Economic News February 2021

2020 was a year that challenged us all but ended with hope. The emergence and rapid spread of COVID-19 pushed the global economy into a deep recession and led to substantial market falls early in 2020. In the absence of a vaccine until very late last year, restrictions on social mobility and business activity were implemented in many countries to control the spread of infection and minimise fatalities. To support households and businesses and sustain the functioning of financial markets, central banks and governments implemented co-ordinated policy measures on a massive scale. As a result, the breadth and depth of the economic decline was not as severe as initial forecasts and encouraging signs of recovery emerged in the second half of the year. This contributed to a remarkable rebound by many share markets following their deep falls in the March quarter, particularly the US share market which was driven by a handful of US technology companies. However, many economies and industries have not fully recovered. Public health policy failures in many countries such as in Europe, the US, UK and Japan saw an acceleration in new virus infections, requiring the reintroduction of lockdown measures.

Confirmation of the successful development of a number of vaccines in November 2020 helped sustain markets into 2021 but the logistical challenges of making the vaccines available to vast numbers of people around the world shouldn't be underestimated.

The economic impact of COVID-19

The economic and health shock caused by the spread of COVID-19 proved to be the worst economic downturn since the 1930s Great Depression. In the US, the Federal Reserve Chair Jerome Powell commented that the US economy had entered a "downturn without modern precedent". In the US, the unemployment rate surged from 4.4% to 14.7% by April 2020 and US retail sales that month also fell a record 14.7% due to the massive job layoffs and business shutdowns. These US statistics were replayed across the global landscape with the June quarter decline in global Gross Domestic Product (GDP) the deepest since World War II.

In Australia, fiscal policy measures such as JobKeeper and JobSeeker support programs and relative success in virus containment meant the Australian impact was mitigated, but GDP still fell by -6.3% over the year to June 2020. This followed the March quarter GDP fall of -0.3%, thereby bringing to an end an almost 30 year period without a recession. Perhaps encouragingly, the Reserve Bank of Australia (RBA) Governor Dr Philip Lowe suggested on 28th May that Australia's economic downturn "will not be as severe as earlier thought". That optimism did prove to be somewhat premature as a second wave of infections in Victoria required extended lockdown restrictions. Despite fears of a collapse in residential property prices, Australian homes continued to rise in value, largely due to the various stimulus programs targeting property such as the homebuilder grant. As a result, there has been a 37% increase in owner occupier home loans since the pre-pandemic peak.

China's economy rebounded strongly following the -6.8% GDP contraction in the March quarter with 3.2% annual growth in the June quarter and then 4.9% in the September quarter. Massive fiscal and monetary stimulus enabled China's industrial production to grow 6.9% in the year to September, which was a remarkable recovery. However, the pace of the global economic recovery has been uneven with economic indicators in many countries remaining below where they were a year ago. India's GDP is 7.5% smaller than it was last year, Japan's GDP has shrunk nearly 5%, Italy's GDP by 5% and the US by 3%.

A major concern in the remaining months of a traumatic 2020 was the sharp rise in virus infection rates in key economies such as the US, Japan, Germany and the UK and the emergence of a new highly infectious COVID variant. The reintroduction of restrictions is likely to compromise the economic recovery, with Europe and the UK particularly vulnerable given lockdowns started in November. Compared to many countries, Australia was of course fortunate.

Consumer confidence in Australia at year end was above pre-COVID-19 levels (as indicated by the Westpac Melbourne Institute's Consumer Sentiment survey) which surged in December to the highest result since 2010. The Mid Year Economic and Fiscal Outlook released in December forecasts the 2021-21 budget deficit, while still massive at $197.7 billion, will be smaller than expected due to the rebound in the economy and surge in the price of iron ore. Unemployment fell to 6.8% in November and around 80% of the 1.3 million people who lost their job or were stood down are now back at work. However, many Australian households will continue to be disadvantaged as unemployment is expected to remain at an average 6.25% into the middle of 2022 and the underemployment rate also remains high. According to the RBA, this will likely require the cash rate to remain at current low levels of 0.1% for at least three years.

Australian business conditions

The profit reporting periods in Australia highlighted the adverse impact the economic slowdown was having on specific industries. Supermarket operators Woolworths, Coles Group and Metcash (IGA) enjoyed growth in sales as households stock-piled food and other essentials. Wesfarmers (Bunnings), JB Hi-Fi and Harvey Norman experienced significant growth as people spent more time working from home and undertaking home improvements. In contrast, industries including airlines, tourism, education, casinos and hospitality were deeply impacted.

Industry sector returns varied with some managing to record strong gains for the year. The best performer was Information Technology (57.8%), emulating in part the performance strength of the US technology companies. Resource-based sectors experienced mixed fortunes. Miners such as BHP, Rio Tinto and Fortescue Metals Group performed well as the iron ore price increased 70.3% due to strong demand by China and ongoing supply issues in Brazil. However, Energy was our market's worst performing sector, falling -27.6%. This reflects the -21.5% fall in the price of oil (Brent crude) over the year. Aside from the collapse in global demand caused by the economic contraction, oil market conditions were also compromised by the initial failure of OPEC and Russia to agree on production cutbacks.

