Economic News July 2021

2020-2021 was a remarkable year of economic and market recovery, but COVID-19 risks remain

Despite the ongoing threat of COVID-19, massive fiscal and monetary support measures were successful in engineering an extraordinary global economic recovery. Share markets recorded very strong gains in response, offsetting the large losses in the March quarter 2020 when COVID-19 first spread across the world. Confidence that the recovery in economic activity and corporate earnings can be sustained received a significant boost in November 2020 when the successful development of a number of vaccines were announced. Markets are hoping that rising vaccination rates will reduce the necessity for disruptive social and business activity restrictions. However, vaccination progress varies across countries and the emergence of COVID-19 variants such as the highly infectious Delta strain means that the world has a long way to go before returning to 'normal'.

COVID-19 concerns prevail, but the global vaccine rollout has commenced

The COVID-19 virus remained a global threat throughout the financial year. After its emergence in early 2020, global virus infections grew to around 200,000 per day by July 2020. Public health policy failures in some countries and the decision by some governments to reopen economies saw global daily infections rise to over 600,00 by December 2020.

The indifference of the Trump administration towards the virus and lax approach to imposing social activity restrictions in some American states caused infection rates and deaths in the US to soar at the end of 2020. The response in Europe to the surge in infections was more strident and decisive with widespread activity restrictions including the closure of bars and restaurants while some countries also imposed curfews.

Confirmation in November 2020 of the successful development of a number of vaccines raised hopes that social and economic circumstances may return to 'normal'. In the US, President Joe Biden's election led to targeted measures, both in reducing the infection rate and accelerating the vaccination of the American population. This was largely successful with infection numbers and deaths falling dramatically. In Europe, lockdown measures were also successful in reducing infections. However, infections in India tragically soared to over 400,000 cases per day by May 2021, as a new and highly contagious 'Delta' variant emerged. As with the original COVID-19 virus, the Delta strain has spread globally. The Delta strain contributed to an alarming spike in UK daily infections, while in Australia the virus necessitated lockdowns that at one stage affected nearly half the population.

In a welcome contrast to the first months of the pandemic, hospital admissions and deaths fell dramatically as some countries successfully implemented their vaccination programs. By June 2021, around 11% of the world's population was fully vaccinated and around 23% were partially vaccinated. However, country specific vaccination rates varied considerably. In the US and UK, 46% and 48.7% of the population respectively were fully vaccinated by 30 June 2021. European vaccination rates are improving after a slow start with many of the larger nations like Germany and France having fully vaccinated between 30% - 40% of their populations. However, vaccination progress has been slow in Asia with Singapore's 35.8% fully vaccinated status looking to be an outlier compared to Japan's 12.1%, South Korea's 9.8%, Indonesia's 4.9% and India's 4.2%.

Unfortunately, only 5.9% of the Australian population had been fully vaccinated by 30 June 2021. The vaccine rollout is expected to accelerate when the anticipated supply of Pfizer and Moderna vaccines increases towards the end of the year. The vaccination rate should also improve once people who are partially vaccinated receive their second injection.

The global economy staged a remarkable recovery despite the presence of COVID-19

Around the world, economies have begun to recover alongside the vaccine rollout. However, the economic recovery in various countries has been uneven, with the US and China rebounding strongly while Europe and Japan have lagged in comparison, due principally to social mobility restrictions to halt the spread of the virus.

Thanks to the powerful combination of monetary and fiscal support by the US Federal Reserve (the Fed) and the US government, the US economy recovered strongly. The recovery that was evident by the end of 2020 was reinforced by the massive spending agenda of newly elected President Biden. As the economy improved, the unemployment rate fell from a high of 14.8% to 5.8% by May 2021, although there are still 7.6 million fewer jobs in the US than in February 2020.

China's economy rebounded strongly following the sharp contraction early in 2020. China's assertive stimulus measures helped the economy grow strongly although signs that China's economic activity was moderating emerged later in the year as stimulus measures were wound back or removed.

In Europe, the implementation of activity restrictions including curfews across the continent late in 2020 (in response to high rates of infections) slowed the eurozone's recovery. The 0.7% decline in the December quarter's gross domestic product (GDP), followed by a 0.6% contraction in the March quarter, represents the eurozone's second technical recession in 12 months.

Japan's economic recovery has also lagged behind other developed economies as it has been forced to contend with waves of virus infections and a comparatively low population vaccination rate. Japan faces the added pressure of hosting the Olympic Games commencing on 23 July following their postponement last year.

