Upswing to a 'new normal'

Paul Bloxham, Chief Economist, HSBC Australia spoke at a FINSIA Economic Indicators Lunch on Friday 12th February and he said, "This is not over yet" referring to Covid, the recovery will be "bumpy and uneven".

International

- China is the only economy to grow in 2020 +2.2%. This continues the growth momentum. In 2021, HSBC forecast China growth at +8.2%. So a V-shape recovery:
- North-East Asia has dealt well with Covid. There is a tail wind from manufacturing, because people in houses are buying goods. So a V-shape recovery is expected as well.
- Southern- Asia including India, the Philippines and Indonesia were hard hit by Covid and slowly recovering.
- Western Europe (WE) was impacted with European GDP -15% and UK GDP -20%. This is because these economies are more services orientated. WE began to bounce back, but Covid wave 2 has set Europe back. W shape recovery, lost momentum in the fourth quarter of 2020 and a 2022 recovery.
- USA can be described as a W shape recovery. US GDP down 10% in the first half, bounce back, but losing momentum.
- Overall, global trade is favouring manufacturing over services and thus the demand for commodities.

Australia

- Australia has fared better than the developing economies generally, showing the benefit of being an international island. GDP was -7.5% in the first half of 2020, but bounced back in the third quarter. 2020 calendar forecast GDP is -2.8%. A U or V recovery is forecast HSBC see Australia GDP rising +3.5% in 2021. A consumer-led recovery is supported by massive fiscal transfers. Savings rate increased from 7.5% to 22% in the second quarter and 19% in the third quarter. These savings will lead to an upswing in economic activity led by the consumer. The stimulus has created a housing upswing, supported by low interest rates. Business investment is challenged. While there will be an upswing to the new normal, the new normal is not the same as pre-covid.

- While there have been benefits from having distant borders, there are also costs in the form of tourism, students and immigration. The shutdown of outbound tourism has somewhat offset the barriers to inbound travellers. The challenge of opening borders even post vaccine, manifests with Australian States hypersensitive to small numbers of cases.

Changed behaviours

As a result of the Covid pandemic, there are a number of behavioural changes. The use of Zoom, more people at home, more shopping online, a significant decline in business travel. We have not seen the full adjustment to all these changes. While Jobkeeper in its present form is unlikely to be extended being a broad-brush, costly and somewhat inefficient program, Paul Bloxham does expect more stimulus and support for business in the budget.

Commercial property will show some challenges particularly in the office segment with more working from home. Industrial property is being supported with more buying online. Shopping centre assets continue to be challenged. Unemployment is at 6.6% alongside the Government target of 6%.

Interest Rates

The Government stimulus comprises of both monetary policy stimulus known as Quantitative Easing (QE) and fiscal stimulus. These policies are keeping yield curves flat and low. These stimulus measures are being seen in the developed world. HSBC have the view that fixed interest rates will be lower for longer for a considerable time. Burrell's expect the 10-year long bond in Australia and the USA to increase.

Policy changes in 2021

The vaccines are marvellous news for the world and for the world's economies. While there is some residual uncertainty around the proportion of the population domestically and internationally who will 'take the jab', medical professionals have indicated a level of 70% vaccination together within areas where outbreaks occur controls over spread, masks, sanitiser, distancing, contact tracing would in time lead to the virus control we all seek.

It looks like it will become a race against the mutations. The key challenge for Australian policy makers is to manage the balance between protective health policy and the economy. It seems more likely that annual doses of the vaccine will be required as we currently have with the flu vaccines to deal with mutations.

Monetary policy is near its limits, while fiscal policy has taken on a greater role and this is likely to continue. Incremental fiscal adjustments are expected. The net result of this stimulus is that higher Government debt is likely, the annual Government net debt rising from 25% GDP pre-Covid to over 40% GDP. Because of the low interest rates, this high Government debt is sustainable.

Key highlights from a recent UK strategy & global economics webinar by internationally renowned Capital Economics included:

- Inflation to increase internationally in the coming decade by ½ to 1% which will give corporates some pricing power and the hope of some modest wage increases. Inflation is not expected to 'spike' which in the event would be of concern across various asset classes
- The degree of leverage/borrowing by corporates globally are nothing resembling pre GFC, the 'tech bubble' or the later part of the 1920's
- The developed world to recover faster than the emerging countries

HSBC say, "the broader opportunity should not be missed'. Their view is that fiscal policy makers should focus on four elements: infrastructure investment, tax reform, climate energy policy and competition policy.
Adequate provision of infrastructure supports businesses' ability to operate. In particular, Australia's major cities have become congested, which is likely to be weighing on productivity. Infrastructure also extends to utilities where productivity has been particularly weak.

Portfolio Performances
The portfolio performance letters are currently being dispatched for Individually Managed Portfolios/Premium Portfolio Service Clients for the periods 1 July 2019 - 31 December 2020 (18 months) and 1 July 2020-31 December 2020 (6 months).

The majority of portfolios have recovered all of the March 2020 Covid falls being circa 30% to the low on 23 March 2020. This means portfolio values are restored back to 1 July 2019, a commendable result.

The January bourse looked at some of the strategies employed to achieve this result.

