

Economic Update

Sydney | 27-01-21

January 2021

Outlook for Investment Markets

Local and international equity markets continue to take comfort from the prospect of vaccinations bringing the coronavirus pandemic under control, even if in the near term the number of new cases in some regions (notably Western Europe) is still alarmingly high. There is indeed a good chance that global and local economies will gradually move back toward normality, and to that extent current optimism is warranted. There are important caveats, however: the virus is mutating, the efficiency of vaccination rollouts remains to be seen, and the current wave of optimism may not be allowing for the permanent impact of COVID-19 on sectors such as commercial property. Post-vaccine optimism has also taken some risk-asset markets into expensive valuation territory.

Australian Cash & Fixed Interest — Review

Short-term interest rates remain very low, with the 90-day bank bill yield effectively zero (0.01%). Bond yields have moved slightly higher, echoing a rise in the U.S. bond market, but the 10-year Commonwealth bond yield is still very low at 1.1%. As with other financial markets, it is early days, and year-to-date movements may not mean much, but the Australian dollar is 0.6% higher in overall trade-weighted value since the start of the year.

Australian Cash & Fixed Interest — Outlook

The Reserve Bank of Australia, or RBA, does not want to take the target cash rate lower than its current 0.1% as it is not in favour of negative interest rates, but it equally is very unlikely to raise the target rate. At its December policy meeting, it said that "the Board is not expecting to increase the cash rate for at least three years." An extended period of very low rates remains highly likely: the financial futures market's pricing suggests that rates will stay where they are out to the middle of 2022. Investors are unlikely to see any improvement on the return from money in the bank (0.3% on average in December for the "specials" that the banks promote, according to the RBA).

The recent uptick in local bond yields may carry on a bit further, but there is not much scope for any significant rise as the RBA would be likely to deploy its bond-buying programme to keep long-term interest rates at low levels and in particular to defend its target 0.1% yield on three-year government bonds. Forecasters currently typically expect only modest increases: National Australia Bank is picking a 1.20% 10-year yield at the end of this year, for example, while Westpac expects 1.25%.

Currency forecasting remains hostage to shifts in global investor sentiment. At the moment, the conventional wisdom is that foreign-exchange investors, encouraged by the prospect of successful vaccination programmes, are in a risk-on mood and are more likely to run foreign-exchange risk and buy currencies like the Australian dollar. Australia's very low incidence of COVID cases and quick recovery from the epidemic's first appearance may also be on their minds. Consequently, forecasters are currently inclined to the view that the Aussie dollar will appreciate against the U.S. dollar: The Commonwealth Bank expects USD 0.78 at the end of the year, Westpac expects USD 0.80 and NAB has picked USD 0.83.

Australian & International Property — Review

The A-REITs underperformed in 2020 relative to the overall share market, and although the year is young, the pattern has continued in early 2021. The S&P/ASX 200 A-REITs Index is down by 2.5% in capital value year to date, compared with the wider market's 3.2% gain.

The global listed property market shows a similar outcome. The FTSE EPRA/NAREIT Global Index in U.S. dollars is essentially unchanged (up 0.1%) so far this year, lagging the 2.5% return from the MSCI World Index.

Australian & International Property — Outlook

While the quick recovery from the first wave of COVID-19 has been helpful for the sector, Australian listed property faces the issue of contending with the longer-term impacts of COVID-19. This has been especially pertinent

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for the office sector. The ANZ Bank Property Council of Australia quarterly commercial property survey has taken to asking which sector will be most affected by the virus: while the hotels, tourism, leisure sector is obviously the big loser, the proportion picking offices has been steadily rising. ANZ said that the December result "likely reflects ongoing weakness in office occupancy rates, and the more permanent shift to partial work-from-home models by a number of large businesses."

Conditions in the other sectors are mixed. Industrials is in robust shape, and the outlook for housing-development REITs has improved after the unexpected resilience of house prices through the pandemic. Retail, however, remains under a cloud. Referring to the surge in online shopping, ANZ Bank said, "The probability that some of this shift to online sales will be permanent is clearly weighing on the outlook." While there are analysts who regard the likes of the shopping mall REITs as oversold bargains, on balance the overall REIT sector looks as if it still needs a clearer steer on the post-COVID landscape.

Internationally, COVID-19 obviously put many landlords in a tight spot as tenants were, at least temporarily, unable to pay rent. Knight Frank compiles the Global Occupier Market Dashboard, which shows whether conditions in a market favoured tenants, landlords, or were balanced. The latest version (September quarter 2020) shows markets overwhelmingly in tenants' favour in 2020, with only modest improvement expected in 2021. While a number of markets are expected to become more balanced, among mainstream markets only Brussels, Seattle, and Taipei are expected to be outright landlord-friendly.