Australia's economy also staged a remarkable turnaround, although at a considerable cost as the Federal Budget deficit forecast of $161 billion is the highest for decades. However, the deficit is below earlier forecasts, thanks to a better than expected economic recovery and the 108% rise in the price of iron ore which is Australia's largest export. Signs of Australia's recovery were widespread although some sectors remain constrained as a result of COVID-19. The revival in the jobs market and hours worked saw the number of people employed recover to pre-pandemic levels by March 2021 and the unemployment rate fell.

Record low interest rates contributed to a 40% rise in housing construction approvals and prices for dwellings increased across the country. The 5.4% March quarter rise in residential property prices was the strongest quarterly growth since the December quarter 2009. Consumer spending has rebounded strongly while recent business and consumer sentiment surveys suggest that Australia's economic recovery still has considerable momentum, barring a serious rise in infections.

Inflation emerges

One of the unexpected consequences of the global pandemic and the economic recovery that began in the middle of 2020 has been the emergence of inflation pressures.

The substantial economic recovery following the rollout of massive fiscal and monetary support measures caused demand to rebound, outpacing the supply of many goods and services. This was especially the case for manufactured goods as the closure of factories early in the pandemic, firstly in China followed by the rest of the world, created supply shortages at a time of rising demand. The pandemic also changed demand patterns with stay-at-home workers shifting their consumption to goods at the expense of services.

Despite the widespread evidence of higher inflation and potential for further rises, most central banks have avoided changing interest rate policies. This is because they expect price pressures to be "transitory" and eventually recede as supply side disruptions abate. In Australia, the RBA's guidance is that interest rates are on hold until 2024. In the eurozone, the ECB is keeping its policy settings and bond purchasing program steady despite upgrading growth and inflation forecasts. However, the US Fed sent the first signal in June 2021 that the era of low interest rates will eventually come to an end, while also maintaining the view that recent inflation pressures will transition lower to its target range.

Australian share market performed strongly

As numerous lockdowns across Australia forced people to spend more time at home and prevented travel, the sector that produced the best return was Consumer Discretionary, with an increase of 46.1%. Companies such as Wesfarmers, JB Hi-Fi and Harvey Norman experienced significant demand growth as people spending more time from home undertook maintenance and put in place work-from-home office infrastructure. Information Technology increased 39.8%, emulating in part the performance strength of the US technology companies.

The Materials index was another strong performer. The 34.5% rise was due largely to ideal market circumstances for the iron ore miners BHP, Rio Tinto and Fortescue Metals Group as strong Chinese demand and constrained Brazilian supply pushed the iron ore price upwards by 108.4%. This led to higher earnings and dividends for shareholders.

Of greater significance to the market and a key contributor to its financial year return was the revival in performance of the four large banks - Commonwealth Bank, ANZ, NAB and Westpac - which collectively account for approximately 18% of the ASX200 value. After suffering sharply lower profits last year, the banks have been significant beneficiaries of the economic recovery. Bank share prices rebounded as investors grew confident that the economic recovery would result in lower loan deferrals and bad debts and revive credit growth. Commonwealth Bank reached an all-time high of over $100 per share during the year. The strength of the Australian residential property market and high demand for housing finance also benefitted the banks.

Fixed income markets also recovered

In credit markets, the support provided by policy makers allowed companies to raise record levels of debt as they sought to build a buffer to see them through the COVID-19 crisis. The cost of that borrowing has been extremely low, and at the same time earnings have been stronger than expected, meaning companies are generally well capitalised and unlikely to face financial difficulties over the next year or two. Default rates over the past 12 months were much lower than expected, and looking forward, default expectations even among the lowest-rated companies are lower than they have been for many years. This has been reflected in pricing, delivering strong outperformance for credit markets.

Geopolitical issues were prominent as the year progressed

A concerning development in Australia 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, Australia speaking out on 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. 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. Should this change, the impact on Australia's economy, government revenue, share market and currency would be immense.

Current investment environment

The current investment environment in Australia represents a challenging point in our economic cycle. The combination of high share market valuations, low return potential from cash and fixed income, an unstable inflationary outlook, and lingering risks to growth from new COVID-19 variants justifies continuing to hold existing assets whilst being cautious when adding any new funds.

For the equity market, which is already above its pre COVID-19 high, the policy responses from the pandemic are unquestionably positive and the combination of factors driving the market higher - corporate consolidation, funds inflow, favourable policy and high savings – will be seen as the positives that have emerged from a very negative event. How the market deals with increasing inflation and the prospect of rising interest rates remains to be seen.

The experiences of the past year have certainly demonstrated the need to invest for the long term. We continue to monitor market conditions and to persevere with the proven concepts of appropriate asset allocation and choosing high quality, professional funds management.

We have attached an updated Financial services guide version 12, 1st July 2021 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,

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