs, the strong lift has not, however, been enough to make up for earlier sharp losses for the retail, hotel and office REITs

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most impacted by COVID-19 lockdowns, and year to date the index is still down by 15.1% in capital value and by 12.0% on a total return basis (including dividends).

Australian & International Property — Outlook

The outlook has turned for the better for the sector after the significant shock of COVID-19. The impact of rental losses can be seen in the MSCI/Property Council of Australia index data, which showed that the return from holding physical commercial property in the year to September was only 0.9% (4.6% income less 3.7% capital loss). MSCI commented that "The annual income return of 4.7% represents the lowest figure since the index started 35 years ago. This has been due to difficulties in rent collection rather than income compression."

Conditions are now on the mend as the largely Victoria-centred cases of COVID-19 have come under greater control. Data from property management software company Re-Leased showed that rental collection has been getting better. The company said that "The Australian rental collection data for September shows payment rates continue to improve, though not to pre-COVID levels. For September, 81% of commercial rent was received by landlords within 30 days, compared to 77% in August and the pre-COVID monthly average of 90%." The news of a vaccine has obviously been a further boost for the sector. Some sectors, particularly hotels, will continue to find it tough going until border restrictions can be lifted, and even when they are, residual traveller caution may see lower demand than previously. But provided there are no further major outbreaks, the recent price gains for the retail and office A-REITs in particular look to be a realistic assessment of improved conditions ahead.

Overseas, November's rally led to quite remarkable price rises in some sectors. In the U.S., for example, prices for all retail REITs are up 21.2% month to date, with the big shopping centres up 33% and the large regional malls up 19.1%. Office REITs also had a substantial 20.5% increase. Yet despite these strong rises both retail and office U.S. REITs are still well down for the year to date (retail down 29.8% and offices down 22.8%), which more accurately reflects the ongoing challenges that COVID-19 still poses. Vaccine or no vaccine, it is likely that the longer-term impact of online shopping on retail brick and mortar, which was known pre-COVID, and the new threat to office REITs from remote working, still have to play out. It does not help that, while a vaccine is now on the near horizon, the immediate cyclical outlook has got markedly worse, with sharp rises in new COVID-19 cases in the U.S. and much of western Europe, which are likely to lead to a further round of pre-vaccination lockdowns and rental defaults. The industrial sector continues to do well as an e-commerce facilitator—the U.S. industrial REITs are up 14.5%, and data centre REITs are up 26.1%—but for the rest of the sector the relief rally may be premature.

Australasian Equities — Review

Like the overseas share markets, Australian shares eased off going into the U.S. election uncertainties, and then rallied strongly more recently as the election results became clearer and there was good news on a potential COVID-19 vaccine. The S&P/ASX 200 has had a strong November—to date the index is up 8.1% since the end of October. The rally has not, however, been strong enough to counteract the COVID-19-related weakness earlier in the year. The index is still down 4.2% year to date (down 1.6% allowing for dividend income). IT shares continue to do very well, up 45.3%, but the poor outcomes in the larger financial and industrial sectors (down 14.0% and 10.3%, respectively) have kept overall performance on the loss side of the ledger. The miners have made a small gain of 3.0%.

Australian Equities — Outlook

Recent surveys show that Australian businesses are doing better as they emerge from the COVID-19 lockdowns, but the improvement is modest rather than strong. The latest (October) National Australia Bank business survey, for example, found that "the economy has rebounded from the sharp fall in activity in H1 2020 and will likely continue to recover as the economy reopens. However, it will likely

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take some time for activity to fully recover, with capacity utilisation restored and the pipeline line of work replenished. The improvement in confidence is encouraging but remains fragile, and it will likely remain that way until a vaccine is available."

The latest (September) Westpac/Melbourne Institute leading indicator is also signalling an upturn. Westpac said that "growth in both the September and December quarters will be clearly in positive territory, as the Australian economy opens up. We have also revised up our growth forecasts for 2021 and 2022 following the announcement of the Federal Budget. Consistent with the steady progression in the leading Index we expect growth of 2.8% in 2021 and 3.5% in 2022."

But whether you go by the Westpac forecasts, or the RBA's in its latest Monetary Policy Statement on 6 November, either way the answer comes out the same: it will be 2022 before the Australian economy will get back to pre-COVID-19 levels of activity. Profits have taken a big hit—the RBA pointed out in the Statement that outside the miners and the financials, the companies in the ASX 200 index in aggregate racked up a loss in the first six months of this year—and will take an extended period to rebuild. The recent share price rally, while welcome, may be taking an overly upbeat view of the timescale involved.

International Fixed Interest — Review

The key international bond yield, the yield on the U.S. Treasury 10-year note, has been gently trending upwards since its low point in the wake of the COVID-19 outbreak. It had reached a low of just above 0.5% on 4 August, but by the end of October had moved up to 0.88%. More recently, the outcome of the U.S. election, and news of a promising vaccine, sent the yield higher again, hitting 0.96% on 10 November. At the time of writing, it had eased back a little to 0.9%.

