Economic Update

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Outlook for Investment Markets

While equity markets have generally recovered from their coronavirus-affected lows in late March, the prognosis for the world economy remains uncertain. While forecasters are typically running with a range of scenarios, most agree that their baseline or best-guess scenario is for a serious setback to world trade and gross domestic product this year, followed by a recovery next year. The shape and speed of the recovery remains very uncertain, however, with fund managers inclined to believe it may be a more gradual affair rather than a rapid return to normality. In the interim, equity markets will continue to be confronted by generally downbeat economic and financial news, even as more countries succeed in bending the curve of new infections. On the plus side, bonds have preserved capital and prices are likely to be supported by ongoing central bank buying. In New Zealand, the relaxation of the lockdown is good news, but there is still a long way to go before the full extent of COVID-19's impact becomes apparent.

New Zealand Cash and Fixed Interest — Review

Like everywhere else, monetary policy has been used vigorously to help offset the impact of COVID-19. The official cash rate, or OCR, is 0.25%, 90-day bank bills are yielding only 0.39%, and the 10-year government-bond yield is only 0.92%. A lower exchange rate has also helped the overall easing in monetary conditions. The New Zealand dollar is down 7.3% in overall value since the start of the year, with especially large falls against the two main currencies regarded as relative safe havens--it is down 11.6% against the yen and down 10.7% against the U.S. dollar.

New Zealand Cash and Fixed Interest — Outlook

Currently there is a very strong consensus that the OCR will be kept at 0.25% over the next year. The Reserve Bank has committed to it, and it is also the view of both the futures market and the economic forecasters. Apart from providing ongoing support to the post-COVID-19 economy, the OCR would need to be kept very low in as inflation looks very likely to be well below what the Reserve Bank would like.

Long-term interest rates are also likely to remain unusually low for an extended period. As part of what it calls its Large Scale Asset Purchases programme, the Reserve Bank has committed to buy $33 billion of central and local government bonds over the next year, which, like similar quantitative easing programmes overseas, will keep bond prices up and bond yields low. At some point, the huge supply of new government bonds (as part of anti-COVID-19 fiscal policy support) may require higher yields to find homes with buyers, but that still looks to be a long way away.

The outlook for the currency remains, even more than usual, hostage to the global unfolding of the COVID-19 outbreak. Currently investors are in a strongly risk-averse mood and currencies like the New Zealand dollar have had little appeal to global investors who have preferred to stay closer to home. As the outbreak is better contained, it may be that peak pessimism diminishes and appetite for risk picks up. The low point for the New Zealand dollar could be behind us. There is still a very wide range of views, but the average pick in the latest (early April) Reuters' survey of foreign-exchange forecasters is that the New Zealand dollar will stabilise around U.S. $0.60 over the next three months, and pick up to $0.64 in a year.

New Zealand Property — Review

Listed New Zealand property has had a difficult time through the COVID-19 period. The S&P/NZX All Real

Estate Index year to date has lost 18.1% in capital value, substantially underperforming the 7.0% capital loss from the overall share market.

New Zealand Property — Outlook

The recent poor performance of the sector is not unique--the listed property sector is out of favour globally, and New Zealand shares many of the same circumstances. Valuations are under pressure as rentals weaken and vacancies threaten to rise, and cap rates (the discount rates used to value property) are on the rise (causing further valuation losses) as investors look for higher returns to compensate for the risks that are becoming more evident. Kiwi Property, for example, has recently announced an 8.5% valuation loss on its $3.1 billion portfolio. Merger and acquisition activity has dropped away--as evidenced by Centuria, an Australian REIT, walking away from its proposed takeover of Augusta Capital--and dividends are being cut as the New Zealand REITs aim to conserve cash. There is the odd bit of good news--as part of the government COVID-19-policy response, property owners will be able to claim depreciation on whole buildings, and not just on fixtures and fittings. However, it is likely to be counterbalanced in coming months by negative sentiment from ongoing difficult trading conditions.

