Economic & Financial Markets Update
July 2020

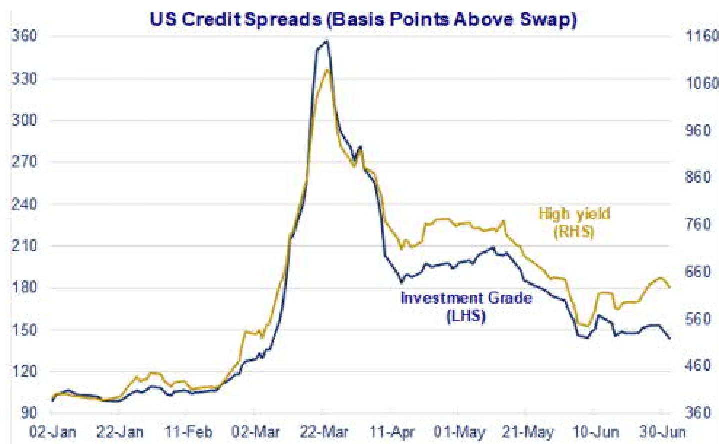
Prices in most asset classes experienced extreme volatility over the six month period to June 2020 as COVID pandemic induced containment measures created shocks to both demand and supply and collapsed the global economy, and governments and central banks implemented mammoth stimulus measures to support the functioning of societies and financial systems.

Market Benchmarks %	6M	1YR	5YR
Australian Shares	-10.6	-7.6	6.0
International Shares	-3.6	5.2	9.4
Australian Property	-21.0	-20.7	4.7
Australian Bonds	3.9	4.5	5.0
International Bonds	3.6	5.2	4.8
Cash	0.2	0.7	1.4

To 30 June 2020 in AUD terms.

The New World

The income and liquidity bridges created by authorities, along with preliminary success in flattening the virus infection curve, optimism around the potential for vaccines and some signs of effectiveness of antiviral drugs has resulted in a strong recovery in equity markets and credit markets settling down. The US Federal Reserve (the Fed) provided markets with a "*do whatever is required*" moment when it announced on 17 March that it would step into corporate credit markets including so called high yield (junk) debt, as did the Reserve Bank of Australia (RBA) when it announced a range of policy measures on 19 March.



Source: Perpetual July 2020

These programs are directly and indirectly providing businesses with much needed liquidity (cash and debt facilities) and have allowed for only moderate insolvencies to date thereby assisting with containing job losses. However, as liquidity absorption begins to reach its limits higher rates of bankruptcy are unavoidable without a resumption in revenues.

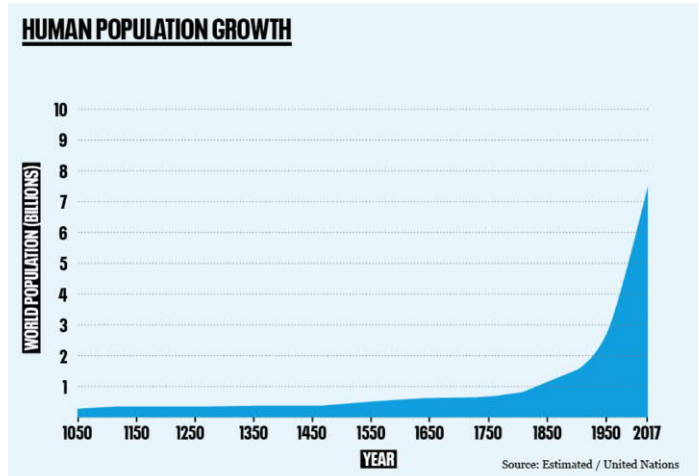
Bankruptcies are most likely in sectors such as air travel and tourism, hospitality, retail, retail commercial property, energy and start-up businesses that rely on investor funding. Together these sectors are significant employers and there will be multiplier effects through the global economy to most other sectors.

Each generation that has faced a major economic or societal event has developed deeply rooted behavioural biases that impact their propensity to spend versus save, and the manner in which they execute other functions of daily life. A partial shift back towards the frugality of past generations that were shaped by events such as those in the 30's and 40's could have material implications for demand.

Authorities now face difficult decisions around whether to meet new virus outbreaks with containment measures or to accept a certain level of community transfer to allow economic activity to recover. Recent reintroduction of containment measures in Victoria and some US states indicate that there is limited appetite for the latter at this stage. Further broadscale lockdowns would be economically devastating.

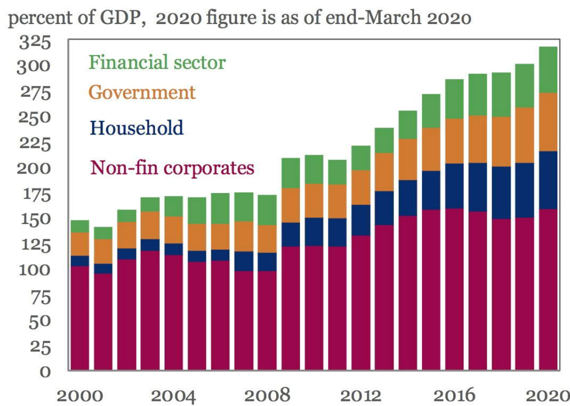
All this comes at a time of high global debts which have grown substantially since the GFC and are throwing accelerant on the economic fire. If confidence does not return it is possible that we enter a substantial corporate and household deleveraging cycle which will have further negative multiplier effects on consumption and jobs. Governments will need to increase spending further and effectively absorb these debts to try and offset this. Sovereign debt levels were already elevated coming into the crisis providing more limited capacity to do so (although this is not a near term issue).