Other analysts also see gradual improvement. The U.S. trade group NAREIT in its latest forecast says that "REITs, CRE [commercial real estate] markets, and the [U.S.] economy as a whole are bolstered by the solid fundamentals that were in place when the pandemic hit, in sharp contrast to prior recessions. Conditions will be mixed in the first half of the year, strengthen in the

second half, and 2022 is likely to see a more complete recovery."

Beyond the cyclical recovery, the NAREIT forecast picks that the longer-term COVID impact has been exaggerated: "These fears appear overblown ... and most workers are likely to return to the office, shoppers want to get back to the malls and shopping centres, and a return to conditions similar to those prior to the pandemic will lift REIT performance in 2021." It thinks that the U.S. REITs have a 35% chance of outperforming the S&P 500 by 5% to 10%, and a 30% chance of outperforming by more than 10%. It would be nice if it came to hand, but so far investors seem more inclined to wait and see.

Australasian Equities — Review

Australian shares have started the year well, with the S&P/ASX 200 Index up 3.2%. The resources sector did especially well, up 6.1%, and for once financials, which had been a major drag on performance in 2020, helped the outcome with a 5.1% gain. Consumer discretionary shares were up 4.4%, and the runaway star of 2020, the IT sector, chipped in with a 3.5% gain.

Australasian Equities — Outlook

In the near term, the outlook is for continued recovery from the various COVID-19 episodes, and although one can never be sure about what COVID-19 might spring next, the latest news is encouraging. At time of writing, both Victoria and New South Wales were reporting no new local community cases, and it appeared likely that New South Wales would shortly begin rolling back its restrictions. Business surveys show the impact of the improvement: The most recent (November) National Australia Bank survey found that "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."

There will clearly be a boost to near-term profitability, and it is likely that the large fall in corporate profits in the

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2019-20 reporting year will be fully recovered in the current 2020-21 season. It helps that the miners should continue to benefit from a recovery in global growth and that the banks are emerging from their long gloom, assisted by an unexpectedly strong housing market. These are conditions where the share market could continue to perform reasonably well: CommSec's prediction for 2021, for example, was that the S&P/ASX 200 Index would end the year at 7,200, which would be a 9.3% gain for the year.

The big issue, however, is the outlook beyond the immediate V-shaped bounce. *Crédit Suisse*, for example, shares the immediate optimism about near-term earnings: It expects earnings per share at the ASX 200 companies to grow by 20% in 2021 after a drop of 19% in 2021, but it expects no further growth in 2022. Businesses themselves are also beginning to wonder: As the early results from the January IHS Markit activity indexes showed, "Businesses were upbeat toward the year-ahead outlook for output, with hopes pinned on vaccine developments and the eventual lifting of restrictions globally. However, optimism weakened in January, dampened by concerns over the long-term effects of the COVID-19 pandemic on the economy." It may be some months before we can be sure of the true strength of the post-COVID Australian economy.

International Fixed Interest — Review

Global bond yields have moved a little bit higher, led by the U.S. Treasury bond market, where the yield on the benchmark 10-year Treasury note has risen from 0.9% to 1.1% this year. The resultant capital losses mean that at this early stage of the year bond investors are out of pocket. The Bloomberg Barclays Global Aggregate Bond Index in U.S. dollars is down by 0.7% year to date.

International Fixed Interest — Outlook

The rise in U.S. yields, and the smaller rises in other markets, reflect two developments. One is the general improvement in investor sentiment about the prospect of COVID-19 coming under progressive control as

vaccination is rolled out. This has meant reduced demand for safe-haven assets like government bonds, and in addition the prospect of stronger economic growth also tends to generate upward pressure on interest rates. U.S. yields also rose on the news of the Democrats' Senate wins in Georgia. A Democrat majority in Congress means there was greater political scope for a sizable fiscal stimulus, again adding to the likelihood of faster growth, and also boosts the supply of Treasury bonds as the Biden administration borrows to fund the stimulus.

The recent rise in bond yields is expected to continue, at least in the U.S. The latest (January) *Wall Street Journal* survey of U.S. forecasters found that the median view is that the 10-year Treasury yield will rise to around 1.25% by midyear and to 1.4% by the end of the year. Whether this increase eventuates is still an open issue, however: The Federal Reserve at its latest policy pronouncement made it clear that it will not be tightening monetary policy anytime soon, and its ongoing programme of bond-buying may keep bond yields lower than the forecasters expect.

Yields in other markets are less likely to trek upward. The European Central Bank, for example, expects that inflation will be lower than its 2% target all the way out to 2023, and the eurozone will continue to need monetary policy support for a long time. The central bank expects that the eurozone unemployment rate will still be an unacceptably high 7.5% in 2023. It is very likely to stay on its current course of keeping long-term interest rates very low for a considerable period.

