

Market & Economic Update

30 June 2020

It's fair to say that we finally have alignment between markets and economics with both in a state of flux at present. That alignment could be short-lived (in either direction) or it could be the status quo for the remainder of the year given the uncertainties that lie ahead.

Key will be some milestones ahead

Namely government fiscal (stimulus) cliffs, virus waves and the proximity of a vaccine, and the US presidential race. De-globalisation and US-China relations are a close 4th and 5th.

Since the March lows, investment markets, particularly equities, have taken most of the bad news, fears and concerns in their stride. You could say equity markets have built up a level of immunity (pardon the pun) since the GFC which has only continued and been somewhat exacerbated by the extraordinary central bank and government stimulus we've seen since lockdowns began. This can be evidenced by the extremely sharp rally we saw in April, on almost little to no new positive news, and also again a few weeks back where equity markets fell sharply (circa 6%) for all of one day before investors were ready to buy back in yet again. The reason for this is what central banks have done to cash rates and government bond yields, which in the developed world are all between 0-1%, and what central banks are currently doing in asset markets (ie. buying large amounts of bonds, and equities in some instances, support asset prices). "Don't fight the Fed" is a catchphrase used regularly in investment markets and for now it could be extended to don't fight the RBA, BOJ, ECB, BOE, and PBOC, and which ever other central bank that is easing.

But will central bank action be enough? It's possible in the very short term, but in the medium to longer term governments will need to step up and take the lead from central banks as they are best placed to put stimulus into the hands of consumers and small business, which today power most economies.

Equity markets

This month are showing a tendency to be range-bound – ie. trade within a band – with prices falling on concerns regarding the milestones mentioned above, before prices then rising when equity markets get “too cheap” relative to the returns on cash and bonds.

The key consideration then is what those milestones look like now, and more importantly, what they’re likely to look like as we get closer to each one. Two of the milestones have a fixed date (ie. fiscal cliffs and the US presidential race) whilst virus waves and a potential vaccine have a variable date. Over the last 5 years or so, markets have better navigated concerns / risks with a fixed date, whilst struggling and taking a little longer to overcome those with a variable date.

In a nutshell, the fiscal cliffs are the upcoming dates we have for the expiry of certain government measures put in place during the depths of March. For the US, many of these end in July and August, whilst for Australia they largely end in August and September. In addition locally, the bank freeze on mortgage repayments also ends in September. Absent an extension, or some other new stimulus to fill the void, unemployment will rise significantly and likely remain high for multiple years.

Locally

Many businesses don’t have the cash flow and/or balance sheets to continue to meet some of the highest wages in the world (ie. the minimum wage was increased again last week whilst we already had the highest minimum wage in the world) given the drop in demand for goods and services since the lockdowns began. Other businesses will have taken the last 2-3 months to either make their business more efficient / productive and/or figure out which roles they really need in the weaker economic period ahead. That all doesn’t relate well to employment. It means higher unemployment, higher underemployment, less hours worked, and lower wages. Right now, it’s fair to say markets are betting that governments either extend and/or provide fresh new stimulus over the coming months. But we really don’t know. We’re assuming they do, because they have to, given the economic consequences, but we can make a fairly rational argument for not doing so as well.

Virus waves and a vaccine

Are really a function of the pace of reopening (ie. easing restrictions) and the government response / narrative to each. As much as we’d like, lockdown won’t make the virus disappear.

Even a vaccine won't make the virus disappear. So governments need to be very careful about their response to waves of the virus. The first lockdowns in March were to allow governments and health authorities to get prepared and to not overburden the health system. Considering preparations have all been made and considering many of the hospitals locally and globally are now relatively empty, reinitiating restrictions and/or going into lockdown again makes absolutely no sense whatsoever. All it would do is make the economic contraction deeper and more prolonged, crippling more businesses, instilling more fear, and decimating consumer and business confidence and sentiment.

We are currently seeing a 2nd wave of sorts in the US, China, and closer to home in Victoria. It's important to note that these waves are an increase in virus cases, not an increase in virus deaths, with daily deaths continuing to reduce all around the world. These waves are to be expected as greater easing of restrictions are lifted and as more testing takes place. These waves shouldn't be ignored, but nor should they be a source of panic or fear, and any form of government overreaction will simply set us back on both the health (ie. herd immunity) and economic fronts. Until there is a readily available vaccine that is effective in the majority of the population, the virus will be prevalent. Recent studies have confirmed a few effective treatments for the virus for those more adversely affected by it (ie. those with significant pre-existing conditions, usually 2 or more). These treatments will help save lives, may shorten how long a person is contagious, and will remove some fears and concerns for the public.

The US elections

Take place in November and right now it's a fairly open race. As it stands, we have a Democrat led lower house, a Republican led upper house, and a Republican President in Donald Trump. Recent polling has been less favourable to Trump and the Republicans, which is in stark contrast to pre-virus polling which had Trump winning the election fairly easily. Polls haven't been as effective over the last few years largely because the polling has been conducted poorly and/or with bias and voters have changed their voting intentions right up until the day of the vote.

Currently we're seeing political warfare play out in almost civil war-like conditions with the Left (Democrats) taking full advantage of the situation started by lockdown and exacerbated by a death allegedly caused by police at the time of arrest. This has coincided in a surge in support for the Democrats, but has it gone too far? There has been little to no Republican response date, almost like the strategy is to let the Left take it too far, expose themselves, and then implode, which would push swing voters and states firmly in favour of Trump (similar to the last election). But it's a dangerous ploy this time around as the Republicans risk alienating their own voter base through lack of action, which together with the help of news and social media

could result in a clean sweep for the Democrats (ie. the House, the Senate, and the Presidency), which would set the Republican party back years.

Why is this important? Democrat policies are generally negative for share markets, generally involve higher taxes (hampering the economic recovery), and generally involve significant expenditure (which would put the US budget, and hence the US government bond market, at serious risk) but would actually aid in the economic recovery assuming the expenditure was appropriate and productive. The US remains the lead economy and the lead share market globally, hence the importance of a recovering US economy and a healthy US equity market.

The US political outcome also lends itself to the 4th and 5th milestones mentioned above, namely de-globalisation and US-China relations. Both are significant risk events and well worth watching and monitoring, but won't be of impact until after the US elections.

For now, equity markets continue to be forward looking, focusing on next year's likely earnings, whilst bond markets are still operating with some trepidation given risks have not yet passed and plenty of unknowns remain. Property and Infrastructure fortunes are closely linked to the easing of restrictions, whilst the oil price has risen on faster than expected reopening and strong levels of compliance in relation to production cuts from oil producing countries. The Aussie dollar has also risen, breaking through the US70c mark, before weakening a little more recently. We continue to believe that diversification and selectivity remain key. In general, we wouldn't advocate adding a whole lot of risk into portfolios right now, but we also wouldn't advocate taking a whole lot of risk out of portfolios right now. We remain very watchful of the milestones mentioned above as these will dictate investor behaviour in the short term, whilst looking for opportunities with the medium to longer term in mind.



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