AMP CAPITAL

13 March 2020

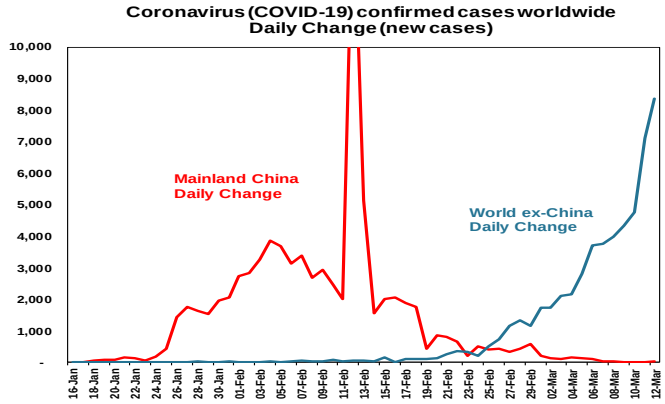
SHANE OLIVER
Head of Investment Strategy and Chief Economist, AMP Capital

Investment markets and key developments over the past week

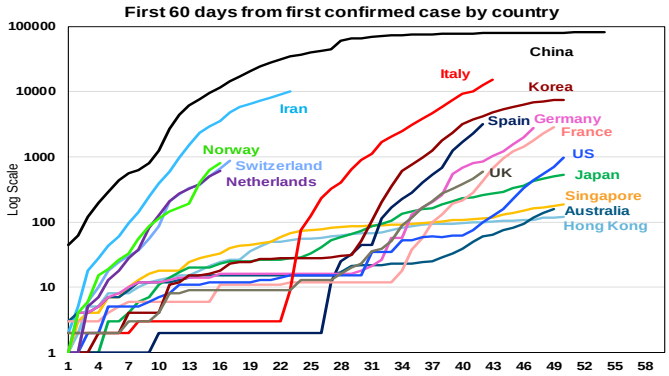
Share markets collapsed over the past week as concerns about the global economic impact of the coronavirus intensified, oil prices plunged as part of the secondary impact and policy responses by President Trump and the ECB were seen as not enough. Australian share fell around 20% with energy shares leading the way down but selling was broad based with industrials, financials and property stocks hit hard given the impending impact on the local economy. Bond yields fell in the US and Germany but rose in Australia and rose sharply in Italy on deficit concerns. While the iron ore price was flat, oil prices plunged, and metal prices fell. A rebound in the US dollar saw the $A fall below $US0.63.

The news on coronavirus and its economic flow on just seems to go from bad to worse and so its little wonder shares, commodity prices and bond yields have remained under pressure:

- New cases are still rising globally– although they have collapsed in China (highlighted by President Xi visiting Wuhan) they continue to surge elsewhere. The US and Australia are no longer immune to this. See the next two charts.
- WHO has finally called it a pandemic, which is a statement of the obvious, but it adds to the sense of panic.
- Lockdowns and social distancing policies are spreading globally and set to ramp up in Australia.
- And the first really big secondary effect showed up with 30% or so plunge in oil prices as OPEC and Russia failed to agree production cuts in response to the slump in oil demand on the back of the virus which then saw Saudi Arabia announce much lower prices and higher production. All of which led to concerns about a slump in US oil related capex and worries about energy companies not servicing their loans.
- President Trump's address to the US added to the panic by underdelivering on promised stimulus, banning foreigners travelling from Europe for 30 days and initially saying the ban included goods as well. And the ECB's response was a long way from Draghi's "whatever it takes".



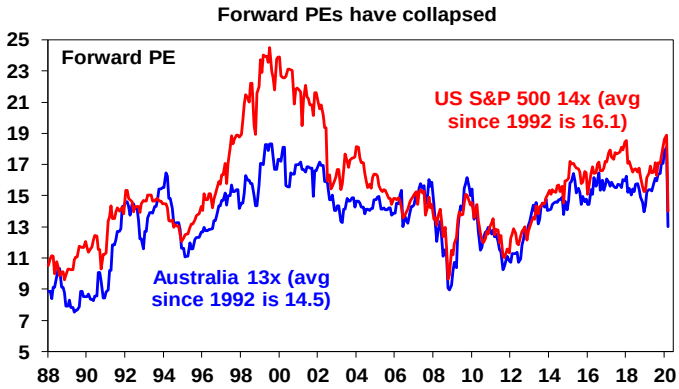
Source: PRC National Health Commission, Bloomberg, AMP Capital