Source: Financial Times Sept 2019



The '*Chinese miracle*', responsible for a substantial portion of global growth over the last 10 years is less likely to be supportive this time around. China's growth has not been organic, it too has built its economic house on an eyewatering stack of debt.

Chart 1: Sharp surge in debt in China: Déjà vu all over again?



Source: Haver, BIS, IMF, IIF estimates

The post war debt cycle has coincided and been supported by a global population explosion that is showing signs of strain (e.g. fresh water availability, social tensions, biosphere and biodiversity degradation). Population growth may have much further to run (exploitable resources remain vast and technology is finding alternative solutions) but it is an assumption that needs ongoing consideration (and particularly in some developed countries). Advocates of buy and hold strategies such as ourselves have greatly benefited from this trend and we would argue that its impact on the growth of long-term corporate profits is taken for granted. Having said this a long growth trajectory remains from equalising living standards with the developing world.

In addition to population growth, higher taxes, asset sales, bad debt write-offs and productivity improvements will all be required to work through the global debt pile. Each of these has its own consequences.

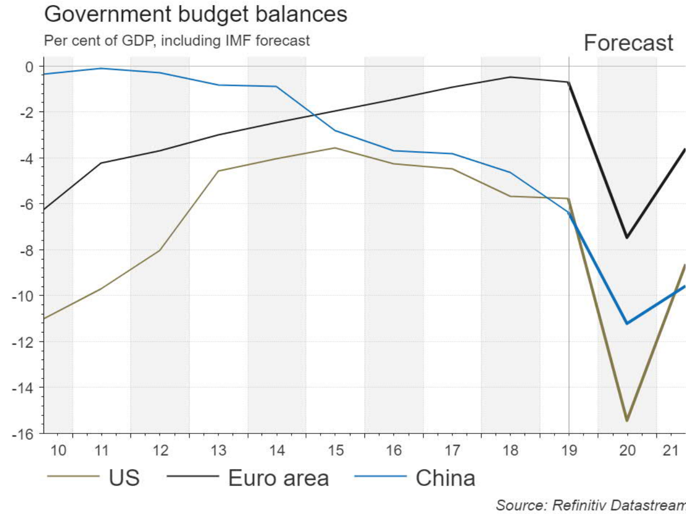
Whilst all this paints a challenging picture there are reasons to be equally optimistic and be highly sceptical of comparisons to the Great Depression period.

The accumulated experience and intellectual sophistication of central banks today versus 90 years ago is not comparable. By its own admission the Fed made a multitude of mistakes in the early 30's that accelerated the then recession. This included raising interest rates after the downturn had begun, failing to stem a decline in money supply which generated strong deflationary forces, allowing widespread failure of banks, failing to act as a lender of last resort, and operating with a decentralised structure that resulted in differing decision making between its regional arms.

In addition, data availability, accuracy and timeliness is not comparable - with obvious consequences to the reaction time of central banks and governments. Indeed the reactions have been swift and meaningful and should give us confidence that it is less likely that there will be substantial mis-steps that perpetuate a deeper financial crisis.

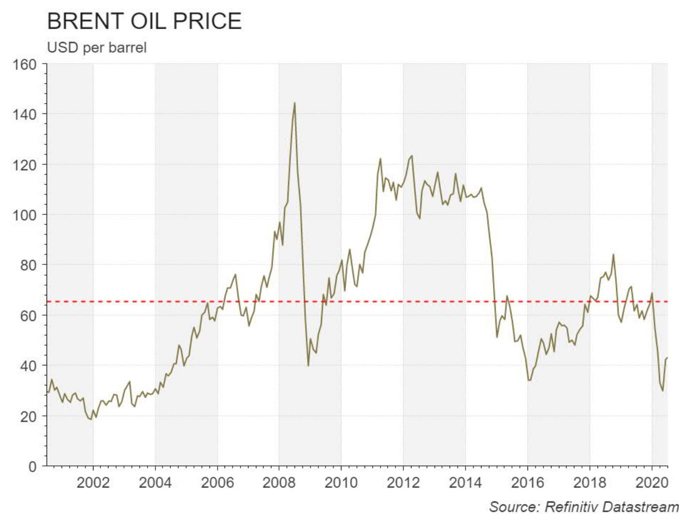
Likewise, governments have clearly indicated that they will be highly active in spending and there is plenty that they can do. It is estimated that the US needs to spend US$3.6 trillion to fix its creaking roads, bridges, railways and utility distribution networks and issues with dilapidated infrastructure are similar in Europe. This is low hanging fruit that can drive economic activity if bureaucratic impediments can be overcome.