Australian and International Property — Review

The A-REITs have also significantly underperformed the wider market, with the S&P/ASX 200 A-REITs Index suffering a capital loss of 25.2% compared with the S&P/ASX 200 Index's 17.9%.

Global property has also been out of favour. The FTSE EPRA/NAREIT Global Index in U.S. dollars has lost 25.6% in capital value, worse than the 14.5% capital loss for the MSCI World Index. Losses were similar across most of the main regions, ranging from the Asia Pacific's 22.2% loss through to the U.K.'s 29.2% loss.

Australian and International Property — Outlook

Operating conditions have become very difficult for property owners. The latest (June quarter) ANZ/Property Council of Australia survey, which added some special questions about COVID-19, found that it was already having a serious impact on 35% of property businesses. Over the next three months was expected to have a serious impact on 52% of them. The impact was expected to be particularly severe for hotel, tourism, and leisure properties, but all sectors reported sharply lower expectations for capital growth, with hotels and an already pessimistic retail sector in the worst shape. Even the relatively resilient industrial sector turned pessimistic about capital values. Respondents expected cap rates to increase, again depressing valuations, and, realistically, given the sector's various issues, also expected debt availability to worsen over the coming year. As the Reserve Bank of Australia said in its April Financial Stability Review, "In the period ahead, declines in both sales volumes and valuations are likely, reflecting the weakness in the rental market and a repricing of risk by institutional investors." And it looks likely that the REIT sector will remain weak until all the ramifications of COVID-19 have played out.

Global listed property faces all the same challenges. The retail sector has been hit by a double whammy. Its own businesses have faced reduced revenues as shoppers have been in lockdown and tenants have been unable to pay rents. A survey by the U.S. trade body NAREIT found that U.S. shopping centres collected only 46% of their normal rent in April, while its existential threat from e-commerce has surged as people, perforce, have turned to online retail channels. The impact on the retail REIT subsector has been dramatic. In the U.S., the prices of shopping centre REITs have effectively halved (down 49.6% year to date) and regional shopping malls have fared even worse (down 59.3%). Offices, while not as badly shaken (down 23.2% in the U.S.), also face the prospect that enforced remote working through COVID-19 lockdowns may permanently impact the demand for office space. Industrial property everywhere has been a beneficiary of the e-commerce demand for warehouses and logistics. The U.S. industrial REITs are down only 2.1%--and there are other pockets of good performance (big data has led to strong performance by data centres)--but the few bright spots are unlikely to counterbalance the bigger picture in coming months.

Global Infrastructure — Review

Global listed infrastructure has behaved very like global property--year to date the S&P Global Infrastructure Index in U.S. dollars has suffered a capital loss of 23.5%.

Global Infrastructure — Outlook

While infrastructure might have offered some initial promise as a relatively defensive equity sector through the recent turmoil, in practice it has underperformed, as particularly poor operating conditions in two of its component sectors have outweighed the steadier outlook for essential utility services.

Roughly half (48.7%) of the S&P index is utilities, which have indeed held up better than equities. The FTSE global sector indexes, for example, show that while the FTSE World Index is down 15.2% in GBP this year, utilities are down by less (10.6%). But the rest of the S&P index is made up of more cyclically sensitive industrials (34%) and energy (17%). Cyclically exposed infrastructure has been savaged. As infrastructure manager Magellan said in early April, "The problem for airports, toll roads and rail segments is that they face significant short-term declines in patronage," while infrastructure vehicle Argo said in its latest (March) update that, "With transportation-related businesses particularly vulnerable to the effects of severe travel restrictions and reduced economic activity, airport stocks plunged -29.2% and toll roads fell -24.5%." On top of the patronage decline, the energy subsector contributed its own problems as oil prices plunged. For example, the FTSE Index of oil equipment and services has dropped by 39.4%.