Source: PRC National Health Commission, Bloomberg, AMP Capital

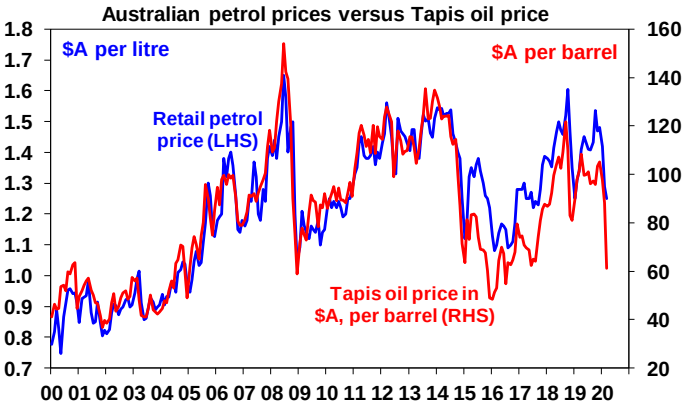
But while it seems somewhat irrelevant for now there are some positives that investors need to allow for in assessing the outlook for the next 6-12 months:

- After 30% or so falls shares are now cheap, particularly against ultra-low bond yields & interest rates. Forward PEs are now well below long term averages.



Source: Thomson Financial, AMP Capital

- Investor sentiment is now very negative – with the VIX (or fear index) at levels last seen in the GFC - which is positive from a contrarian point of view.
- While it may not be enough just yet, policy stimulus is ramping up dramatically with the BoE and the ECB easing and providing liquidity support, more liquidity support from the Fed, fiscal stimulus in the UK and Australia, the US moving towards fiscal stimulus, Angela Merkel saying Germany will do "whatever is necessary", etc. More stimulus will be needed but policy makers are moving in the right direction at least. Stimulus won't stop the virus or the economic disruption, but it will help limit the secondary economic fallout and help boost the recovery.
- While the collapse in the oil price will weigh on US oil company capex and debt servicing it's actually a net boost to developed countries via consumers who now have more spending power, albeit they may not spend it for several months. Australian petrol prices are likely on the way to below $1.1/litre which will save the average family around $13 a week on their petrol bill compared to what they were paying in December.



Source: Motormouth, Bloomberg, AMP Capital

But while these things will help minimise the downside and boost the recovery we really need to see evidence that the virus and its economic impact will come under control such that shares and other investment markets can be confident that the worst has been factored in before markets will bottom. Right now this is still lacking. However rapidly improving valuations and policy stimulus provide confidence that growth will rebound once the virus runs its course and that share markets will be higher in 6-12 months. Key to watch for in the short term are: signs that the number of new cases (outside China) has peaked – the shift to the northern summer may help here (although it's not so bright in Australia as we approach winter); signs that corporate and household stress is being kept to a minimum; signs that market liquidity is being maintained and supported as appropriate by authorities; and more policy stimulus to minimise the fall-out from shutdowns.

On the policy front the decisive fiscal stimulus in Australia shows what needs to be done. The Federal Government's stimulus package gets my tick. The $17.6bn package is mostly front loaded over the next year and particularly the next few months. Combined with the $2.4bn health spending package and the $2bn in bushfire assistance it will actually get us a bit above the roughly $20bn (or 1% of GDP) in fiscal stimulus over a year that I thought was necessary. The measures - focussed on boosting investment and maintaining wages and employment and providing a cash boost to welfare recipients (much of which will get spent) - are all in the right areas. This won't stop the virus or the lockdowns – which risk extending into August in Australia given our approaching winter – and so probably won't stop a recession which runs the risk of extending into the September quarter. But along with monetary easing it may help Australia avoid a second consecutive quarter of contraction in the June quarter and even if it doesn't it will minimise secondary economic effects and hence the depth of the downturn and will help boost the recovery once the virus runs its course - hopefully sometime in the next few months.

By contrast President Trump (and Congressional leaders) has botched things by building up expectations only to under deliver and show no sense of urgency and with Trump throwing in travel bans and even a goods ban (since walked back) with Europe that only add to the sense of impending recession. The Administration and Congress appear to have reached some compromise on a deal, but it doesn't look big enough yet. The US needs a stimulus of at least 1% of GDP. They will get there because neither Trump nor the Democrats want to get the blame for a recession, but it may take more market falls beforehand. Similarly, the ECB botched its message a bit by not offering support for Italy which will likely be required in the months ahead. Now is the time for another ECB "whatever it takes" commitment. Where is Draghi when we need him!