Even Germany which has been preoccupied with austerity for itself and its European Union (EU) counterparts for the last decade has engaged in one of the worlds largest fiscal stimulus programs, equivalent to 13.3% of its GDP in 2019.



Additionally it has endorsed so called Euro Bonds which in-effect result in the transfer of liabilities from the '*have nots*' in the south to the '*haves*' in the north. There is no doubt that there is a strong desire to keep the EU intact which, for all its many failings, has been overwhelmingly successful to date in its primary objective of stemming a continuous cycle of conflict in the European continent.

Along with falling interest costs and government support measures the collapse in energy prices has provided a shock absorber to the global economy. Notwithstanding that this does present risks (given the energy complex is significant to both jobs and the financial system) we view this positively.

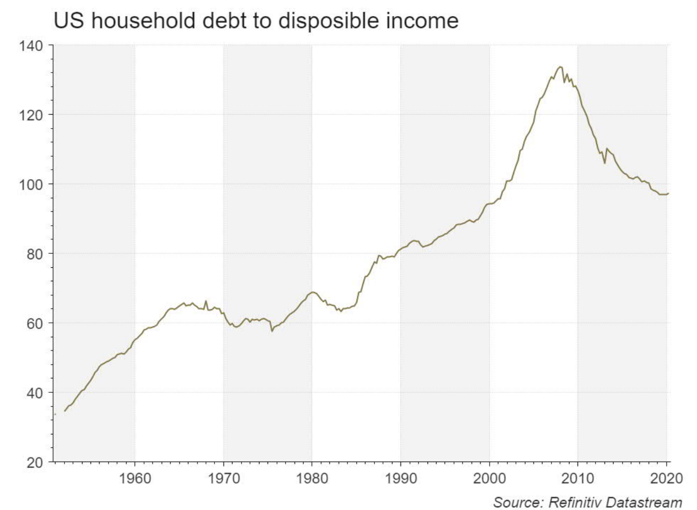


There is also potential for a moderate rebirth of manufacturing in developed economies, and acceleration in their adjacent geographies (such as Mexico and Eastern Europe). Deglobalisation of supply chains will be a headwind to productivity (and on balance could be inflationary) but we view additional jobs creation and increased self sufficiency as healthy. Just in time inventory management is good in theory but, as we have just seen, can expose the supply of essential goods if manufacturing is disrupted for even short periods.

As a result of this and an acceleration of the shift to e-commerce we expect increasing demand for warehousing and logistics. This is positive for certain property trusts and companies and as such we have recently initiated coverage of Goodman Group (GMG) and will look to take a position in due course.

This highlights an important point. Whilst the world has been turned upside down humankind is not passive. We are naturally optimistic, adaptive, and durable and from our changes in behaviour trends will emerge and accelerate - creating both winners and losers. This presents investment opportunities.

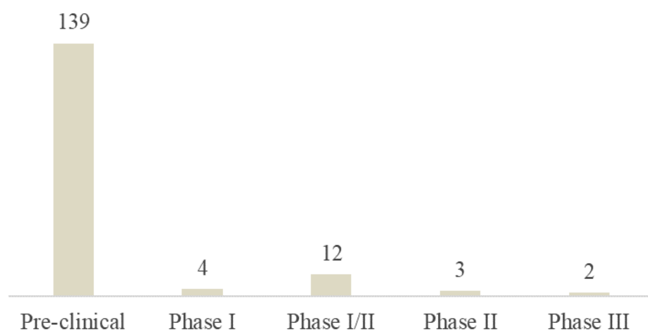
And whilst we are concerned about the potential of a much more conservative consumer there are signs that confidence can return quickly. In Australia Westfield has reported foot traffic in its shopping centres in mid June at 86% of 2019 levels, which is quite remarkable. It is important to remind ourselves that whilst the current income shock may be larger, the US consumer has come into this crisis in a stronger position than the GFC.



Similarly in Europe household debt to disposable income was less than 95% at the end of 2019, which compares favourably to Australia at nearly 190%.

Although it is impossible to know definitively we feel it is reasonable to be optimistic that an effective vaccine will receive approval and be available within an acceptable timeframe. Current commercial vaccines have taken very long periods to develop, have approved and commercialise but the collective energy and funding being poured into developing a COVID-19 solution vastly surpasses these. Additionally the technology platforms that are available to use as a starting point have advanced substantially.

There are currently around 160 developments or evaluations in progress including 21 clinical trials in various stages. Furthermore, development of production facilities and manufacturing of the most likely successful candidates is being advanced ahead of health authority approvals to provide for a rapid rollout.



Source: WHO July 2020

Application of antiviral drugs is also making progress. For example, in recent weeks it has been claimed that the steroid Dexamethasone is effective in reducing mortality in severely ill COVID-19 patients.

