Economic & Investment Update – July 2020

During the June quarter, despite the coronavirus pandemic continuing to weigh heavily on the global economy, positive investor sentiment led to a rebound in financial markets. Factors behind the rebound included significant fiscal and monetary support, a revival of economic activity in many countries and optimism that a vaccine might be available later this year.

In the US, the Federal Reserve (Fed) delivered massive monetary accommodation, pushing its balance sheet above $7 trillion by the end of June. The Fed ramped up purchases of Treasuries and mortgage-backed securities (MBS), bought municipal and corporate bonds, and provided support via other activities. Europe and Japan significantly increased their quantitative easing (QE) programs as well, with global central banks injecting more than twice the liquidity of previous easing periods. In Australia, stimulus packages and employment support payments totalling almost $300 billion were announced while QE programs were utilised for the first time.

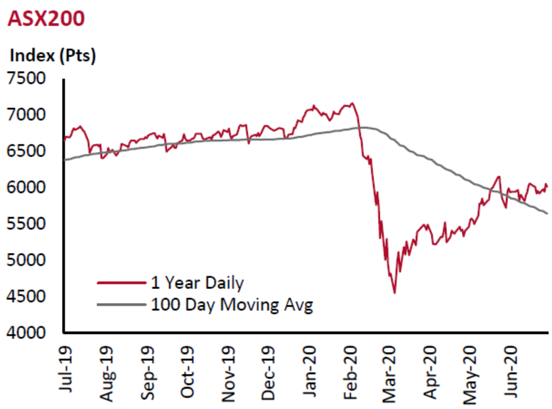
In anticipation of a pandemic peak, many countries began easing social restrictions from early May and alongside this, there were tentative but encouraging signs of an economic recovery. This was most evident in the US, which added 4.8 million jobs in June – reversing some of the massive job losses in previous months. This positive momentum was further reinforced through May retail trade data (up 17.4% after three consecutive monthly falls). Australia also experienced progress with economic activity. While the unemployment rate rose to 7.1% in May, compared to 5.1% before Coronavirus, some leading economic indicators pointed towards stronger economic growth. Retail trade in May grew by a surprising 16.3%, reversing most of the 17.7% fall in April.

The full impact of the coronavirus pandemic on the global economy was reflected in the International Monetary Funds (IMF) most recent global growth projection with 2020 world growth now expected to be -4.9%. In Australia, while the economy experienced mildly contracted economic growth of -0.3% in the March quarter, continued coronavirus-related shutdowns during the June quarter makes it almost certain that the Australian economy experienced its first recession in 29 years.

MARKETS

Equity markets rebounded from a dismal March quarter by posting their best quarterly returns since 1987.

In Australia, the S&P/ASX 200 Accumulation Index rebounded from its March low and finished up 16.5% for the June quarter (but down 7.7% for the 2020 financial year). At a sector level, the Information Technology sector produced the best quarterly return (+44.4%) due largely to the unrelenting surge from Afterpay, which gained +224%. The Consumer Discretionary sector also produced a strong quarterly return (+30.8%) assisted by improving retail sales data. The Healthcare sector (+2.9%) produced the lowest return.



Source: Bloomberg

The Small Ordinaries Index (top 100-300 companies) outperformed the top 100 companies, finishing up 23.9% for the June quarter.

Global equity markets also produced solid gains during the June quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up by 17.8% (1.3% for the financial year).

Across global markets, the standout performer was the US Nasdaq Composite Index (up 30.6% for the June quarter) with Microsoft, Apple, Amazon, Alphabet and Google benefiting from increased demand due to work-from-home lockdowns and a continuation of the digital and e-commerce revolutions. Hong Kong's share market (Hang Seng Index) produced the lowest return for the quarter (up by only 3.5%) due to uncertainties over the city's future after Beijing unveiled its effort to introduce a controversial national security law.

Gains on unhedged global equity investments were lower during the June quarter with the Australian dollar appreciating against most major currencies. The MSCI World (ex-Australia) Net Return Index (unhedged) rose by 5.9% for the June quarter (5.2% for the financial year).

As global markets steadied, Australian listed property securities bounced back over the June quarter (up 19.9%) but remained down -21.3% for the financial year. Global property securities also recovered during the June quarter (+8.6%), with quarterly unhedged property returns (-2.1%) hindered by the recovery in the Australian dollar. At a sector level, data centres and industrial property produced the best returns while retail property and hotels lagged.

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, increased by 0.5% over the June quarter, driven by the Reserve Bank of Australia's unconventional monetary policy measures. For the financial year, the bond market benchmark returned 4.2%. Global bonds, as measured by the Bloomberg Barclays Global Aggregate TR Index (AUD Hedged) index, returned 2.3% for the quarter and 5.2% for the financial year. Globally, both Investment Grade and High Yield spreads tightened over the quarter as central bank monetary intervention had a positive impact on credit spreads.

