



# Australia: Coping with Covid

Looking to end the lockdown in July.

June 2020

## KEY INSIGHTS

- While Australia's domestic economy is reopening, the country's fortunes also depend on global links including the restoration of international travel and tourism, education services, and global commodity prices.
- In the near term we are cautious toward Australian and global equities as we think markets have become too optimistic on the prospects for early economic recovery.
- We took advantage of the sell-off in the high-growth quality part of the market, adding to structural growth companies in consumer discretionary, health care, communication services and technology.



**Randal Jenneke**  
*Head of Australian Equities & Portfolio Manager*

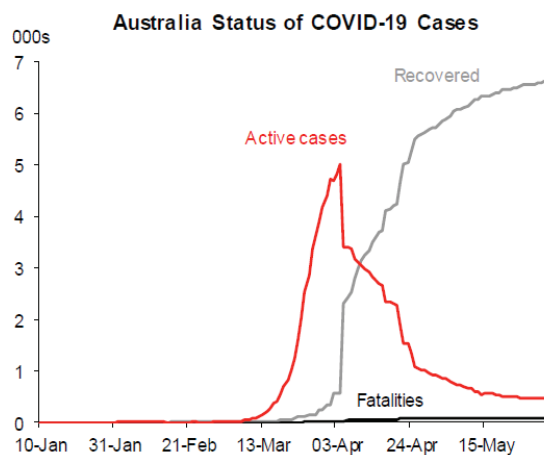
## Australia Has Coped Well with the Coronavirus

Australia's public health authorities are among the most successful in the fight against the coronavirus outbreak. They took swift action and succeeded in flattening the curve at a relatively early

stage, resulting in a low number of cumulative cases and a health system that was not overwhelmed. In turn, this gave the government the confidence to open up the economy earlier than in many other countries. Decisions on how and when to reopen are

## Australia Coped Well against the Coronavirus

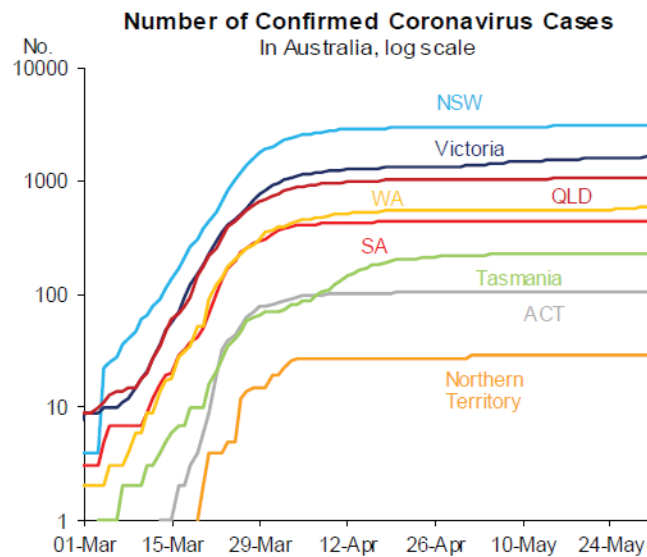
(Fig. 1) Active and recovered cases ('000s)



Source: Macquarie Desk Strategy, June 16, 2020.

## Australia Coped Well against the Coronavirus

(Fig. 2) Covid curve flattened early in all States



Source: Macquarie Desk Strategy, June 16, 2020.

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largely taken at State level. To facilitate coordination and efficient policy operation, the Federal government set up a national cabinet, with State and Federal members. It is generally agreed that cooperation between the Federal and State governments has been very effective. Although there are still points of friction, notably over the wish by some States to impose border controls between States.

State governments have been removing restrictions faster than initially expected and Australia should be out of shutdown by July, though borders are likely to remain closed to most international travel. It is anticipated domestic travel should be free of restrictions sometime in July. As in other countries, there is still considerable concern over the emergence of a second wave of infections, a process that is not well understood. However, we believe that an alert Australia has the experience and resources to neutralize any small clusters of new cases that might emerge. The government is confident the health system has the capacity to respond successfully, with the number of ventilators and ICU beds at hospitals having been ramped up. And

for contact tracing, some 6 out of 25 million Australians have installed the smartphone tracing app developed by the government.