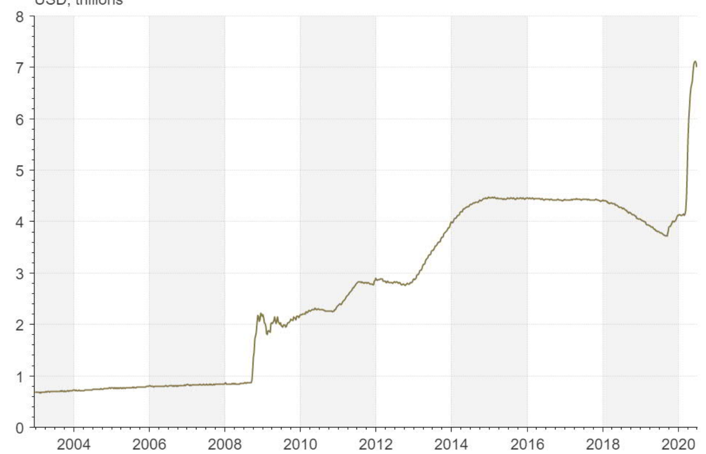
Despite the remarkable mobilisation of medical science we must be realistic and cautious. Statistically less than 50% of developments that get to Phase III trial are commercialised, and the odds are much lower for those that get to Phase II and Phase I. Markets are placing a lot of weight on a positive outcome and there is a risk that the financial implications become too great before vaccines can be rolled out. Under this scenario it is possible that there could be a transition to acceptance of community spread. Countries that are currently experiencing high transmission such as Brazil and the US may be the global test cases for this approach.

If nothing else, a lesson of the last 10 years has been that politicians and central banks have no appetite for economic downturns and it can be dangerous to bet against them. Hence the measured approach we have taken to investment of your capital discussed further in this newsletter.

Inflation

Historically aggressive money printing has resulted in high inflation and in some extreme cases hyperinflation. Although this has not always been the case it is a risk as central banks push new boundaries.

In the short to medium term deflation is the pre-dominant risk given the broad-based shock to demand that has occurred. In an entrenched deflationary environment debts become larger relative to income and consumers hoard cash which reduces consumption and investment. This has negative multiplier impacts through economies. Hence the determination of central banks to offset this by increasing the supply of money. Maintaining optimism is key, even if an outcome is asset price inflation.



Looking further out there remain strong secular deflationary forces that may keep inflation in check including ageing populations, high debt, technology driven productivity improvements, abundant labour and low energy prices.

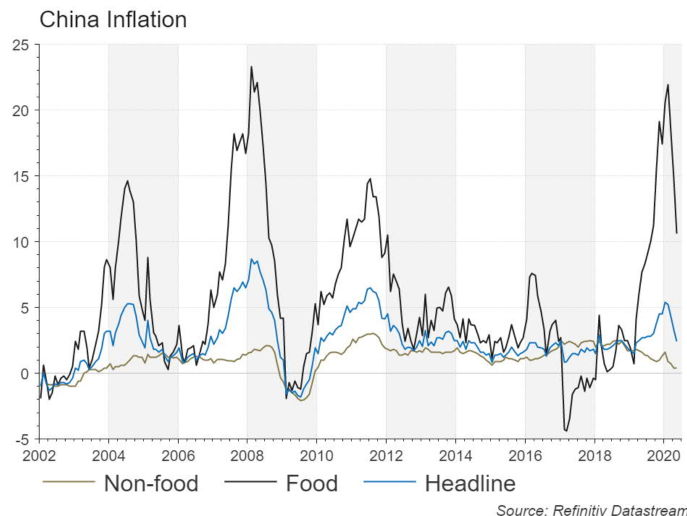
There are also new inflationary forces emerging such as ESG (environmental, social, governance) focused investing, tariffs and potentially increased supply chain localisation.

In the event of a higher inflation environment the types of assets that we own will be important. Companies that can pass on inflation to customers (such as supermarkets) or experience widening profit margins (such as banks) will be beneficiaries. Property trusts, which are valued based on their yield relative to bonds (interest rates), and high growth companies with low near-term profitability are likely to have their earnings streams devalued. Holding cash and fixed interest bonds (particularly those with

long maturities) may be wealth destructive other than for short periods.

Gold and other scarce commodities would also be expected to be beneficiaries, but we are cautious that oil will be as an effective hedge against inflation as it has been in the past. The world is currently swimming in oil and whilst there is a substantial contraction in production taking place that could be supportive of higher prices in the future, the shale sector in the US can come back quickly as prices recover into the more sustainable range of US$50 - $70 a barrel. This could place persistent downward pressure on prices in lieu of a change in production policy from OPEC+.

Increased scarcity of other goods and particularly food could create increased risks. COVID led interruptions and reduced pork availability due to a swine flu outbreak have created a spike in food prices in China.



Interestingly larger central bank balance sheets may actually be positive for fighting inflation if/when it comes as they provide more tools to work with. That is, there is a greater ability to manipulate interest rates across the curve (short to long term) by actively managing which bonds to stop re-investing in as they mature and which bonds to buy versus sell with the overall outcome of reducing money supply. This is referred to as Quantitative Tightening.

We have had a watching brief on inflation since the GFC and understanding impacts to your investments has been an ongoing part of our assessment process.

US Presidential Election

The world is waiting to see who wins the US Presidential Election in November 2020. Joe Biden currently holds a lead of up to 10% over Trump in some polls, however the outcome is far from certain with ongoing questions around the accuracy of these given divergences between population and electoral representation.

