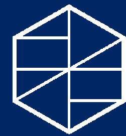
Count

# Market Wrap



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## May 2020

### Economics overview

- Mobility restrictions started to be eased as the number of new coronavirus cases continued to fall in most key regions.
- This news was well-received by equity and credit investors, as it suggested company profitability could start to improve.

- **US**: The second published estimate suggested the US economy contracted at an annual pace of -5.0% in the March quarter; the worst reading since during the Global Financial Crisis in 2008.
- Unemployment indicators are particularly concerning. Jobless numbers are already close to 40 million and forecasts suggest a further 10 million Americans could lose their jobs before unemployment troughs and the economy starts firing again.
- Despite the widespread job losses, personal income rose 10.5% in April. This underlined the scale of government income support programs. For now, much of the additional money being distributed to households is being saved; the savings rate in the US increased to 33%, from 13% previously. At the same time, consumer spending dropped to the lowest level on record.
- We will have to see a reversal in these indicators for growth in the economy to gather pace over the next few months.
- In the near term, the reopening of the US economy is being hampered by large-scale social unrest. Several cities have seen rioting, looting and destruction of property as citizens protest about the unlawful death of a man in police custody.
- This issue has the potential to erode consumer confidence, just when the economy is in desperate need of a pickup in spending.

- **Australia**: Ratings agency Fitch joined S&P by downgrading its outlook on Australia's sovereign credit rating to 'negative', from 'stable'. This reflects the adverse impact that COVID-19 disruptions will have on the local economy and the significant increase in government spending associated with the pandemic.
- Fitch forecasts Australian GDP will shrink -5.0% this year, reflecting subdued household consumption and reduced business investment. The closure of Australia's borders to overseas citizens is also expected to have a detrimental impact on areas of the economy exposed to tourism and overseas students.
- More encouragingly, Fitch expects the economy to claw back almost all of its lost ground in 2021 as restrictions are lifted and as businesses start to function more normally again.
- There was unwelcome news on the geopolitical front too, after the Prime Minister called for an inquiry into China's handling of the coronavirus pandemic. In response, China slapped large tariffs on Australian barley imports, effectively closing the Chinese market to Australian farmers. The value of barley exports are not significant, but the standoff could become serious for the Australian Treasury if hostilities escalate and tariffs are applied on higher value goods like iron ore and coal.

- **New Zealand:** NZ is gradually reopening, but it is clear that virus-related closures have had a meaningful impact. Credit card spending was down nearly -50% in April, for example.
- Both consumer and business confidence improved in May from April, but nonetheless it will take time for the economy to recover from the significant disruptions in March and April.

- **Europe**: The German economy – Europe's largest – entered a technical recession following two consecutive quarters of negative GDP growth. The economy shrank -2.2% in the March quarter, following a small contraction in the December quarter.
- The combined Euro Area economy shrank -3.8% in the March quarter; the steepest drop since records began 25 years ago.
- Like elsewhere, business closures and rising unemployment are weighing on household consumption and business investment.
- In the UK, the first estimate of Q1 GDP showed a contraction of -2.0%, slightly better than the -2.5% consensus forecast.
- Some other economic indicators in the region showed signs of improvement. PMI surveys, for example – a reasonable gauge of activity levels in both manufacturing and services sectors – bounced back in France and Germany in May, from very depressed levels in April.
- That said, these particular measures only show conditions improving or deteriorating from one month to the next. Things may be 'less bad' than they were, but it remains challenging to know just how poor economic conditions in Europe really are.
- Cross border travel within Europe is expected to resume in June, which will hopefully see conditions improve a little.

- **Asia/EM:** Unusually, Chinese officials said they were unable to provide economic growth projections for 2020, citing ongoing virus-related disruptions and uncertainties. Retail sales in the first four months of 2020 were down around -16% on the corresponding period in 2019 and exports are down more than -10% from a year ago.
- Australia, the UK, the US and Canada suggested China's plan to impose new security laws in Hong Kong violate international commitments. This was a further indication that China is seeking to increase its control over Hong Kong, which was supposed to maintain autonomy from Chinese rule until 2047 at the earliest.
- This development threatened to reignite tensions between the US and China, only a few months after the two superpowers agreed a truce on their trade dispute.
- There were also signs of an intensification of geopolitical tensions on the Korean Peninsula, with North Korea outlining plans to expand its nuclear and missile capabilities.
- Often these kinds of developments would adversely affect equity markets, but with financial markets awash with liquidity due to central bank stimulus packages, the news did not appear to have much impact this time around.
- In Japan, inflation turned negative for the first time in more than three years, underlining the weakness of economic conditions. Industrial production is currently around -14% below levels from this time last year and exports are down ~20%.
- The Japanese government is responding with an enormous economic stimulus package; in fact the largest in the world on a per capita basis.

### Australian dollar

- The general improvement in risk appetite boosted the Australian dollar. The currency gained 2.4% against the US dollar and more than 3.0% against the Japanese yen.
- The dollar also appreciated against a trade weighted basket of international currencies, closing the month 1.7% stronger.