Despite the recent yield rise (and the associated capital losses), international fixed interest is still ahead for the year to date, reflecting the sharp falls in yields earlier in the year. The Bloomberg Barclays Global Aggregate index in U.S. dollars is up 6.7%. Long maturity U.S. Treasuries remain the big winner, with a 17.6% gain, while the riskier sub-sectors continue to underperform: global "high yield" (low credit quality) is up 2.8%, and emerging market bonds up 4.2%.

International Fixed Interest — Outlook

Income-oriented bond investors might have had their hopes raised by the recent rise in U.S. yields, but the greater likelihood is that the asset class has probably not emerged from its remarkable journey into historically low and even negative returns. Earlier this month the market value of debt carrying a negative yield rose to a new record of USD 17.05 trillion, according to the Bloomberg Barclays Global Negative Yielding Debt index, narrowly surpassing the previous record set in August 2019.

While there is some justification for the recent yield rise—a normalisation back from the extreme "safety first" bond buying in the early days of COVID-19, plus the effect of the vaccine news—it is likely that central banks virtually everywhere will continue to press down on bond yields to support post-COVID recovery.

In recent days, for example, the vice-chair of the Fed has talked up the ongoing deployment of its bond buying programme. In the U.K., the Bank of England has launched a new GBP 150 billion (AUD 245 billion) round of bond buying. And in the eurozone the president of the European Central Bank, or ECB, has said that "the key challenge for policymakers will be to bridge the gap until vaccination is well advanced and the recovery can build its own momentum ... The ECB was there for the first wave and we will be there for the second wave." The bank is widely expected to increase its bond buying programme at its December meeting, and to extend it out to at least the end of 2022.

For now, bond yields look set to stay very low, and the main attraction of the asset class will continue to be its portfolio insurance role as a preserver of capital. The

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lower quality end of the asset class is likely to remain challenged: the credit spread returns for taking on low-quality corporate risk have dropped considerably, but the immediate cyclical outlook remains problematic.

International Equities — Review

World equities had been in subdued mood in the second half of October, with the MSCI World index of developed markets in U.S. dollars dropping by 7.5% between 12 October and the end of the month. Since then, however, there has been a strong rally following the resolution (in most people's minds) of the U.S. presidential election and the news from BioNTech and Pfizer that they had had promising results from their new COVID-19 vaccine.

The MSCI World index is up by 10.3% since the end of October, and year to date is now up 7.2%. The outcome continues to depend heavily on the U.S. market, where year to date the S&P 500 is up 11.0% and the Nasdaq up 31.8%: ex the U.S., world shares year to date are down by 2.2%. European shares in general (FTSE Eurofirst 300 index down 8.3%) and U.K. shares in particular (FTSE 100 down 16.0%) have been notably weak.

The emerging markets are up 6.6% in U.S. dollars on the MSCI index, with the core BRIC members (Brazil, Russia, India, China) up 9.5%. Chinese shares account for virtually all of the gain, with Indian shares little changed and Brazilian and Russian shares markedly weaker.

International Equities — Outlook

It is easy to see why the markets have been cheered by the news of a potential vaccine, on top of the earlier evidence, pre the vaccine announcement, of a pickup in global economic activity from the shock setbacks of the first half of the year.

The J.P. Morgan global composite indicator of business activity, for example, has continued to improve. The bank commented that "October saw the fastest expansion of global economic output for over two years. Growth was underpinned by rising intakes of new work, improving business optimism and the continued stabilisation of trends in new export orders and staffing levels."

IHS Markit, which organises the national surveys that go into the J.P. Morgan global composite indicator, runs a business outlook survey three times a year. Its latest survey, in October, also showed that the world business cycle seemed to be turning for the better. According to IHS Markit, it "recorded the strongest degree of optimism among companies since late-2018. The business activity net balance rose from a near survey low of +15% in June to +26%. Hopes that a vaccine could be rolled out over the coming 12 months underpinned the improvement in confidence from the lows earlier in the year."

On the plus side, the executives' hopes were realised in November, with the vaccine news. On the down side, however, respondents' fears were also realised: "the recovery in business sentiment is largely pinned on hopes of a reduction in COVID-19 case numbers, as well as the roll-out of a vaccine over the course of the next 12 months, meaning any renewed controls to halt the spread of the virus could derail this recovery ... An increase in worldwide COVID-19 cases means further containment measures look set to be introduced in coming months. Hence, businesses may have to brace themselves for some tough months ahead before any sustainable economic recovery takes place."

The recent upsurge has been alarming. Three months ago, there were about 250,000 new cases a day worldwide, according to the tally maintained by the *New York Times*; at the time of writing, there are around 550,000 new cases. In the U.S., in particular, new cases have skyrocketed, with new records being registered every day (159,000 on 14 November alone). President-elect Biden is mulling a national lockdown under his administration, while a range of European countries have reimposed tight lockdowns.

Fiscal and monetary policies everywhere are on maximum stimulus settings, and there may well be an effective

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vaccine starting to be deployed in the first half of next year. But it is hard to avoid the conclusion that local and global equity markets may currently be glossing over the difficulties that still lie ahead. As one example, at the moment the sharemarket analysts surveyed by data company FactSet think that the S&P 500 companies in 2021 will make back all the profits lost in 2020 and a bit more (an earnings gain of 22.1% compared with 2020's 14.5% decline). With the likelihood of business disruption rising sharply, that looks a big ask.

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