Current Seats %	Democrat	Republican	Other
Congress	53.9	45.8	0.2
Senate	45.0	53.0	2.0

There is a consensus view that a Biden victory is likely to result in a de-escalation of both global and domestic tensions, and an effort to re-establish the influence of post war institutions that have been critical to world order and peace. Markets should view this positively.

Conversely Biden is expected to be less friendly to the corporate sector with expectations of higher corporate taxes, re-regulation, increased union power, and a focus on equality measures.

Taxation

Higher and '*progressive*' global corporate taxes are a likely implication of COVID induced government spending in our view. Large corporates are experiencing an increase in market power as smaller competitors fall away and they absorb significant direct benefits in the form of lower funding costs from central bank actions.

Many are paying unsustainably low tax rates relative to small and medium businesses and individuals. As illustrated below this is particularly the case for multinational technology leaders who operate with less defined borders and consequently are best able to take advantage of aggressive tax minimisation strategies. We consider this a likely, but manageable, risk to the valuation of our investments in these companies.

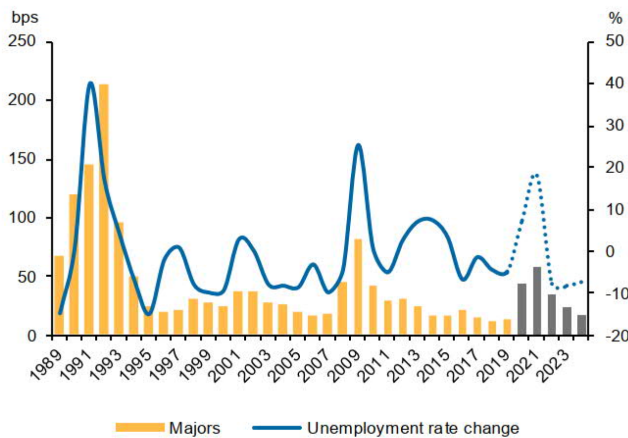
Forecast tax rate FY20 %			
Alphabet	15.5	Amcor	21.7
Apple	15.1	BHP (ex royalties)	33.2
Microsoft	16.9	CSL	20.3
Visa	18.8	Nestle	21.7

In addition to corporate taxes we see the possibility (including in Australia) of implementation of or increases to income, inheritance, superannuation, land and wealth taxes. The potential for these is greatly under-appreciated and particularly in a climate with an underswell of equality disenchantment and unfettered free speech on social media platforms.

Australia

In our January 2020 newsletter we highlighted debt levels of Australian households and consequent susceptibility to any global shock. Aggressive support measures from governments and the RBA and a strong performance in containing community spread of the virus to date mean that the outlook for jobs is better than first thought. Treasury's current expectation is for unemployment to peak at 8% versus 10% previously although the outbreak in Victoria will push this back.

Nevertheless Australia is likely to experience its largest bad debt cycle since the early 1990's when unemployment peaked at 11.2%. Household debt to income ratios were 70% then versus 190% now, and consequently we view Macquarie's forecast of bad debts to total loans below as too low.



Source: Macquarie April 2020

This, along with contracting profit margins are the key drivers of our decision to further reduce exposure to Australian bank ordinary shares (equity). Bad debts are a line item on bank income statements and directly impact dividends.

We do not have any concern regarding the solvency of the Australian banking system, it remains very well capitalised with strong security backing for a meaningful portion of its loans. The average loan to value ratio of Australian housing loans of the major banks ranges from 45% to 57%. Furthermore (unlike the US) they are protected by strong bankruptcy laws with an ability to seek recourse against a borrowers broader asset base.

As such the amount of loans that need to fail to produce bad debts is much higher than appears on the surface. We roughly estimate that the majors have ~$1.6 trillion in bonds and equity, representing ~38% of their total loan books, that would need to be absorbed by bad debts before depositors were at risk. Given this, the above described shock absorbers, potential mitigating actions and RBA intervention tools, losses to deposit holders are almost inconceivable. We have very strong banks.

It is also noted that there are some important differences to the early 90's period. Rock bottom interest rates mean the cost of servicing debt is much lower, Australian cities have become global property investment destinations, and governments have indicated a willingness to be much more supportive.

Australian governments (State and Federal) retain strong balance sheets and understand the importance of a strong property sector to jobs and the financial system. They do not want negative sentiment to take hold. As such stimulus measures have been announced including grants for homebuilders and renovators that are provided in addition to payments and stamp duty concessions for first home buyers.

We estimate benefits to a first home buyer in WA who signs a house and land package of $400k to be nearly $70k inclusive of stamp duty concessions. Reports suggest lots in first home buyer corridors have been selling at 4x to 5x pre-COVID levels in June.

