Economic News July 2020

The 2019-20 financial year was dominated by the COVID-19 pandemic

After initially appearing as a health issue limited to a province in China, the COVID-19 disease began to spread rapidly across international borders to countries such as Korea, Iran and Italy in February 2020, eventually prompting the World Health Organisation (WHO) to declare a pandemic on 11th March 2020.

The global surge in infections and fatalities forced governments around the world to impose restrictions on movement and operations to protect public health. The economic consequences of these necessary actions were dramatic, effectively shutting down economies around the world.

To limit the economic fallout and sustain the functioning of financial markets, central banks and governments implemented supportive policy measures on a massive scale. Share markets subsequently rallied from their lows in March, based in part on the belief (perhaps mistakenly) that the virus was manageable, and that economic distress would be short lived. The financial year concluded with no vaccine in sight and rising infection rates in various parts of the world, especially in Brazil, India and the United States.

The economic deterioration caused by COVID-19

The first half of 2020 will live long in the memories of investors. Firstly, as a devastating health crisis and secondly, because of the impact that efforts to contain the spread of the virus has had on the real economy and investment markets. After the Australian share market hit record highs in February 2020, investment markets tried to grapple with the impact of lockdown measures on individuals and businesses, resulting in a peak-to-trough sell off of -37% in only twenty trading days. Following record amounts of domestic and international fiscal and monetary stimulus, the Australian share market stabilised and has subsequently risen by 29% from the March low.

In the US, the number of people unemployed increased by 15.9 million people to 23.1 million in April 2020, with the unemployment rate surging from a near fifty year low of just 3.6% in February to a high of 14.7% in April 2020. This was the highest unemployment rate recorded and the largest monthly increase since data collection began in April 1948. The unemployment rate could have been much worse if not for Congressional support for a Protection Plan which provided US $660 billion in loans to support retaining employees which helped mitigate further damage to employment.

European economies also recorded dramatic falls in economic activity. The most severely impacted countries – Italy, Spain and France – experienced a surge in infections and fatalities, placing immense strain on their hospital system. This prompted many European governments to impose lockdowns and restrictions on personal mobility, resulting in widespread factory shutdowns. French and German car manufacturers announced production closures across Europe. News that the British Prime Minister Boris Johnson had contracted the virus only added further to financial market concerns.

The serious impact of COVID-19 on Australia's economy closely followed economic challenges caused by the devastating bushfires and the drought. Some industries such as travel, hospitality, education services and entertainment were immediately impacted by social distancing restrictions and other measures such as border closures implemented by the Federal and state governments. In the two months to the end of May, job losses totalled 838,000. Australia's March quarter Gross

Domestic Product (GDP) fell 0.3% and the Reserve Bank of Australia (RBA) warned that unemployment could reach 10% in the June quarter.

Central banks and governments to the rescue

Central banks and governments around the world are committed to implementing measures to limit the economic and financial disruption caused by COVID-19. The global scope of the stimulus measures is both extraordinary in nature and substantial in magnitude.

The US Congress passed the largest fiscal stimulus package in its history, with measures introduced in March and April 2020. The US $2.8 trillion package was targeted to support households and businesses through a comprehensive range of initiatives. Total fiscal support initiatives so far amount to the equivalent of 14% of US nominal GDP.

The European Central Bank (ECB) announced its own program to support markets and the eurozone economy. In March 2020, the ECB committed to purchase up to 750 billion euros in government and private sector bonds and vowed to keep interest rates low to support businesses and consumers. In June 2020, the ECB added an extra 600 billion euros to its support program and extended the duration of its purchase program until at least June 2021.

In Asia, China's central bank cut interest rates and provided guidance to the major banks to lend to small and medium enterprises. The Bank of Japan committed to buy corporate bonds, exchange trade funds and real estate investment trusts.

The RBA and Federal and state governments also announced extraordinary stimulus measures and assistance packages to support businesses and households. The RBA cut the cash interest rate twice in March to a historic low of 0.25% and committed to an expansion of its balance sheet through the purchase of Australian Federal and state government bonds. The Federal government also announced a range of fiscal support packages totalling A$213 billion (or circa 10% of nominal GDP).