### Prompt, Effective Policy Response to the Pandemic

Fortunately, Australia possessed considerable policy space when the pandemic first struck. The authorities were quick off the mark with decisive action to support the economy, easing monetary and fiscal policy by record amounts. Significant containment measures began on March 15 and increased to an effective shutdown of the economy by the end of the month. In order to try to mitigate the economic impact of the coronavirus the Federal Government announced three significant fiscal stimulus packages in short order. Additionally, the Reserve Bank of Australia (RBA) quickly cut the cash rate to 0.25%, introduced yield curve control with a 0.25% target for the 3-year bond yield, and also launched a term lending facility of up to AUD90 billion. Interest rates were already low entering the coronavirus crisis and as the RBA does not favor negative interest rates, the major burden of fighting the coronavirus has fallen on fiscal policy.

Australia's pre-Covid-19 fiscal position was strong. We think this may help to lessen the longer term risks of what is an unprecedented level of stimulus. As a share of GDP, Australia's direct fiscal response is estimated to be around 11.5%. With the global economic outlook highly uncertain, Australia has room for further policy support should it become necessary.

Fiscal and monetary policies have mainly been directed toward businesses and jobs due to the disruption in economic activity created by the coronavirus. As such, their aim is more to stabilize the economy than to drive new growth. The key fiscal supports are (i) the JobKeeper wage subsidy set at 70% of the average weekly income, tying workers to the business that employs them; and, (ii) the JobSeeker program that provides increased unemployment benefits until late September. 1.7 million workers are expected to be on JobSeeker by September, up from 815,000 in February. JobKeeper payments to firms began in May and the government expects 3.5 million workers to benefit under the scheme. Other elements of the fiscal package included bank loan deferrals for six months, and landlords asked to forego rents for SMEs and households (larger tenants are to negotiate directly with their landlords for relief).

For us, a key uncertainty is over what shape the Australian economy will be in when these key fiscal support measures come to an end in September. They will probably need to be extended in some shape and form, since significant areas of the Australian economy including restaurants, entertainment, international tourism and education may only recover slowly. If fiscal support is not extended beyond September, a 'fiscal cliff' effect could deliver a significant setback to economic recovery in Q4. We have concerns that government support measures only delay the contractionary impact of Covid-19. Another risk is to the banking system. Loan deferrals, at AUD234 billion (as at June 12, 2020, including AUD173.5 billion of housing

mortgage loans) are greater than the capital base of commercial banks. Lending support policies may also be building up problems for the future by postponing bankruptcies and loan defaults from the present.

### **Short-term Economic Outlook Challenging**

Despite the prompt policy response and surprisingly resilient commodity exports, the Australian economy cannot escape the costs of the lockdown and global recession. Undermined by social distancing and the closure of non-essential businesses, real GDP is set to shrink in the first half of 2020 by a record amount. For 2020 overall, private consumption could be down as much as 10%, with unemployment peaking in Q2 above 8%. Another important sector that may be slow to recover is the Australian housing market. Not having suffered a recession since 1992 encouraged Australian households to load up on debt, so that pain in the housing sector in 2020 and beyond will come as a particularly unpleasant shock. Residential property could take some time to fully recover. Turning to external trade, exports are very difficult to predict given the continuing disruption to air transport, the collapse in PMI new export orders and falling global trade volumes. Exports in value terms by year end could potentially be down by 20%. Despite this, the greatest export weakness is likely to be in services credits, given only a slow recovery is expected for tourism and education services, two of Australia's top 5 export earners.