Implications of the above for 2021
A number of themes may be pursued based on the above economic and portfolio touchstones.

a) Industries recovering at different rates
Just as the economic recovery will be bumpy and uneven, so different industries and sectors are recovering at different rates. A number of defensive sectors were beneficiaries of Covid e.g. packaging. A further question is whether those industries have a second leg up as a more permanent reaction to Covid e.g. hygiene including hand wash and disinfectants, or whether the Covid uptick is temporary and industry/company activity will return to "normal" levels e.g. supermarkets?

Some industries/companies will lag the general economic recovery e.g. international tourism may not resume for several years because not only is vaccination required, but Australian borders may be closed until highly infectious areas such as South America, Africa and Southern Asia bring Covid and its mutations under control. In between companies with more defensive earnings with Covid and those which are laggards, sit the majority of companies, which primarily depend on the economic recovery. The February reporting season has shown sound company results to date and is not likely to result in a material further drag on Australian stock market performance.

b) Some overvaluation

With interest rates low and forecasted to stay low for several years, this is masking overvaluation in some companies and sectors. In hindsight we will see the move to favour all things online to have some elements of the 2000 tech bubble, fuelled by sentiment and momentum from some self-directed Robinhood investors rather than in-depth analysis of company strategies, quality of management, balance sheets and profits. As in the 2000 tech bubble, a number of these companies have no profits and are trading on revenue multiples which are stratospheric. There will be casualties, as shown by the recent US GAMESTOP trading frenzy.

c) Banks

Australian banks lagged the recovery as concerns rose as to the level of businesses, which would default and result in bad and doubtful debts for the banks. The $10 price fall from around $25 to $15 for the three major banks was a fall of around 10 x 3 Billion = $30 Billion for each of those three banks. As anticipated, the banks recovered around half of this fall when it became clear that programs such as Jobkeeper and other income support measures meant that there would be few company failures in the short term. All of the banks have reported that bank customers that entered into loan deferment arrangements have fallen dramatically in recent months with most customers now meeting bank loan repayments. As a result, the banks have continued to recover with ANZ and NAB above $25 and CBA above $85 ex the restoration $1.50 February 2021 dividend. We thought the restoration of dividends would see the banks take a further step up in price and this is exactly what has occurred.

d) Oil & gas stocks

The oil and gas sector also was oversold and lagged the recovery. Despite economic growth showing a good recovery in most of the developed world, the oil price lagged through December 2020 and it is only in the first two months of 2021 that the oil price recovered through $50 USD/bbl and more recently $60 USD/bbl. The cold winter in the northern hemisphere, particularly Asia, has seen LNG prices firm. Australia is not a strong oil province, but we have terrific reserves of liquefied natural gas (LNG). These stocks have recovered to an extent over the past couple of months, but is likely they have further to retrace to their pre-Covid prices.

e) Stronger commodities cycle

The analysis favouring goods over services supports a stronger commodities cycle. We need to be careful not to underestimate the strength of the commodity cycle as economies continue to recover post the Covid-vaccine.

f) Infrastructure

Infrastructure is a likely beneficiary globally as governments move from broad based income support measures such as Jobkeeper to supporting the replacement of aging infrastructure. This is both an Australian and global theme. Major construction projects were somewhat interrupted by Covid in contrast to home building in Australia which was strong.

g) Agriculture & weather

The breaking of the drought at the beginning of 2020 was a theme pre-Covid. Since that time, we have seen good follow up rains in many parts of Australia resulting in bumper crops. Covid has also supported a number of themes including the Mediterranean diet and the substitution of cheaper protein for beef e.g. chicken.

h) Growth stocks

A number of portfolios did not participate in the January/February 2020 uptick prior to Covid. Those that had a smattering of growth stocks generally fared better. Per earlier blogs, we have split growth stocks into growth at reasonable prices (GARP), growth at realistic prices (Higher PE but justified by the growth and profits) and other growth stocks (which should be viewed as speculative). There have been opportunities since March 23 at different times for different growth stocks as this category of stocks requires ongoing analysis to select those to be included in portfolios to broaden the shoulders of the portfolios but without adding speculative stocks.

i) Corporate actions.

There have been a number of takeovers and corporate actions in recent months, which have led to above normal gains for those stocks. It is always helpful to portfolios returns to have one or two stocks in the portfolio where a possible corporate action is likely on the balance of probabilities.

j) International

We have continued to identify a number of direct international stocks with good business models and attractive pricing, despite some bubble characteristics, particularly in the USA stock market technology sector.

k) Property

With term deposit rates at 0.5% and less, Australian property has yielded plenty of work for our property group. A 6 or 7 % yield on a property trust looks compelling compared to current term deposit rates. It should be pointed out that term deposit rates are artificially low as the Australian Government and Reserve Bank of Australia have flooded the banking system with liquidity, which is not being taken up for investment by the corporate sector in sufficient quantity.

l) Fixed Interest

There are a number of alternatives to term deposits on a risk of return basis which our Fixed interest desk has identified and actioned during 2020 and into 2021. Again, some diversification from term deposits is possible without taking undue risk and to achieve higher fixed interest returns. Avoid long duration where any firming of the 10-year bond is currently causing capital losses on those bonds.

Happy Investing,
Chris