Infrastructure manager 4D has argued that post-COVID-19, infrastructure will look a lot better: "There is no global growth recovery without roads, railways, pipelines, communication infrastructure, power transmission networks, ports and airports. These assets are currently offering very attractive value to investors willing to be patient and work through the ongoing turbulence that we are likely to see for a few months yet." The longer-term assessment is likely correct, but so is the prospect of further volatility before we get there.

Australasian Equities — Review

New Zealand shares have followed the global COVID-19 pattern, dropping sharply from mid-February to late March, before staging a partial recovery in more recent weeks. Year to date the S&P/NZX50 Index is down 7.0% in capital value and down 6.2% in total return terms. In a flight to quality world, the biggest names have done best: the top 10 index is up 1.3%, whereas the small-caps index has slumped by 22.2%.

Australian shares are also weaker, with the S&P/ASX 200 Index down 17.9% in capital value and down 16.9% in total returns. The financials, which will be exposed to business defaults and the costs of debt relief, have been particularly weak, and are down 28.0%. But weakness is pervasive across most subsectors, with the industrials down 20.6% and the miners down 13.0%. Consumer staples are the only resilient sector, with prices up slightly, by 2.3%.

Australasian Equities — Outlook

The latest state of business sentiment, which now reflects the full impact of COVID-19 and the tight level-four lockdown is, unsurprisingly, dire. The April ANZ Bank business survey said that, "We've never seen numbers like these. All key activity indicators fell further from March levels, most to record lows ... Firms are reeling from the abruptness and ferocity of the storm that has enveloped them, and with uncertainty extreme, planning a way out is very difficult. The quick-fire fiscal and monetary response will have helped, but times just don't get much tougher than this."

With uncertainty so high, the best forecasters can do is to sketch out a range of scenarios. Treasury, for example, came up with five possibilities, and modeled two of them in more detail, including the impact of further fiscal support on top of the $20 billion or so already announced. Even with a reasonably short lockdown period and an extra $20 billion in fiscal support, the economy shrinks by 4.5% this year, and by 0.5% in 2021, but comes back strongly in 2022 with 8% growth. If lockdowns had to be reimposed, however, things could be worse. Even factoring in $40 billion of extra fiscal support would still see the economy shrink by 8% this year before growing a little in 2021 and then coming back extremely strongly with 10.5% growth in 2022.

The recent rally in local equity prices likely says more about a rethink of the original level of panic rather than anything more substantive about the business outlook. In particular, the apparent success of the stringent lockdown has been reassuring. But business conditions are going to be challenging--even on the more upbeat scenarios--into 2021, and inevitably some businesses with higher levels of debt and fixed costs are not going to make it. At some point the equity market will start being driven by the later 2021/2022 upswing, but there are going to be some challenging periods ahead where bad news will dominate. In particular, the release of the June quarter GDP outcome, scheduled for Sept. 17, has the potential to be an unpleasant reality check on the damage from COVID-19.

The situation in Australia is very similar. The latest (March) business survey run by National Australia Bank found that, "Business confidence saw its largest decline on record and is now at its weakest level in the history of the NAB business survey ... the decline in forward orders and business conditions imply a large fall in GDP in the next 6 months ... The timing of a recovery is extremely uncertain at this point ... For now more businesses expect it to get worse before it gets better. It could well be that conditions fall to the lowest level since the 1990s recession in coming months – but we will be closely watching the survey for a turn in business confidence which may take some time to recover following an economic shock of this magnitude".

In current conditions point forecasts remain highly speculative, but for what they are worth the current view is that there will be a V-shaped recovery, with quite a sharp fall in activity this year followed by a reasonably rapid recovery next year. The International Monetary Fund, for example, expects that the Australian economy will shrink by 6.7% this year, followed by 6.1% growth in 2021. Even on this relatively optimistic view, unemployment would still be markedly higher in 2021, at 8.9%, than it was pre-COVID-19 (it was 5.2% in March, before the pandemic began).