Scheme	Amount	Tested
HomeBuilder		
National	$25k	Yes
WA	$20k	No
First Homeowner		
NSW	$10k	Yes
VIC	$10k	Yes
QLD	$15k to $20k	Yes
WA	$10k	Yes
SA	$15k	Yes
TAS	$10k	Yes

Australia's multi century immigration story has been a cornerstone of economic growth and remains critical to filling these houses and supporting ongoing construction activity and jobs. As a result we feel that it is more likely that the Federal Government will seek to accelerate than slow numbers. Rising geopolitical risks increases the probability of this - '*populate or perish*' has never been more relevant. Quarantine rules should not be an impediment to immigration as they are to tourism.

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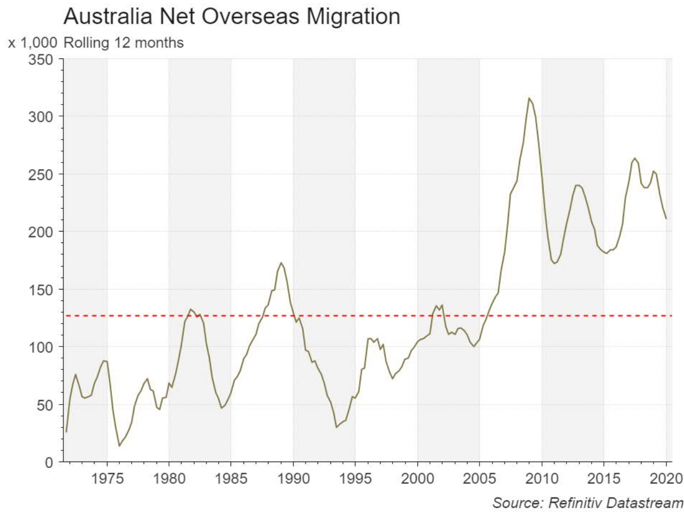
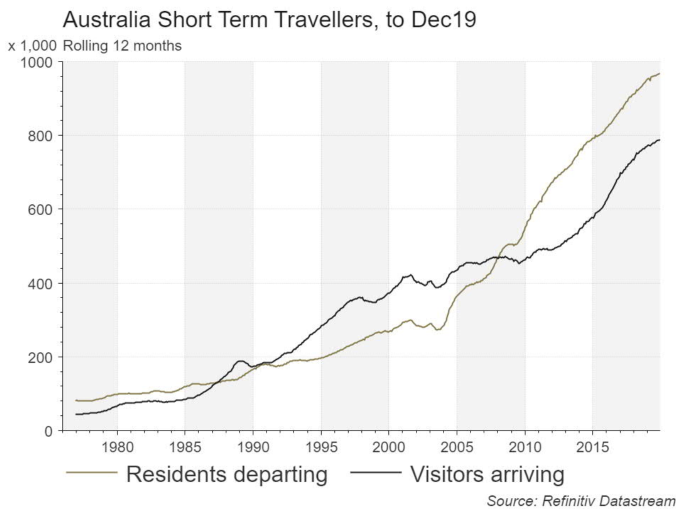


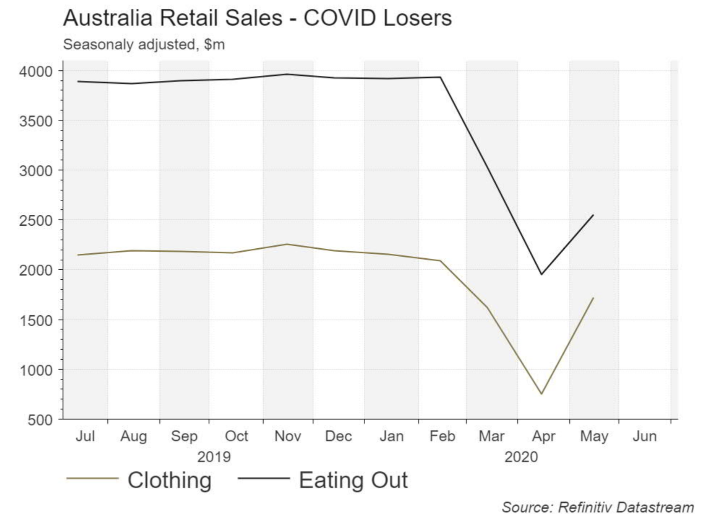
Australia has experienced a boom in international tourism over the last 10 years. However, there has been even larger growth in Australian's travelling overseas (assisted by retiring baby boomers, a high AUD and falling travel costs). In 2019 there were 1.2x more Australians that travelled overseas on short-term trips than there were international visitors and ~50% of the $150bn spent on tourism came from domestic travellers.