These measures included wage subsidies to encourage businesses to retain staff, extra payments to existing welfare recipients as well as direct financial grants and loan guarantees for small businesses. State governments launched their own initiatives to support households and businesses.

Global share markets rallied despite risks

Global share markets in the June quarter staged an astonishing recovery. This was based on many economies moving towards a relaxation of social distancing measures, raising expectations (probably seriously misplaced) that the economic dislocation will be temporary and a 'V' shaped recovery will eventuate.

Due to the economic decline and precarious outlook, a significant number of companies withdrew their earnings guidance for fear of misleading investors. Many companies chose to preserve capital by cutting dividends, while some initiated capital raisings to underpin their balance sheet and position for the eventual recovery.

This was a very challenging year for the major banks following the conclusion of the Royal Commission early in 2019. The weaker Australian economy, substantial remediation and compliance costs and the downturn in the housing sector led to fears of lower earnings and dividend cuts. These concerns were realised in the second half of the financial year as the economic decline caused by COVID-19 resulted in substantially lower profitability.

The substantial stimulus measures provided by the Federal and state governments plus the measures initiated by the RBA led to hopes that the economic decline may not be as deep or long-lasting as originally feared.

Signs of recovery emerged late in the year – false hope?

Encouraging signs of a resumption of economic activity emerged late in the financial year as many economies began to ease social mobility and distancing measures, allowing some industries and businesses to reopen. A marked improvement in surveys of global manufacturing activity suggest the deep economic downturn may be ending.

Early signs of a turnaround have also occurred in Australia as success in containing the virus and the relaxation of social restrictions have enabled some sectors of the economy to restart. The RBA commented that the downturn may not be as severe as was originally anticipated in March and April.

However, there are still considerable risks. In parts of the world, COVID-19 infections either continue to rise or have reaccelerated. In the US, COVID-19 is spreading at an alarming rate and is forcing some states to reimpose restrictions. This may jeopardize recovery in the US and require another bout of fiscal stimulus. The infection rate in South America and India continues to accelerate, suggesting the pandemic is intensifying on a global scale. In Australia, an acceleration in locally transmitted infections in Victoria is a reminder that the outlook remains contingent on containing the virus. Until a widely accessible and affordable vaccine is available globally, economic activity and financial market returns will remain vulnerable to COVID-19.

Portfolios remain defensively positioned

Looking ahead, we think the recent complacency of markets towards the ongoing presence and spread of the virus and the economic dislocation it is causing is concerning. Economic uncertainty will persist until either the virus is contained or a widely available and affordable vaccine is developed. The dispersion of market earnings forecasts is very wide and share valuations look stretched. How the pandemic could evolve from here dominates investment scenarios thinking.

Most portfolios continue to employ alternative investments such as risk-controlled return strategies to help preserve capital in a very uncertain future. The huge uncertainty surrounding what comes next has resulted in significant dispersion amongst countries, asset classes, sectors, and companies. Despite the rebound in asset prices, the short-term outlook remains murky, given that much of the global economy has not returned to normal, while in Australia many individuals and businesses are making use of emergency measures such as the JobKeeper allowance or bank mortgage holidays.

The risk of a second or third wave of COVID-19 transmission is ever-present, and the international geopolitical backdrop suggests heightened levels of uncertainty for the remainder of the year, given US elections and US-China friction. This backdrop and the extreme volatility we saw earlier in the year has reminded many of us of the value of diversifying portfolios and active management. It has also reminded us that timing market swings is impossible, so staying invested over medium and longer time periods is critical. A strategy that mitigates the downside risk and smooths the return over time can help investors maintain the confidence they need to stay invested and reach their investment objectives.

Fiscal policy support has been extended with the Commonwealth Government continuing to provide support through its JobKeeper program until March 2021.

Central bank policy stimulus has also helped to suppress financial market volatility since March 2020. As there may be positive news on a vaccine or, alternatively, a continued second wave of infections, we will likely see continued short bouts of volatility over coming months.

We have attached an updated Financial services guide version 11.1 24th June 2020 for compliance purposes. There is nothing you need to do with this. 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