The path of unemployment in coming months is of particular importance due to the negative feedback loop from jobs to housing, investment and the real economy back to jobs etc. We are concerned the unemployment rate is an unreliable signal, as it is being suppressed by the government's Job-Keeper package. Unemployment could rise after Job-Keeper benefits are withdrawn, though neither the Treasury nor the RBA think it will rise above 10.0%. However, the ABS measure of unemployment is heavily biased to the

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low side, as it excludes workers who have been forced to accept reduced hours or who have stopped looking for work in the current environment. Including these workers probably gives a more accurate picture of the state of the labor market. On this basis, in May the unemployment rate defined to include workers on zero hours due to being furloughed and those with not enough work is over 13%. We think that going forward, hours worked may be a better labor market series to monitor than the headline unemployment number that receives most of the media attention.

Bringing all of the above together, the consensus forecast is for a decline in Australia’s GDP of around 4.5% this year, followed by a relatively subdued recovery of 5.0% in 2021. In view of the strong contractionary forces unleashed by the coronavirus, economic forecasters do not expect a return to the pre-crisis level of GDP until the second half of 2021 at the earliest. Supporting a gradual recovery scenario for the second half of 2020, high frequency data series such as Apple and Google mobility trends, meals eaten out etc. continue to improve, though they have much

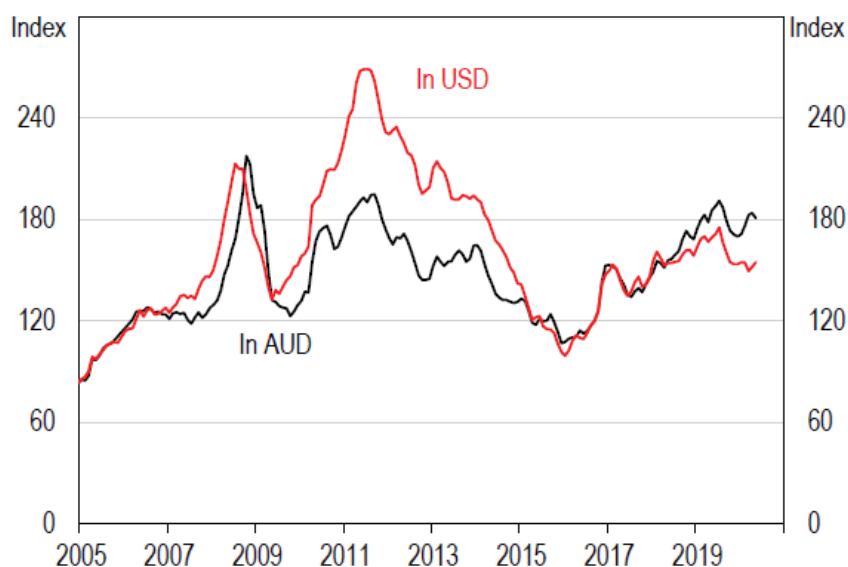
further to go to attain pre-crisis levels. More traditional economic indicators of consumer confidence improved significantly in May, as did a popular online survey of personal spending. Business sentiment indicators have also hooked up, although their improvement is lagging the consumer, a potential worry for the resumption of investment spending amid significant excess capacity.

### Terms of Trade Hold Up As Global Recession Beckons

Australia’s terms of trade have held up well given the world has entered the deepest economic contraction since the 1930s. The initial pessimism in the global crude oil market in March was overdone, fanned by the technical oddity of a negative near-term futures price. An end to the self-defeating Saudi-Russian price war followed by OPEC production cuts saw the price of Brent crude rebound by 33.7% in May. Meanwhile, strong Chinese demand following a quicker-than-expected industrial recovery from the coronavirus (steel inventory is already back to normal levels) plus supply weakness from Brazil saw the iron ore price rise a robust 20.7%.

### Australia’s Commodity Prices Are Up YTD in AUD

(Fig. 3) Index 2005 = 100



Source: HSBC Global Research, RBA, June 1, 2020.

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One might expect negative global growth in 2021 to pose a significant threat to the price of Australia's commodity exports. For oil, the number of U.S. shale oil frac fleets in operation has fallen 80% since end-March, and is far below the number necessary to raise output to the pre-COVID-19 level. Overall rig count has continued to shrink to a level well below the 2016 low. As the breakeven price for U.S. shale oil is close to USD50 per barrel, then U.S. oil output may decline further into 2021, an important part of the mechanism for a sustained recovery in the crude oil price.