Business conditions even on a relatively optimistic assessment are likely to remain difficult for the rest of this year, despite substantial fiscal support--the AUD $130-billion JobSeeker wage subsidy scheme alone is worth some 6.5% of GDP. Treasury estimates that without the scheme, unemployment would have hit 15% in the June quarter, but even with it kicking in, unemployment is likely to reach 10%. In these difficult conditions, there will be unsavable casualties, like Virgin Australia, for example, who had just gone into voluntary administration at the time of writing. In time the equity market will start factoring in a 2021 turnaround, but the coming few months are more likely to see it having to absorb a stream of very poor news.

International Fixed Interest — Review

Bonds have done their portfolio-protection job year to date. The Bloomberg Barclays Global Aggregate Index in U.S. dollars has eked out a small 0.7% gain, protecting capital as equity markets slumped.

The outcome depended on the U.S. bond market (the U.S. index was down 2.1%) and on the strong performance of higher-quality assets like government bonds, which gained 1.7%, compared with the 1.7% loss for global corporate bonds. Lower-credit quality corporate bonds recorded a large loss of 10.7%, and the relatively risky subsector of emerging-markets debt lost 7.4%.

International Fixed Interest — Outlook

The outlook for monetary policy everywhere is essentially the same: both short-term and longer-term interest rates will be kept at extremely low levels for an extended period of time--at least until the COVID-19 outbreak is controlled and some normality has returned. But, in all probability, it will take longer. Many economies will be experiencing lower inflation for some time after the immediate COVID-19 impact, and unemployment will be higher than ideal. In these circumstances, central banks everywhere will have a strong incentive to keep a stimulative monetary policy well into 2021 and possibly into 2022. Any reappearance of COVID-19 would also extend the period of very low interest rates and other forms of monetary stimulus.

In the U.S., for example, Fed chair Jerome Powell said on April 9 that the Fed is "committed to keeping rates at this low level until we are confident that the economy has weathered the storm and is on track to achieve our maximum-employment and price-stability goals." He also said that the Fed would continue to use its emergency lending powers "forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery." Powell's use of the words "confident" and "solidly" imply support beyond any immediate upturn.

The U.S. forecasters in the latest (April) poll run by *The Wall Street Journal* now expect that the Fed will keep its current 0% to 0.25% target cash rate at least until the middle of next year. They also expect the U.S. 10-year bond yield to remain below 1.0% this year, and for it to rise only gradually to 1.4% by the end of 2021. Other central banks will be following similar policies, which means that bond investors can expect stable government-bond prices, albeit at the cost of pitiful running yields. According to the J.P. Morgan Global Government Bond Index, yields are negative (currently negative 0.19%) across the asset class, with positive yields only available by taking on duration risk in long-dated bonds.

While government bonds will remain solid, the low-quality end of the asset class is in serious trouble. According to the ICE Bank of America Index, which tracks the spread between the yield on U.S. bonds with a credit rating of CCC or lower and the yield on U.S. Treasuries, low-grade borrowers were paying around 10% more than the U.S. government before COVID-19 erupted. At the peak of the equity sell-off, the gap had blown out to 19.6% and is still high at 16.3%. Year to date the index has lost 18.8%. More corporate distress is likely, and the outlook for the high-yield subsector remains hazardous.

International Equities — Review

World share prices fall very sharply between mid-February and late March. From its Feb. 12 peak, the MSCI World Index of developed markets in U.S. dollars dropped by over a third (34.2%) before bottoming out on March 23. Since then the index has rallied, and is up by 25.9% from its low, but the earlier loss still dominates the year-to-date outcome, with investors suffering a 14.5% capital loss.

Relatively resilient U.S. markets have helped to cushion the loss: The S&P500 is down by *only* 11.0%, and the Nasdaq by only 3.6%. Other major markets have fared markedly worse. In Europe, the FTSEurofirst 300 Index is down by 19.4%, with Germany (down 19.8%), France (24.7%), and the U.K. (down 23.3%) all suffering large setbacks. Japan's Nikkei Index is also down by 15.9% year to date.