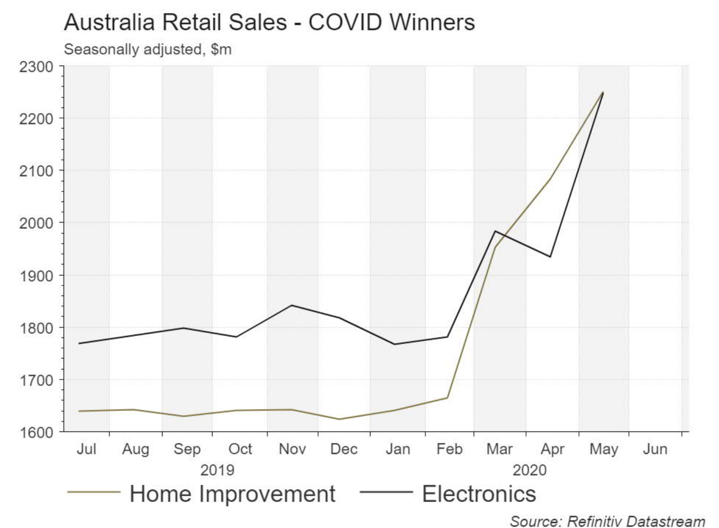
We believe Australians will switch more of their travel spending to domestic holidays (and New Zealand) which could be a substantial offset or even create growth in some geographies. Indeed, there is anecdotal evidence with some regional holiday spots experiencing strong in and out of season bookings and buying demand for properties, and spiking caravan sales. As such we are optimistic that the impacts on domestic tourism jobs will not be as bad as some forecasts (subject to internal containment of COVID and the re-opening of internal borders). Qantas is forecasting its domestic passenger numbers to fully recover by fiscal year 2022, but its international passenger numbers to be running at an average of only 50% over this period.

We have initiated a minor position is Sydney Airport (SYD) which is a high quality asset leveraged to long-term growth in air travel. We intend to take a larger position when its share price is more reflective of the bleak short to medium term outlook and excessive balance sheet leverage has been dealt with.

The discretionary retail sector, also a substantial source of jobs, has also shown some signs of rapid recovery assisted by JobSeeker and JobKeeper payments.

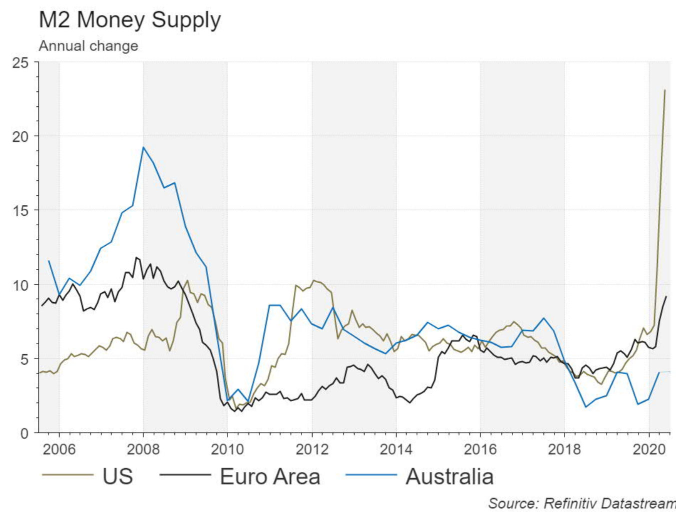


Some sectors such as supermarkets, home improvement and electronics and office supplies have experienced a sales boom as people have prepared for life in lockdown. Whilst much of this is a temporary sugar rush we see potential for structural increases of share of spending in these categories. This is supportive of investments in Wesfarmers (WES), Coles (COL) and Woolworths (WOW).



In line with historical experiences the Australian Dollar (AUD) fell during the height of the market panic period providing a cushion for our largely unhedged positions in global companies and the Australian economy.

With interest rates now near or near enough to zero in most developed countries differentials between these is no longer the primary driver of currencies. The AUD has rebounded as a result of a much better performance to date in controlling the spread of COVID, but we also point to Quantitative Easing programs. Australia has embarked on its largest ever money printing program but the rate of growth in supply of money is dwarfed by programs in the US and Europe. Quite simply we are issuing less new money and consequently our currency has become relatively more valuable.



Given this we have developed a more balanced view towards the outlook for the AUD and now believe risk is more equally weighted to the upside versus the downside. A substantially appreciating AUD would pose a challenge for the RBA at a time of higher than average unemployment as it reduces the competitiveness of exports and labour.

WA Residential Property

Following comments in our January 2020 newsletter our views for the outlook of the WA residential property market have become more nuanced.

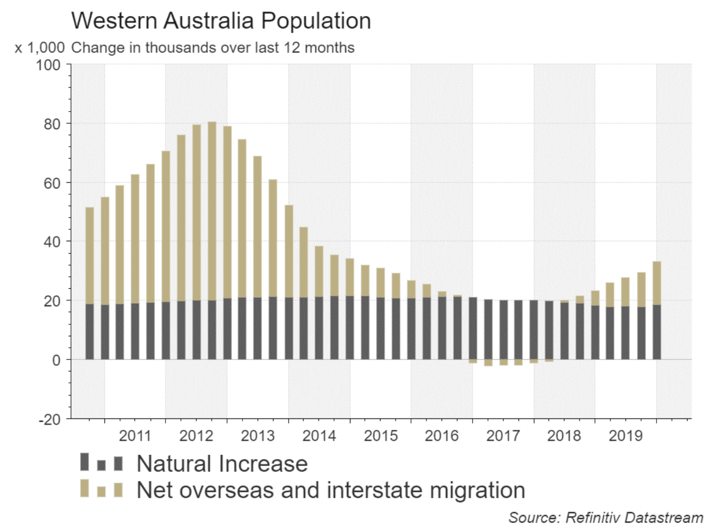
A strong performance to date in virus containment, what appears a solid recovery in economic activity, and strong prices for some key commodities has been supportive of local jobs. Perth residential property is well placed given this and having already been through a material price correction, household deleveraging cycle, experienced some stock absorption, and having house to income price ratios much lower than other major cities. Albeit it is far from immune from a deeper global economic crisis.