In the short term, iron ore is set to remain in strong deficit, although a price above USD100/t may not be sustainable. Brazil's shipments fell 28% year-on-year in May due to production problems related to the coronavirus, and despite a low comparison base due to the Vale disaster in 2019. Major mining facilities in Brazil continue to close, with no early solution in sight. In contrast, Australia's iron ore exports from Port Hedland (BHP/FMG/Roy Hill) were up 6% month-on-month. Iron ore is the only non-precious commodity price that is currently higher year-on-year (12%). Even as Brazilian supply comes back on stream, China's reliance on infrastructure capex as its main fiscal stimulus suggests resilience in ore prices should extend into next year. Finally, gold has received a strong bid in the Covid-19 era, rising 2.6% in May and 13.2% year-to-date (as of June 16, NYM USD/ozt, front month).

#### **Investment Themes in the Post-Covid Era**

In the near term, we are cautious toward Australian and global equities as we think markets have become too optimistic on the prospects of economic recovery. They appear to be pricing in a V-shaped recovery from the coronavirus-induced disruption that downplays the many challenges and difficulties that still remain. The market's optimism over recovery is behind the sharp reversal rally in value stocks including banks and cyclical stocks. We are suspicious of this early switch in favor of cyclicals

based on an early V-shaped recovery as we don't believe it will be supported by durable demand. Given the likely issues with the re-opening of economies globally we believe this type of favorable economic scenario is unlikely. Whilst the world may have avoided the worst-case virus pandemic and ensuing economic scenario, many challenges and risks remain as economies re-open. Fiscal stimulus, which has so far been relatively successful in supporting economies, is expected to fade or be wound back in 2H 2020.

The next few quarters will thus be a crucial period for the Australian and global economies in determining the path of their economic recoveries and also their interdependence. Having successfully contained the coronavirus locally, how quickly Australia restores international air links may depend on how quickly Covid-19 hotspots around the world are brought under control or a vaccine is found and deployed. Looking beyond the short term, the massive nature of the global fiscal and monetary stimulus applied to what is a deep but temporary shock, could potentially lead to a stronger inflationary global expansion in 2021-22 if the aggressive fiscal stance is maintained. Under such a scenario, Australia's high cyclical gearing and strength in commodities would likely prove a significant advantage.

For now, our preference is for higher quality companies with strong balance sheets or products that can position themselves favorably in the post-crisis environment. We took advantage of the sell-off in the high growth quality part of the market, adding to structural growth companies in sectors like consumer discretionary, health care, communication services and technology. We have been diligent in reducing exposure to companies that we consider to be higher risk in a post-Covid-19 environment. For example, we remain underweight Australian banks amid the RBA's moves towards zero interest rates and yield curve control plus the poor economic environment for lenders and likely rise in loan defaults.

Within our portfolios we have also reduced exposure to U.S. and Australian housing stocks, as with unemployment spiking sharply higher in both economies it is going to take some time before buying appetite comes back to the property market. And in the commercial property sector, future demand for office space might fall as more businesses realize that many of their staff can work more cheaply and effectively from home. On the positive side, since the coronavirus there has

been a surge in the demand for online services during lockdowns. This is a trend that many think may continue to impact post-pandemic working habits. Pent-up demand and the need for inventory restocking as business activity comes back online could provide near-term tailwinds for some stocks. We have also increased our exposure to companies we expect to benefit from the downturn and those exposed to early improving economies such as China.



#### **WHAT WE'RE WATCHING NEXT**

The relaxation of social distancing and reopening of the business sector are critical for the domestic economy. But Australia's fortunes are also tied to global developments. In the coming months we shall be watching closely for the restoration of international air links, tourism, education services, and the impact of the global cycle on commodity prices. At the same time we continue to keep a close eye on the spread of Covid-19 and the possibility of a second wave.

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