The big and rapidly growing risk for President Trump is that the US economy slides into recession that combines with his policy failure to allow around 30 million Americans to go without health insurance ahead of a health crisis to see him lose the election. This is now looking 50/50. The good news is that moderate Joe Biden continues to consolidate his position as front runner for the Democrat nomination in primaries over the last week. While he may want to raise corporate tax rates his steady hand may be seen as welcome by markets through periods like the present and in general he is seen as business friendly.

Major global economic events and implications

US small business confidence surprisingly rose in February and remains high and jobless claims remain low while core CPI inflation came in a bit higher than expected in February. Unfortunately, activity data is likely to slow in the months ahead and the inflation data is irrelevant given the deflationary hit coming from lower oil prices & a likely recession.

Chinese exports and import growth fell in January and February on the back of disruptions, particularly exports. More weakness is likely in exports ahead although imports may improve as economic activity returns to normal. Chinese core inflation weakened in February leaving plenty of room for policy stimulus.

Australian economic events and implications

Australian business confidence as measured by the NAB and consumer confidence as measured by Westpac and the Melbourne Institute fell further in February and March respectively, no doubt reflecting coronavirus concerns. While housing finance commitments rose strongly again in January this is set to slow again in the months ahead as coronavirus temporarily impacts buyer demand.

RBA Deputy Governor Guy Debelle indicated "quantitative easing" would likely be the next step if it cuts rates to 0.25% (which we expect to occur in April) and confirmed media talk that the RBA will do it by announcing a target for the bond yield (say 0.25%) rather than a target for bond buying as occurred in the US. The mere threat of bond buying may turn out to be enough to hit the yield target. Japan has done something like this with so called "yield curve control" but it was backed by a bond buying target too. Targeting a yield without much actual bond buying may limit the transmission channels of QE via a lower $A and forcing bond investors to take more risk and hence its actual economic impact. So, yield targeting may just turn out to be an intermediate step to the RBA being forced to do actual QE.

What to watch over the next week?

The increasing number of Covid-19 cases globally and spreading lockdowns will no doubt continue to dominate in the week ahead as investors attempt to assess how long it will take to be contained and how bad the hit to economic activity will be.

In the US, the Fed (Wednesday) is expected to announce another rate cut of as much as 1% and additional liquidity measures to help deal with the threats posed by coronavirus. On the data front, expect another solid rise in February retail sales, a bounce in industrial production and continued strength in the NAHB's home builders' conditions index (all due Tuesday), a fall in housing starts (Wednesday) but a rise in existing home sales. Manufacturing conditions indexes for the Philadelphia and New York regions for March are expected to fall.

Chinese economic activity for January/February is likely to show a sharp contraction as a result of coronavirus shutdowns. Expect a fall in January/February industrial production, retail sales and investment of around 3% year on year.

In Australia, expect the minutes from the last RBA meeting due Tuesday to contain a strong easing bias. Meanwhile ABS house price data (also Tuesday) for the December quarter will show a 4% rise consistent with private sector surveys long ago released. Labour market data for February (Thursday) is expected to show a 10,000 gain in jobs with unemployment rising slightly to 5.4%.

Outlook for investment markets

Shares are likely to see further short-term falls given the uncertainty around the coronavirus both in terms of the outbreak's duration and its economic impact even if it's soon contained. But for the next 12 months shares are expected to see good total returns helped by an eventual rebound in growth and easy monetary policy.

Low starting point yields are likely to result in low returns from bonds once the dust settles from coronavirus.

Unlisted commercial property and infrastructure are likely to continue benefitting from the search for yield but the decline in retail property values and the hit to growth from the virus will weigh on near term returns.

Our base case is that capital city house prices will continue to rise but at a slower pace than has been the case. However, this is now under threat given the expected recession in response to coronavirus disruption. A sharp rise in unemployment would pose a major threat to the property market. Hopefully stimulus measures will head that off as occurred in the GFC.

Cash & bank deposits are likely to provide very poor returns, with the RBA expected to cut the cash rate to 0.25%.

The deepening hit to global growth from Covid-19 is now likely to see the $A pushed to $US0.60 or even below. Given the uncertainty around the virus the short-term risks for the $A are on the downside.