In recent weeks transactions closures have been above 1,000 per week which is double the average of recent periods driven largely by aforementioned land purchases in first home buyer corridors.

Whilst listings have also been down substantially as vendors hold out for a better environment we feel this could result in subdued demand for low to mid-price range established housing and place further downward pressure on prices in adjacent (mainly outskirts) areas. The quality of these developments is low relative to decades past with much smaller block sizes and we would caution against these as investment destinations.

Conversely inner ring suburbs are likely to be well supported and particularly the aspirational areas. We feel that these (like it or not) are primed for a flood of overseas money looking for a safer home. It is just a question of when it comes, not if given large valuation discrepancies to the East Coast. Similarly, homes and small holding lots in popular holiday areas could attract a sustained increase in interest. Quality locations underpinned by land value will outperform in our view.

Ultimately increased population growth is required to drive a broader housing price cycle. Continued outperformance in virus containment and job prospects becoming relatively better than the East Coast could be catalysts, but are not certainties.



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Concluding Remarks

Economies are showing signs of recovery however there is a high risk of further lockdowns which would be economically devastating and trigger a broader loss of jobs and potentially accelerate a corporate and household deleveraging cycle. This could prolong and deepen the recession.

On the flip side there are signs that infection is manageable with existing anti-viral drugs and we believe that it is reasonable to be optimistic about a vaccine given the energy being poured into development. There also remain questions as to whether there will be acceptance of a certain level of community transfer.

Furthermore central banks and governments have indicated they will do whatever it takes and are acting with speed and force to create liquidity and income bridges. Further lockdowns and/or financial market volatility is likely to be met with additional measures.

Markets are likely to continue to swing heavily between exuberance and panic as we interchange between periods of realising the fundamentals are poor, and periods of excitement about additional central bank liquidity pushing capital into risk assets such as shares.

In this environment of money printing, shares (business equity) and real assets (property, infrastructure etc) that have natural inflation protections are the least worst long-term investment options despite elevated valuations. Relative to bond yields markets are not excessively valued although there are large discrepancies between sectors and earnings expectations may be too optimistic.

Note: below the line indicates shares are more expensive than average (based on earnings expectations) and above the line cheaper than average.

Cash and fixed rate bonds may be wealth destructive other than for short periods or if deflation takes hold.

This is currently a higher risk than inflation, but we would expect this to change in the medium term. Higher bond yields would be expected when inflation returns which will be a headwind to asset valuations. Just as multiples have expanded and yields contracted with declining interest rates they will reverse when rates rise.

We continue to consider the management of your portfolio in deflationary, high inflation and potentially stagflationary (high inflation, low growth) environments.

Putting all these competing forces together we believe a more moderate exposure to shares remains appropriate at present. We want heightened cash and other defensive assets to protect against volatility and to provide optionality to buy at lower prices, but we do not feel that more extreme asset sales are preferable. Long term returns in advantaged companies should still be reasonable and increased favourability of trends and reduced competition do justify higher prices for the winners.

Whilst portfolios were already high quality we are focused on extending this further with asset quality, balance sheet strength, long term thematics and scarcity being our primary anchoring points.

Many companies that exhibit these qualities are very expensive and whilst long term returns may be reasonable, as mentioned, they may be lower than for higher risk/lower quality opportunities.

Advantaged companies we have been building positions in include; Microsoft (MSFT) which will benefit from a multidecade trend of business digitisation, transition to cloud computing and transition to a subscription model; the world’s largest payment network operator Visa (V) that will continue to benefit from a transition to a cashless society which has been accelerated by COVID; Sonic Healthcare (SHL) which is consolidating the global pathology sector; Resmed (RMD) which is a leader in the significantly under-penetrated sleep apnoea market and in the short term offsetting impacts to this business with sales of ventilators to hospitals; and global hospital operator Ramsay Healthcare (RHC) which will benefit from trends in aging population and (sadly) increasing chronic disease.

In addition, we are targeting a position in Alphabet (GOOGL). It generates much of its revenue from advertising which is economically sensitive, however, it has placed itself in a position of extreme market power through its platforms and operating systems. These collect immense amount of data daily that is of great value and can be monetised in a range of different ways.

We have given up returns in recent years by avoiding sectors that do not meet our quality thresholds, some of which have attracted very strong interest amongst the broader investment community. Recent events and price action in many of these areas has strongly vindicated our approach in our view.

We also believe that a balanced outlook for the AUD is now appropriate. Previously we thought that depreciation was the higher risk. Portfolio exposures remain almost fully unhedged to currency movements.

In summary we will continue to take a measured and active approach to the quantum of exposure to shares relative to defensive investments to provide some protection from short term share market volatility. Your agreed investment strategy sets the guidelines for how this is managed.

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