Economic Update

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December 2020

Outlook for Investment Markets

Markets have had two bits of good news that have boosted growth assets: The first coronavirus vaccinations are underway, and in many countries (including Australia) the economic bounceback from the initial lockdowns has been stronger and faster than earlier expected. On the downside, however, vaccination is likely to be a prolonged and patchy process, and in the meantime, there has been a second, larger wave of infections and deaths across a number of large economies, triggering a second phase of disruption. Even with vaccinations underway, there is likely to be a long period where our border controls will need to stay in place, meaning ongoing challenges for sectors such as tourism. In the wake of the vaccine news, financial markets both overseas and here in Australia may have become somewhat overoptimistic, and they risk colliding with the more complex reality that is likely to unfold in 2021.

Australian Cash & Fixed Interest — Review

At its monetary policy meeting on Dec. 1, the Reserve Bank of Australia maintained its 0.1% target cash rate, and as a result, short-term interest rates are unchanged, with the 90-day bank bill yield staying close to zero (0.02%). Bond yields have also been quiet: While they rose in early November in response to news of vaccines and resolution of uncertainty over the U.S. presidential election, they have stabilised since then, and the 10-year Commonwealth bond yield has been steady in recent weeks, close to 1.0%. The Australian dollar has appreciated: In overall trade-weighted value, it is up 3.5% for the year to date. A large element in its rise is its recent 3.7% rise against the U.S dollar: A month ago, it was worth 72.7 U.S. cents, compared with its current 75.4 cents.

Australian Cash & Fixed Interest — Outlook

The RBA at its latest meeting said that it "remains committed to not increasing the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range … Given the outlook, the Board does not expect to increase the cash rate for at least 3 years". Some think that the three-year time frame may be too long, given the recent strong bounceback in economic activity: The chief economist at Westpac has said that "By 2022, if the near term forecast is for the unemployment rate to be returning to near pre COVID levels, it will be difficult to justify forward guidance that the cash rate will remain on hold for a further three years". Either way, though, the cash rate looks set to stay where it is at least to the end of next year.

Local bond yields have reflected changes in global sentiment about the upside from a COVID-19 vaccine. Some forecasters are starting to think that, in addition to the upward move from less demand for insurance against risk, the faster than expected economic recovery from COVID-19 may also push yields higher: Inflation pressure may be a bit stronger, and central banks may not feel the same pressure to keep monetary policy quite as stimulatory as they first planned. We may be near the low point for bond yields, though any increases are likely to be modest and gradual. National Australia Bank sees the 10-year yield only a tad higher (at 1.2%) by the end of next year, while Westpac sees a slightly larger rise, to 1.25%.

The outlook for the currency remains linked to global investor sentiment. In recent weeks, sentiment has firmed on news of vaccine development, and this has had two consequences. Investors have felt less need to huddle in the safety of the U.S. dollar, which has dropped in overall value by 3.4% since the end of October. They have also felt more confident in buying 'risk on' currencies like the Aussie dollar, possibly also influenced by Australia's effective COVID-19 control by international standards and by the strength of some commodity prices (notably iron ore). While this mood prevails, further appreciation may well be on the cards, with (for example) both National Australia Bank expecting a 78 U.S. cent exchange rate at the end of next year and Westpac expecting a larger rise again to 80 U.S. cents.

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Australian & International Property — Review

Although they enjoyed a good bounce in the post-vaccine-news market rally, for the year as a whole, the A-REITs have had a difficult time, and the S&P / ASX 200 A-REITs Index is down by 7.3% in capital value and returned an overall loss including dividends of 5.2%.

There was a similar outcome, only worse, for global REITs. Again, there was a relief rally on the vaccine news, but it did not compensate anywhere near enough for the previous COVID-19 losses, and for the year to date, the FTSE EPRA / NAREIT Global Index in U.S. dollars is down and has delivered a capital loss of 14.3% and an overall 11.1% loss including dividends.

Australian & International Property — Outlook

The latest (September quarter) commercial property survey run by National Australia Bank made for grim reading. At the time of the survey, the Victoria lockdown was still in full swing, so severe industry pessimism (only a little better than its record low in June) was understandable. But focusing just on what participants expected two years ahead, when COVID-19 was likely to be out of the reckoning, the results showed that respondents expect some long-lasting impacts.

There was the usual tiering. Respondents were happiest about industrial, where in two years' time they expected to see slight increases in rents and capital values and a slightly lower vacancy rate. But office values were expected to drop by 2.8%, office rents to drop also by 2.8%, and the national vacancy rate to rise to 9.9% from 9.0%. Retail was seen as worse again, with values expected to drop by 3.6% and rents by 4.4%. It was somewhat cold comfort that retail vacancy is expected to drop to 8.2% from 8.8%: Pre-COVID-19, the retail vacancy rate has been steady for some years at around 5%. With industry players themselves pointing to a degree of permanent COVID-19 scarring, it seems likely that A-REIT investors will stay on the sidelines until they can see a clearer picture of the damage.