Overall, the big picture is that, on the assumption that the global economy gets COVID-19 progressively under control, central banks will stick with existing monetary policy settings for some time. But if the global economy starts to pick up strongly in the second half of this year and beyond, the bond markets will start to look ahead to a progressive unwinding of peak monetary policy support. What would be very good news for firms and households would be a challenging environment for bondholders.

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International Equities — Review

Although the trading history is still limited to only a few weeks, the early data for 2021 show world share markets carrying on where they left off in 2020—with further price gains. The MSCI World Index of developed economy share markets is up 2.4% in U.S. dollars. So far this year the big American tech shares have continued to make the running—the Dow Jones U.S. Technology Index is up 4.0% and the Nasdaq is up 5.1%—but otherwise U.S. markets have not dominated overall returns as they did in 2020. Ex the U.S., the MSCI World is also up 2.4%. Japan has made a good early showing, with the Nikkei up 4.3% (in yen), and European shares have also contributed, with the FTSE Eurofirst 300 up 2.6% (in euros).

Emerging markets have made a strong start to the year. The MSCI Emerging Markets Index is up by 7.9% in U.S. dollars, and the core BRIC markets (Brazil, Russia, India, China) are up by a similar 8.2%. The vast bulk of the performance has come from China, where the MSCI China Index is up 11.8%, with small gains in India and Russia and a 5.6% loss in Brazil (based on the MSCI Brazil Index).

International Equities — Outlook

The outlook remains heavily COVID-19 entwined. On the plus side, the global economy had been showing every sign of a faster-than-expected recovery from the first wave of COVID-19 in early 2020. As one example, the latest (November) estimates of world trade, compiled for the European Commission by the Dutch Bureau for Economic Policy Analysis, showed that world trade in goods had improved to just over its pre-COVID level. The bureau's estimates of global industrial production also show a good recovery, though output is still slightly below pre-COVID levels.

The latest second wave has complicated the picture, however. The global number of new cases had steadied at around 300,000 a day in August and September (according to the data compiled by *The New York Times*) but then rose sharply in the later months of last year and by early January was running at around 700,000. In recent weeks there has been some modest good news,

and the daily number has dropped to around 600,000, but other indicators remain worrying. The number of daily deaths worldwide is still increasing (it is currently some 14,000 a day), and economic activity has taken another hit from a new round of lockdowns across a range of countries, particularly in Western Europe.

Equity markets, however, appear to be looking beyond the latest COVID-19 outbreaks and lockdowns, and the rather worrying emergence of new strains of the virus, and are more focussed on the ultimate outcome of widespread vaccination and a reasonably rapid return to more normal conditions. In the eurozone, for example, the latest "flash" (preliminary) index of activity compiled by IHS Markit found that in January "a double-dip recession for the eurozone economy is looking increasingly inevitable as tighter COVID-19 restrictions took a further toll on businesses in January," but on the other hand, "the rollout of vaccines has meanwhile helped sustain a strong degree of confidence about prospects for the year ahead, though the recent rise in virus case numbers has caused some pullback in optimism."

Markets have also been buoyed by the prospect of a large USD 1.9 trillion fiscal package in the U.S., where the Biden administration hopes to send USD 1,400 cheques to people on lower incomes, extending a temporary boost to unemployment insurance payments, and to roll out various other supports, including a rise in the federal minimum wage and funding for a national vaccination programme.

The latest (January) Bank of America Merrill Lynch global fund manager survey gives some interesting pointers to how these various influences will pan out. The survey shares the optimism about prospects for ultimate world economic activity and corporate profitability, and respondents said they were especially keen on the emerging markets and on rotating out of the previous star sectors (large-cap growth, especially tech and healthcare) into smaller caps and into energy, materials, and the banks.

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But there are also signs of valuation stress. Bitcoin and tech shares were seen by the fund managers as the two most crowded trades, where there may be potential for a correction. The three big risks the managers worried about were also suggestive of over-optimism. Their top risk was setbacks to the rollout of vaccines, where currently investors may be too bullish. Their second-rated risk was a taper tantrum, or a setback to high equity and other asset valuations if bond yields start to rise. And their third-rated risk was the possibility of a market bubble, where various indicators, including rising levels of online trading by retail investors are looking symptomatic of the top of a bull market. Ideally, the long game of eventual post-COVID recovery will prove to be the right move, but it would not be surprising if episodes of overexuberance get punctured along the way. ■■

Performance periods unless otherwise stated generally refer to periods ended Jan. 22, 2021.

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