Market outlook Q&A – disconnect to real economy, growth v value, vaccines, property, gold, inflation and other issues

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Key points

> Share markets often lead economic recoveries.
> Share markets are likely to see a rotation in favour of cyclical stocks relative to growth stocks and this would favour non-US and Australian shares over US shares.
> Markets have only partially priced in a vaccine.
> More downside is likely in the $US and this could see the $A head to $US0.80 over the next 6-12 months.

Introduction

In recently presenting a market outlook webinar we received lots of questions about the outlook but were unable to answer them all given time limitations. Here we try and cover the main questions investors have in a simple Q&A format.

Have markets disconnected from the real economy?

Not necessarily. Share markets invariably lead the economic cycle. Shares led the coronavirus hit to the global economy when they plunged 35% into March. The rebound since then reflects the combination of government measures to minimise the economic damage, ultra-low interest rates which have made shares cheap, some slowing in new cases, positive signs for coronavirus treatments and vaccines and a rebound in a range of economic indicators (eg US GDP looks on track to rebound by around 7% this quarter). So, share markets are anticipating better conditions ahead and that economies will be able to withstand an eventual tapering of government support.

US shares are at all-time highs, what is the probability of a big move down versus a continuing rising trend?

Our base case with around 70% probability allows for a short term pullback in the next month or so then rotation away from US shares and relatively expensive technology and health care stocks into non-US shares and cyclical stocks and a continuing rising trend in shares on a 6-12 month view. This note provides our reasoning as to why the trend in shares likely remains up.

Our risk case with 30% probability is that share markets have another sharp leg down in the next few months with possible triggers being bad news regarding coronavirus, a renewed economic downturn, the US election, tensions with China or an unexpected rise in inflation/sharp rise in bond yields. Relatively expensive tech stocks could be at the centre of this.

Markets are often at all-time highs (as shares rise over time) so record levels do not necessarily mean a sharp fall is imminent.

Are technology/growth shares vulnerable to a crash?

The coronavirus shock has given US tech stocks – particularly mega cap names like Facebook, Apple, Amazon, Microsoft, Netflix and Google – and health care stocks a further boost. The tech heavy Nasdaq is up over 30% year to date and nearly 50% over 12 months. Not only have tech stocks been direct beneficiaries of the crises via stronger demand, but growth stocks with their long earnings streams benefit more from lower interest rates. This is different to the 1999/2000 tech boom as Nasdaq's forward PE is now much lower at 32 times, tech sector earnings are now real and back then most share markets were expensive whereas that is not the case now. But there are several reasons to expect tech and growth stocks to underperform on say a 12 month horizon: their growth may slow as lockdowns ease; they are relatively expensive; interest rates may not fall much further; tech stocks are vulnerable to increased regulation and US/China tensions; and cyclical/value stocks should benefit as global growth recovers.

Will Australian shares continue to lag global shares?

Probably not. The main reason for the underperformance of Australian versus global shares in recent years is the strong outperformance by US shares. They have outperformed global and Australian shares this year and over the last few years. Eg over the last five years US shares returned 14.5%pa versus 7.5%pa for Australian shares. The US share market has a relatively higher exposure to growth stocks whereas non-US and Australian shares have a higher exposure to cyclicals (like industrials, resources & retailers) & financials. As the global economy recovers and interest rates bottom this will likely benefit cyclical sectors and financials and hence see non-US, including Australian shares, outperform. More money printing probably also helped in the US, but this will eventually slow.

How close is a vaccine? What is the market pricing?

We have seen positive news regarding vaccines (that they are safe at least initially and generate immune responses) and various treatments (eg, antivirals like Remdesivir and therapies like Dexamethasone which is a low-cost steroid). The University of Oxford/ AstraZeneca vaccine appears to be most advanced and some are already in production ahead of the completion of Phase 3 tests. However, mass deployment of a vaccine is unlikely until next year and they may not provide complete protection (more like a flu vaccine than a measles vaccine) and so may have to be combined with other treatments. The deployment of vaccines is partly but not fully factored into shares (eg, travel stocks are yet to recover much).

Are investors blind to massive levels of public debt?

Investors are well aware of the surge in public debt flowing from fiscal stimulus, but this is not necessarily as bad as it looks. First, it headed off a bigger hit to the economy and hence an even bigger blow out in public debt. Second, it makes sense for the public sector to borrow from the private sector to support the economy when the latter has cut spending. Third, public sector borrowing costs are ultra-low and often negative. Japan is an example where gross public debt in excess of 200% of GDP has not caused a major problem. It's also conceivable that if a problem did arise, governments could simply cancel the bonds that their central banks now own (which would mean a loss for the investment in their central bank which is offset by a reduction in their debt liability – and so would have no major impact). Finally, in Australia public debt is relatively low. The real constraint to deficit financing is inflation, but its low.

Are bonds still a defensive asset to shares?

Yes. While bond yields are ultra-low and so offer very low medium-term returns, they are still a good diversifier to shares. For example, while Australian shares have lost about 8% year to date, bonds have returned around 4% and so having them in a portfolio has helped smooth out overall returns.