Geopolitical issues unfolded as the year progressed

As in past years, markets had to contend with a range of geopolitical issues. Some were new, while others like Brexit were all too familiar.

The US Presidential election in November was a major focus for markets. The strong performance of the US economy at the beginning of the year was expected to favour the incumbent President Trump. However, the economic damage caused by COVID-19 and the indifferent and inadequate response by the Trump administration to the worsening health crisis enabled the Democratic nominee Joe Biden to win the Presidency with a majority of Electoral College votes. The incoming Vice-President Kamala Harris will have the casting vote in the Senate as both the Democrats and Republicans have 50 seats each for the next two years.

Control of both houses increases the likelihood of further stimulus measures and the successful delivery of President-elect Biden's legislative agenda. Despite the extent of political polarisation in the US, the Republicans and Democrats finally reached agreement on a fiscal stimulus bill just before Christmas. While much less than markets were hoping for and considerably less than the US$2.7

trillion stimulus package implemented in March, the US$900 billion stimulus plan provides much needed support to American households and businesses.

The terms of Britain's exit from the EU was finally agreed between Brussels and London just days before the 31st December deadline. While the agreement means there will be no tariffs or quotas imposed on trade between Britain and the EU from 1st January 2021, the terms of the agreement are complex and may present unexpected challenges ahead.

A concerning development was the deteriorating diplomatic and trade relationship with China, our largest trading partner and destination for approximately a third of Australia's total exports. A number of issues over an extended period have contributed to the growing tension, including banning Huawei from tendering for the 5G mobile network, introducing "foreign interference laws" on national security grounds, Australia speaking out on the South China Sea and human rights issues in China and the call for an inquiry into the origins of the coronavirus pandemic. China imposed high tariffs or import restrictions on a range of Australian agricultural and food exports such as barley, beef, wine and coal. The exports affected so far amount to around $22 billion in value. In response, the Australian government referred China's decision to impose high tariffs on Australian barley to the World Trade Organisation. Exports of iron ore to China have not been affected so far as it is a commodity that is crucial to China's ongoing infrastructure development. Should this change, the impact on Australia's economy, government revenue, share market and currency would be great.

Investment markets outlook

We anticipate the global economy will continue to recover in 2021 – particularly in more developed economies. A number of countries (including Australia) are already out of a technical recession after recording positive September quarter GDP growth. This trend should continue over 2021, with both the US and Australia back to their pre-pandemic GDP levels by the end of the year. Conversely, Europe and Japan are expected to lag and will likely not return to their pre-pandemic levels until 2022.

The first (and perhaps most obvious) driver supporting the global economic recovery in 2021 is the availability of a Coronavirus vaccine. Vaccines developed by Pfizer/BioNTech, Moderna and AstraZeneca/Oxford University have all reported strong efficacy rates that have exceeded expectations. The wide availability of a vaccine should allow for the gradual "re-opening" and normalisation of more developed world economies – starting with the US and Europe, followed by other economies including Australia, and East Asian nations such as Singapore, Hong Kong and Taiwan.

The second driver supporting the global economic recovery should be the low-interest rate regime of central banks in 2021. Many central banks reacted to the pandemic by reducing policy rates close to zero and conducted large-scale asset purchase programs to help support their economies. Several have also changed their monetary policy frameworks to allow for longer periods of low policy rates.

Finally, as the world releases itself from various pandemic constraints, we anticipate a third driver could be expansionary government fiscal policy. While there will be a reduction in the level of support particularly in Australia as Jobkeeper and Jobseeker cease in March 2021, around the world overall fiscal support should remain in 2021 as the pandemic fades. There will be debates on the need for fiscal repair, but for now the consensus on using aggressive fiscal policy to support economic growth will likely remain intact through to the end of 2022.

A significant portfolio challenge exists due to the poor return potential of many standard traditional asset classes used to build portfolios. With interest rates close to zero and likely to remain there for an extended period, the potential for above inflation returns, from fixed income and cash, looks poor. This increases the reliance on shares as a source of return and requires us to look beyond traditional investment exposures if stated fund objectives are to be achieved. Share markets could continue to be underpinned by the massive funds flow from central bank quantitative easing policies. However, share market valuations aren't cheap, especially as the continued presence of COVID-19 could undermine the anticipated economic and corporate earnings recovery that market pricing already reflects.

If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

Andrew Shaw BBus, Grad Dip SIA, CFP
Principal Shaw Financial Planning Pty Ltd
ACN 603 130 963, ABN 80603130963
Authorised Representatives

Suite 30, 1 Ricketts Road Mount Waverley VIC 3149
T 03 9544 1004

SHAW FINANCIAL PLANNING PTY LTD

CFP THE SIGN OF GOOD ADVICE CERTIFIED FINANCIAL PLANNER®

Please note this overview contains excerpts which are reproduced with approval from John Owen, Portfolio specialist