Emerging markets have suffered worse again, in an environment where investors have shunned the riskier end of an asset class. The MSCI Emerging Markets Index is down 19.9% in U.S. dollars, with the key BRIC economies--Brazil, Russia, India, and China--down 16.6%. Within the BRIC bloc, using the MSCI single-country indexes, China had a modest drop (5.7%), but there were substantial declines in the other members, with India down 26.1%, Russia down 32.3%, and Brazil down a massive 47.4%.

International Equities — Outlook

Even though the COVID-19 outbreak appears to be peaking in several countries as health measures are in place to help bend the curve of new infections, forecasters are still very unclear how the world economy will behave in coming months.

Nearly all the big forecasters have opted to run with scenarios rather than point forecasts. As the World Trade Organisation said when it released its scenarios, "These should be viewed as explorations of different possible trajectories for the crisis rather than specific predictions of future developments. Actual outcomes could easily be outside of this range, either on the upside or the downside."

The WTO opted for two scenarios: "A relatively optimistic scenario, with a sharp drop in trade followed by a recovery starting in the second half of 2020 and ... a more pessimistic scenario with a steeper initial decline and a more prolonged and incomplete recovery." Even on the more optimistic reading, world trade suffers a major shock this year, dropping by 12.9%, before bouncing back strongly next year with a 21.3% rebound. World GDP drops by 2.5% this year but comes storming back in 2021 with 7.4% growth.

The more pessimistic scenario, however, makes for grim reading. World trade drops by nearly a third (31.9%) this year and does not make up the lost ground in 2021, rising by only 24%. World GDP declines by 8.8% this year and again does not make good the loss in 2021, with only a 5.9% recovery.

The IMF has also stressed the difficulty of trying to figure out what happens next. In its latest (April) *World Economic Outlook* update it said that, "There is extreme uncertainty around the global growth forecast. The economic fallout depends on factors that interact in ways that are hard to predict, including the pathway of the pandemic, the intensity and efficacy of containment efforts, the extent of supply disruptions, the repercussions of the dramatic tightening in global financial market conditions, shifts in spending patterns, behavioural changes (such as people avoiding shopping malls and public transportation), confidence effects, and volatile commodity prices."

In its baseline forecast, "the pandemic is assumed to fade in the second half of 2020, allowing for a gradual lifting of containment measures." On that basis, the IMF thinks that world GDP will drop by 3% this year, before recovering by 5.8% next year--qualitatively that is very similar to the WTO's optimistic scenario. The advanced economies bear the brunt of this year's setback, with GDP dropping by 6.1%, while emerging and developing economies escape with a relatively minor 1.0% drop in GDP.

The IMF also ran with three alternatives, all worse than its baseline. In the worst of them, it takes longer than expected to get the 2020 outbreak under control, which is then followed by another outbreak in 2021. In that case, world GDP would take a larger hit this year, dropping by about 6%, and there would be no recovery in 2021.

The global fund managers surveyed by Bank of America Merrill Lynch, or BAML, in April are on board with the idea that 2020 is looking bad. Virtually everyone (a net 93%) thinks there will be a global recession this year, which is a record level of pessimism, even higher than in the depths of the GFC. They are less convinced, however, by scenarios of a quick recovery--57% picked a gradual U-shaped recovery, and 27% picked a W-shaped recovery with a double-dip recession. Only 15% currently think a quick V-shaped recovery is in the cards. Their biggest fear (mentioned by 57%) is a second wave of the virus, and their other big worry (mentioned by 30%) is a systemic credit event, where some large institution or market unexpectedly falls over.

In very unsettled conditions, portfolio diversification remains the key defence. Investors may also find it worthwhile to emulate the BAML managers, who are building extra protection into the equity portion of the portfolios by favouring defensive sectors like healthcare, consumer staples and utilities, and underweighting sectors seen as cyclically riskier, including energy (given plunging world oil prices), materials, industrials, and banks. The BAML managers also have a very strong preference for premium names--by wide margins they prefer high-quality earnings to low-quality earnings, and large caps over small caps.

Performance periods unless otherwise stated generally refer to periods ended April 17, 2020.

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