Internationally, surveys show equally glum expectations. On the plus side, the latest (September quarter) Global Commercial Property Monitor compiled by the Royal Institution of Chartered Surveyors was taken before news broke of new vaccines, and arguably sentiment will have improved since then. But on the down side, the survey was also taken before the latest surge in infections, deaths, and lockdowns across several of the major economies.

The Monitor showed that virtually every commercial property market was in the same space, with rents and capital values expected to fall over the coming year. Retail was, predictably, once again worst placed: "prime retail rents are expected to fall by -6% over the coming twelve months (on average across the globe), with projections for secondary retail rents standing at -10%". Industrial was best placed: "prime industrial rents are anticipated to rise by +2% in the year to come, although the outlook remains marginally negative for secondary at -1%". Office markets were in the middle. Overall, this backdrop suggests that the global REITs in aggregate will continue to underperform, though industrial, and some specialised REITs such as data centres and cool stores, may beat the general downbeat outlook.

Australasian Equities — Review

Australian shares have made little ground for the year to date, with the S&P / ASX200 Index slightly down (negative 0.4%) in capital value and returning 2.4% including dividends. There have been some very strong sectors, notably IT, which is up 51.7% thanks to the stellar performance of companies such as 'buy now pay later' Afterpay (which is now about to join the top 20 stock index), and the resources have also done well (the miners are up 16.3%). But the financials (down 6.5%), the A-REITs (down 7.3%), and the industrials (down 12.5%) have been a drag on overall performance.

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Australian Equities — Outlook

Australia has bounced back from its COVID-19 lows more quickly, and more extensively, than earlier feared, even after the disruption of the Victorian and South Australian COVID-19 outbreaks. The speed and scale of the improvement has beaten forecasters' and policymakers' expectations. As one example, the gross domestic product data for the September quarter showed a quarter-on-quarter rise of 3.3%, which was comfortably above the 2.5% rebound that forecasters had been expecting.

More recent data confirm that the turnaround remains well underway. The early ('flash') results from the IHS Markit suite of business surveys showed that "Not only was the Australian economic recovery sustained in December, but growth also gathered momentum as the loosening of COVID-19 restrictions underpinned further improvements in demand for goods and services. As such, private sector output expanded at the quickest pace in five months".

The latest National Australia Bank also brought good news. The bank found that "Business conditions and confidence rose in November, continuing to suggest a rapid rebound in the economy as restrictions are eased and state borders open up ...Overall both confidence and conditions are now above average, and stronger than the period right before the pandemic--albeit this partly reflects some "snapback" following the containment of the virus".

Consumers have also become markedly more upbeat. In commenting on the December Westpac / Melbourne Institute consumer survey, Westpac said that confidence had recovered much more rapidly from COVID-19 than it had when coming out of the recession of the early 1990s or when coming out of the global financial crisis. In particular, households were much less concerned about unemployment than they had been: "This is the best reading of this [unemployment] Index for nearly ten years --in line with the status of the overall index. Contributing to this improvement is likely to have been the government's winding back its forecast for a 10% unemployment rate by December and the widely reported October employment release which printed a remarkable 178,800 new jobs".

The risk, as it is in other equity markets, is that investors will overreact to this positive surprise. It is real, and important, and puts a supporting wind of economic fundamentals into corporates' sails, but it may be optimistic about the longer-term picture. As NAB said, "Even with the significant improvement in trading conditions and profitability, businesses will likely need to see a sustained improvement in forward orders and a complete recovery in capacity utilisation before renewed hiring and investment plans are put in place". There is a hole in the economy where the worst of the COVID-19-affected businesses used to be, with likely knock-on effects for some time on the likes of banks' bad loan provisions, and it will take an extended time to repair.

International Fixed Interest — Review

At the start of 2020, many investors may have wondered whether bonds could make capital gains this year, given that yields were already so low. In the event, COVID-19 led, on the demand side, to a further surge in 'safe haven' buying of government bonds and, on the supply side, led central banks to push yields even lower again to support faltering economies.

Even though yields rose again more recently, particularly after news of vaccines, the net effect is that bonds have indeed made further gains and have proved a useful asset class both in absolute and relative terms. The Bloomberg Barclays Global Aggregate Index in U.S. dollars is up 8.5% for the year to date. The higher-quality end of the bond spectrum fared best, while the riskier subsectors lagged: 'High yield' was up 5.9%, and emerging markets were up 5.7%.

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International Fixed Interest — Outlook

As can be seen from their latest decisions, this month's monetary policy decisions by the Fed and the European Central Bank made the big picture clear: For the next year or two, the big central banks are likely to stick with their current policies of keeping both short-term and long-term interest rates close to their current ultra-low levels.

The Fed said that it would maintain its bond-buying programme of USD 120 billion a month "until substantial further progress has been made toward the [policy] committee's maximum employment and price stability goals". That is still expected to be some distance away: The Fed's internal forecasts showed that a very large majority of the officials involved in the decision expected the Fed to keep its target fed-funds rate where it is (at zero to 0.25%) all the way out to 2023.

The ECB is also committed to long-term low rates. This month, it increased its bond-buying programme for EUR 1.35 trillion (AUD 2.2 trillion) to EUR 1.85 trillion (AUD 3.0 trillion) and extended it out to March 2022. The bank also indicated that the exact amount was secondary to keeping interest rates low.

While the immediate outlook for yields remains unchanged, with ongoing ultra-low yields, there is a case building in the background that the end of the era of exceptionally low yields may be coming closer and that central banks will start to tiptoe away from their current stance a bit earlier than they currently expect.

That is on the basis that the current better-than-expected rebound from the depths of COVID-19 continues to unfold and that vaccination and other measures progressively get on top of the pandemic. The median view in the latest (December) *Wall Street Journal* poll of U.S. forecasters is that by the end of 2022 U.S. inflation will be 2.1%, unemployment will be back down to 4.8%, and in those circumstances, the 10-year U.S. Treasury yield would have risen to 1.5%. At some point, bond investors may well start to have to think harder about the potential for capital loss, but for now bonds remain well-placed as defensive portfolio insurance.

International Equities — Review

Despite the disruption to the global economy in 2020 from COVID-19, world shares are up for the year. The MSCI World Index of developed markets in U.S. dollars is up 11.1% for the year to date. Unfortunately for local investors, the strength of the Australian dollar against the U.S. dollar--it is up by 7.6%, much of which has occurred in the past month--has eaten into the overseas return.

As has been the case all year, returns have depended disproportionately on the U.S. market, and in particular on the big names in its tech sector: The S&P 500 is up 12.9%, and the tech-heavy Nasdaq is up by 38.6%. Ex the U.S., the MSCI World is up by a much more modest 3.0%, with Japan, where the Nikkei is, up 13.0%, the best of the other major markets. European shares have been weak, with the FTSE Eurofirst 300 Index down 6.8%: Within Europe, the U.K. has been especially poor, with the FTSE 100 Index down 13.4%.

The emerging markets have also done well against this year's difficult economic backdrop. The MSCI Emerging Markets Index is up 12.2% in U.S. dollars, and its core 'BRIC' members are up 11.6%, with gains in China and India offsetting losses in Russia and Brazil.

International Equities — Outlook

The gains made by global equities reflect three main factors: enthusiastic investor reception of news of the development of new vaccines; evidence that economic activity in many countries had bounced back quickly from its sharp fall earlier in the year in the immediate wake of the COVID-19 outbreak; and strong fiscal and monetary stimulus in a wide range of countries designed to counter the damage from the pandemic.

The global recovery in business activity was clearly evident in the latest J.P. Morgan Global Composite indicator, for November, which showed that the world

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economy was growing for the fifth month in a row: Based on the historical relationship between the indicator and world GDP, the global economy is currently growing at a respectable 3% or so annual rate. In addition, the breadth of the recovery is improving: In November, output increased in 18 of the 21 industry sectors surveyed, the broadest scale of growth in over two years. Unsurprisingly, healthcare activity was by a margin the busiest sector, but there were also strong output gains for many other sectors, led by especially strong growth in the car and machinery industries.

In the circumstances, it is not surprising that investors have been upbeat. The monthly fund manager survey run by Bank of America Merrill Lynch turned very positive in November, as news of the vaccines was breaking, and the U.S. presidential election returns were in. They turned more positive again in December. Cash was taken to even lower levels, and allocations to equities rose to levels last seen in November 2010 in the emergence from the GFC.

Share market analysts are also positive about the outlook for the key U.S. share market. Their latest forecasts, collated by data company FactSet, are for a strong 21.9% rebound in S&P 500 profits in 2021, which would more than erase the estimated 13.7% setback of 2020. The analysts think the S&P 500 will just tick over the 4,000 mark over the coming year, which would be a 9.7% gain from its level at the time of writing.

All that good news noted, it is hard to avoid the impression that world equity markets have been swinging from one extreme to the next and have not yet reached a fully balanced view. Fund managers, for example, are currently very upbeat about the progress that will be made with vaccinations in the first half of next year. That is not only an ambitious time scale for rollout, for both developed and (especially) emerging markets, but it also ignores the serious worsening of the pandemic in the meantime. A number of European countries, for example, have had to impose tight new lockdowns, and the latest headline in the *Daily Telegraph* newspaper in the U.K. reads “London plunged into toughest [lockdown] tier as ministers warn of new virus strain”. In the U.S., new cases and new deaths continue to run at very high levels, with hospitalisations at a new record and the cumulative death toll now near 300,000.

The current upbeat mood also glosses over the likely permanent damage from COVID-19. With vaccination progress likely to be gradual, and countries likely to vary in the effectiveness of their rollout programmes, border controls are likely to remain a serious challenge for some time. The J.P. Morgan global indicator, for example, shows that the tourism, recreation, and transportation sectors remain in a depressed state, and there will be a swathe of businesses that will not survive a further extended period of travel controls.

All going well, the world economy will indeed gradually pull out of its COVID-19 difficulties, and corporate profitability will be rebuilt. At the moment, however, market sentiment looks overly focused on early widespread vaccine deployment.

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