## Commodities

- Most commodity prices finished the month stronger as the demand outlook improved, particularly in China which unveiled a US$500 billion fiscal stimulus package.
- Major industrial metals finished the month higher, with aluminium (5.3%) and copper (5.3%) leading the way.
- Iron ore (20.2%) strengthened markedly, on supply concerns. Brazilian production is being affected by the spread of COVID-19, with a number of confirmed cases at Vale-owned mines.
- Oil (79.4%) posted very strong gains from a low base, closing the month at around US$35 a barrel.
- The gold price (1.8%) was relatively steady during the month.

## Australian equities

- Uncertainty surrounding the full economic impact of the coronavirus saw the Australian equity market in negative territory for much of May.
- However, an encouraging economic update from the Reserve Bank of Australia late in the month buoyed sentiment and helped the S&P/ASX 100 Accumulation Index finish 3.8% higher.
- A slowdown in activity levels and earnings for most companies seems inevitable, but the completion of numerous equity raisings has helped Australian firms improve their balance sheets. Many are in a good position for when activity recovers.
- The IT sector continued to outperform (17.4%) as the apparent earnings resiliency of technology companies impressed the market.
- Within the sector, Afterpay (+52.0%) led the push higher. Its third-quarter update detailed strong customer and sales growth, particularly in the US, and lower than expected bad debt levels.
- The poor performance of sector heavyweight CSL (-10.7%) dragged on the Health Care sector (-6.2%).
- CSL's FY21 consensus earnings expectations have recently declined – the market has become increasingly concerned over demand and supply constraints, given rising unemployment and lockdown laws in the US.
- Australia's smaller companies delivered another impressive performance in May and outperformed their large cap peers. The S&P/ASX Small Ordinaries Accumulation Index rallied 10.6%, with over 80% of constituents delivering positive returns.
- Given the recent run of strong gains, a performance of -0.5% or better in June would see the Small Ords Index experience its best quarterly return since the Index's launch date in March 2000.

## Listed property

- After posting solid gains in April, global property securities took a pause in May. The FTSE EPRA/NAREIT Developed Index returned -1.1% in Australian dollar terms.
- News flow regarding the COVID-19 situation remained the dominant driver of listed property in May, although geopolitical and domestic tensions affected some local markets too.
- In fact, regional performance varied quite significantly. The best performing markets included Germany (9.4%), Australia (7.0%) and Japan (5.8%). Laggards included Hong Kong (-13.9%), France (-5.5%) and Canada (-2.1%).
- German property landlords fared well as the country started easing lockdowns and reopening its economy. Encouragingly, these moves did not result in a material spike in new cases of COVID-19.
- The Hong Kong market trailed peers. Tensions flared up again during the month after Beijing imposed controversial national security laws in the region, spurring widespread protests.

## Global equities

- Ongoing stimulus packages from governments and central banks, hopes of a coronavirus vaccine and optimism over an impending return to 'normality' helped push global equity markets higher, despite rising trade and geopolitical tensions.
- The MSCI World Index added 4.8% in local currency terms and is on track to record its strongest quarter since the recovery from the GFC in 2009. The strength of the Australian dollar eroded returns for local investors; the Index was up 'only' 3.5% in AUD.
- European equities rallied strongly after the German and French governments jointly advocated a €500 billion debt-financed recovery fund. The German Dax rose 6.7% in euro terms.
- The Japanese Nikkei performed even more strongly, rising 6.9% in yen terms. Japanese investors were heartened by the lifting of the COVID-19 induced national state of emergency in the last week of the month.
- UK equities lagged for the second month in a row, as energy and financial stocks lost value. HSBC and Standard Chartered were both victims of mounting geopolitical unease in Hong Kong.
- The tensions in Hong Kong and potential ramifications for global trade pushed Emerging Markets lower. The MSCI EM Index closed the month -0.6% lower in Australian dollar terms.

## Global and Australian Fixed Income

- Bond markets continued to be underpinned by massive central bank support programs. These measures have helped calm fixed income markets considerably since March's volatility. In fact, government bond yields in most major regions hardly moved at all during May.
- The threat of deflation appears to be an increasing concern globally and is helping to keep bond yields at very low levels. With household and business spending forecast to remain subdued for an extended period, inflationary pressures are expected to remain weak. This suggests interest rates will remain low globally for the foreseeable future.
- With economic data so weak, the investors' focus remained on government stimulus packages designed to help soften the blow of virus-related disruptions. The scale and duration of these packages is important, as it will influence funding requirements and the expected future issuance of government bonds globally.
- With that in mind, there was some good news for the Australian Treasury; it was revealed that the ongoing JobKeeper program might end up costing around $70 billion, substantially lower that the original $130 billion forecast.

## Global credit

- Corporate bonds continued to rebound from March's weakness. Credit spreads – the additional yield paid by corporate bonds over and above comparable government securities – narrowed further as funds continued to flow into the sector.
- Importantly, corporate bonds are included in the asset purchase programs that are underway at the US Federal Reserve and European Central Bank. This appears to be reassuring investors that valuations will be underpinned by ongoing demand from these extremely large buyers.
- US names marginally outperformed those in Europe, perhaps reflecting President Trump's suggestions that large parts of the US economy should be reopening shortly.
- The improvement in risk appetite globally proved particularly supportive of high yield credit. This area of the market followed up April's gains with another strong month of performance.
- It still seems likely that some low-quality firms will fail during and after the COVID-19 crisis. But if economies get back on track sooner than anticipated, default rates might not be as bad as some investors were expecting – this evolving sentiment appeared to act as a tailwind to high yield credit over the month.

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