Commodity prices also rose during the June quarter. Oil had its best quarter in 30 years (up 91.8%), staging a dramatic comeback after falling to record lows in April. Despite this gain, oil prices were still down 33% for the financial year. Gold returned 12.9% for the June quarter as government stimulus measures, falling interest rates and general market uncertainty were tailwinds for gold prices. For the financial year, the gold price has now risen 26.4%.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	16.5	-7.7	6.0
	S&P/ASX Small Ordinaries TR (Accum) Index	23.9	-5.7	7.9
International	MSCI World ex Aust NR Index (AUD)	5.9	5.2	9.4
	MSCI World ex Aust NR Index (AUD Hedged)	17.8	1.3	7.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	5.0	-1.5	5.2
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	19.9	-21.3	4.4
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	8.6	-17.6	1.6
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	10.9	-15.6	3.5
Currencies				
AUD v USD	Against US Dollar	12.6	-1.7	-2.2
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.5	4.2	4.8
	Bloomberg Ausbond Credit All Maturities	1.6	3.8	4.7
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	2.3	5.2	4.8
Commodities				
Gold	Gold – USD	12.9	26.4	8.7
Oil	WTI Oil $/b – USD	91.8	-32.8	-8.0

Outlook

With continued uncertainty surrounding the coronavirus pandemic, the global economic outlook is somewhere between a scenario in which the pandemic stabilizes, with a slow gradual recovery in economic activity from the second half of 2020 onwards, and one where a continued rise in the number of worldwide cases delays the global economic recovery.

With a range of countries reimposing social distancing guidelines and closing businesses that had begun to re-open, as a result of a rise in new confirmed cases, a delay in the global recovery now appears more likely. Regionally, China's recovery appears to be ahead of the rest or the world, particularly within its industrial activity, Europe's progress appears the most tentative, while the US advance has stalled. In the US, the number of people filing for unemployment rose for the first time in nearly five months.

While sharemarkets have shown strength during the June quarter, fiscal and monetary policies have been key drivers. This has resulted in a disconnect between the devastation the coronavirus is wreaking in real economies and the current bullishness in sharemarkets.

As monetary easing measures are expected to remain, an important factor that will drive asset returns in coming months will be the extent to which governments continue with various fiscal measures to support businesses and households. Domestically, many of these programs are scheduled to commence tapering off with the scaled down Job Seeker 2.0 initiative set to run from 28 September 2020 to 28 March 2021.

Geopolitical risks also remain elevated and are likely to continue to impact market volatility. Tensions between the US and China and the likely outcome of the US presidential election in November are two risk areas which could impact markets in the short to medium term.

In relation to investment portfolios, we recommend investors remain cautious. Our views on various asset classes are outlined below.

Australian Equities

Following recent gains, we recommend that investors hold a neutral to underweight position to Australian Equities.

The Australian sharemarket is currently valued on a forward consensus price earnings (PE) ratio of 18.6 times earnings, which is 27% above the long-term average of 14.6 times earnings. The forward consensus dividend yield for the Australian share market is 3.3% (80% franked) — or 4.4% grossed-up. However, valuations are too high at present relative to the level of market uncertainty and we expect further earnings and dividend downgrades over the coming months.

Very few companies have been immune to the impacts of the coronavirus pandemic and numerous businesses have withdrawn their future earnings guidance. As a result, investors are unlikely to avoid a hit to income from declines in dividends.

International Equities

Within International Equities, we suggest that investors retain a neutral to underweight position. Operating conditions are expected to remain challenging and markets volatile in the near term.

Regionally, we feel that investments in the Asian region are currently more attractive from a valuation perspective and in a better position to recover.

In the US, the upcoming half yearly results are unlikely to yield much clarity on the outlook for the second half of the year and into 2021, with more than one third of companies in the S&P 500 having already withdrawn their full year guidance.

Despite recent appreciation of the Australian dollar against most major global currencies, investors should consider the benefits of hedged options (where available) on International Equity holdings. Although the US Dollar has traditionally provided protection as a safe-haven in times of extreme volatility, the US Dollar may weaken further over the medium term, given the likelihood of further stimulus packages and increasing levels of Government debt.

Property

Following recent gains, the Australian Real Estate Investment Trust (REIT) sector is priced on a dividend yield of 5%, a 410 basis point spread over 10-year bonds, well above its long term average of 200 basis points. However, earnings and distributions are likely to come under pressure as tenant's ability to pay rent is impacted by forced and voluntary temporary closures. Net Tangible Asset values are expected to fall in the short to medium term with discretionary shopping centre mall values likely to come under the most pressure. While average gearing is relatively low at 26%, it is expected to increase as asset values fall. However, most REITs are likely to remain well inside loan covenant limits.

We recommend that investors retain their existing holdings but where possible, seek to reduce exposure to the retail sector.

Fixed Interest

We recommend that investors remain underweight to fixed interest securities.

While recent Central bank intervention in the developed world bond primary and secondary markets has significantly reduced market volatility, this is likely to lead to extremely low yields and, in some cases, negative yields for bond investors. Superior security selection by fixed interest fund managers will be needed to add value above benchmark returns and fees

While credit securities appear slightly more attractive, despite a recent tightening in credit spreads, the risks in this segment of the fixed interest market remain elevated.

Alternatives

Despite recent gains, we remain positive about the longer-term prospects for Infrastructure investments on a hedged (currency) basis. As part of government stimulus programs, infrastructure investments are likely to play a key role.

In the current economic climate, we continue to suggest that consideration be given to an allocation to the gold sector within portfolios. Exposure to gold, either through gold producers or via an investment in physical gold, provides additional diversification within portfolios and can act as a hedge against the risk of rising inflation.

Sources: Lonsec