What tangible benefit is RBA quantitative easing?

The RBA's use of printed money to boost liquidity in the economy by providing cheap loans to banks and buying bonds is keeping credit flowing and borrowing costs and the $A lower than otherwise. This helps indebted Australian households continue reasonable levels of consumer spending and helps businesses service their loans and employ people.

What is the risk of inflation v deflation?

Depleted inventories of some products (eg home goods & some foods) due to lockdowns and a switch in demand (from holidays & services to home goods) could boost inflation in some areas, but the main risk in the short term is low inflation or deflation due to lots of spare capacity evident in factories and in terms of unemployment keeping a lid on wages growth. This could be the case for one to three years. However, on a medium term view higher inflation is a bigger risk as the extra money being printed by central banks could at some stage be spent, central banks are now taking more risk with inflation and if the coronavirus shock to supply chains results in more production coming back onshore, particularly if protectionism increases.

Why didn't QE after the GFC in the US boost inflation?

While narrow measures of money supply increased with QE it wasn't lent out and post GFC fiscal austerity may also have headed off the impact on inflation. The same may happen this time, but huge fiscal stimulus is a big difference this time around so there is greater risk of inflation once spare capacity is used up, but that may be several years away.

Will the US dollar continue to fall?

Probably yes. The $US is a safe haven currency that often goes up in times of global uncertainty and declines when uncertainty abates. This reflects the relatively low cyclical exposure of the US economy. From its March coronavirus driven high the $US has fallen around 10% against major currencies and further downside is likely as the gap between US and global interest rates has collapsed, the $US is expensive, the Fed is printing more money than other central banks & a global recovery will reduce safe haven demand for the US dollar.

What does a falling $US mean for other assets?

A falling $US is a sign that global reflation is working and the global outlook is on the mend. This is positive for: commodity prices because they benefit from stronger global growth and are priced in US dollars; non-US share markets including Australian shares because they are more cyclical; and currencies like the $A. We expect the trend to remain up in the $A towards $US0.80 on a 6-12 month view helped by rising commodities and a return to a positive interest rate differential versus the US.

Should investors have gold & bitcoin?

Gold and bitcoin are expected to rise in value as the $US falls. But this is likely just another cyclical fall in the value of the $US rather than a sign of a new crisis – particularly with commodity prices rising too, which is a sign of stronger, not weaker, global growth. There may be a case for gold and bitcoin as a hedge against inflation but it makes more sense to have a well-diversified commodity exposure, neither gold or bitcoin produce any income which makes them very hard to value and there are lots of crypto currencies competing with bitcoin so their supply is unlimited. So, I am not really a gold or bitcoin bug!

What is the outlook for commercial property?

The hit to economic activity and specifically traditional bricks and mortar retail space demand and office space demand (following the surge in online retailing and working from home) and hence rents from the virus will weigh heavily on near term returns from retail and office property. Industrial property is a big beneficiary though. All will benefit from the continuation of low interest rates & the search for yield beyond the short term.

Why covid might result in more Europe, not less?

The coronavirus shock had the potential to expose fault lines in Europe, but so far, its brought it closer together with the ECB's latest QE program buying member nation's bonds on the basis of need rather than some formula based on their weight in the Eurozone and agreement on a €750bn recovery fund much of which will be financed by the common issuance of bonds (which sounds like a step towards a common fiscal policy).

What impact might the US election have?

Shares tend to prefer incumbents and so with 87% accuracy since 1928 a rise in US shares in the 3 months prior to the election would point to a victory by Trump; but a fall would point to Biden. Trump's low tax policies & antagonistic policies to China and to a lesser degree Europe and Japan would favour US over non-US shares and vice versa for a Biden victory. Historically though, US shares have performed best under a Democrat president with a divided Congress and second best under a Democrat clean sweep (see this note) and I see no reason to expect otherwise should Biden achieve the same, albeit markets may initially sell off. Of course, a contested election result would also cause short term uncertainty.

What is the risk of increased tensions with China?

Trump is trying to appear strong on China for political reasons ahead of the election as he knows there is votes in it; but does not want to go so far as to threaten the US economic recovery with say more tariffs and China is biding its time. What happens next year will depend on who wins the US election. Trump will potentially ramp conflict up in a way that could impact markets (although direct military conflict is unlikely) with trade, Taiwan and the South China Sea being the key issues to watch. Biden would likely take a more diplomatic approach.

If Australian house prices fall, what would it mean for banks?

A 10-15% fall (our expectation) is manageable and the associated rise in bad debts has already been provisioned by the banks. A 20% fall would likely mean more trouble for them.

When will the Australian economy recover?

Australia's economy fell by -7% in the June quarter, or -6.3% over the year to June which is the biggest annual fall since the Great Depression. However, the June quarter fall was less than seen in most other comparable countries (eg, the US fell -9.1%, Japan -7.8%, Europe -12.1% and the UK -20.4%) thanks to better virus control, better policy stimulus & exposure to China. Most of Australia is already slowly recovering, but Victoria has been hard hit by its second virus wave which will likely delay a national recovery out to the December quarter.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital