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August 2020

A WORLD OF POSSIBILITIES

Chief Investment Office

A world of possibilities

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Today's investment environment is one where there is a world of possibilities but few certainties. Part of the issue, in our view, is that this recession was caused by an event, rather than anything cyclical. How that event unfolds is uncertain.

We take a look at five possible scenarios and consider what the investment and portfolio implications would be.The scenarios are not mutually exclusive. We could, for example, see a situation where Trump wins the election and we get a vaccine approved. Given this, the assigned probabilities don't add up to 100%.

An event, not a cycle

An event, not a cycle

We subscribe to Howard Marks' view that the current situation has been driven more by an "event" than by anything "cyclical". In other words, we are in a recession not because of anything that happened within the workings of the economy, the usual suspects being excessive debt or excessive exuberance.

This current recession was caused by an exogenous shock which then caused government's around the world to order economies to stop.

The heatmap below compares the key features of the 2008 Global Financial Crisis with the recession today. The map highlights when and where the key features where present with green suggesting little evidence and red suggesting significant evidence.

The policy response today was more immediate and larger in size, starving off the likelihood of a financial crisis. This, in combination with the fact that there were fewer structural issues present before the current crisis hit (in contrast to 2008 when the housing market was in bubble territory), means the economic damage done is likely to be more limited.

		Australia	US	EU	China
Economic policy mistakes	2008				
	2020				
Financial crisis likelihood	2008				
	2020				
Structural economic issues present before	2008				
	2020				
Economic damage from recession	2008				
	2020				
Overall	2008				
	2020				

Understanding this difference is crucial in understanding what the next phase looks like. An endogenous shock, once it goes away, can take years to recover from. An exogenous shock, once it goes away or is at least mitigated, can allow an economy to re-start providing there is little scar tissue.

The two keys to determining how well and how fast the economy re-starts is how well the shock is addressed and or removed and how extensive the scarring is. These two things are related. The faster a mitigation drug can be found, the faster the economy can re-start, the less long-term scarring there will be. The extensive fiscal and monetary support provided by governments will certainly help in keeping scar tissue to a minimum.

1. Effective vaccine

70%

chance

Effective vaccine discovery

According to the World Health Organisation (which is tracking more than 140 vaccines in development) eight vaccines are in phase 3 trials – this is the last trial phase. The next step if successful is regulatory approval and then finally the manufacture phase.

Confidence is growing that some kind of mitigation drug will be available by early next year that will allow us to live and work with the virus. The greatest economic impact under this scenario is that social distancing measures can be relaxed, the economy can open up and people can live, work and consume more freely again.

This would boost economic growth as the sectors of the economy most hit by the shut down can begin operating again. It is estimated in the US about 30% of the economy was affected by the social distancing measures but about half of that 30% were able to continue operations remotely or online.

There is no doubt some damage has been done to the economy. There are some businesses that will not come back and it will take some time for employment to recover but in contrast to past cycles, this event saw most layoffs come with a handshake agreement to re-hire when reopening is possible. Already, half of the 1.3 million Australian jobs lost have been re-employed.

Consumption typically rebounds ahead of the labour market. Consumption will be supported by the pent-up demand that exists and the support provided by governments. Household saving rates have increased across the US, Europe and Australia. This will be spent when social distancing rules are relaxed. This spending will generate the activity needed to re-hire employees, household income levels will rise as a result and the economic flywheel will re-start.

There may be some structural changes that will affect how we work, live and play in the future as a result of the virus. Telecommuting is likely to have received a structural boost, e-commerce and even perhaps e-health. This may mean the property sector is the one sector that will have to deal with longer term issues even after a vaccine is found with office and retail likely suffering the most permanent scarring.

Financials may also be a sector that will feel the consequences of the virus long after a vaccine is found. While most deferred repayments will be repaid, banks will need to digest some proportion of bad debts, particularly for loans in the worst affected sectors such as accommodation, cafes, restaurants, culture and recreation.

The investment winners in a vaccine discovery will likely be the sectors that have lagged the winners to date. This would include transport, materials, consumer staples, consumer services such as hotels, restaurants and leisure and education.

The biggest underperformers under the pandemic, airlines, will likely come back with a bang should vaccines be cleared for broad use and virus counts decrease. At the same time, some of this year's biggest gainers would slump, especially gold.

Gold tumbled and value stocks gained after Russia's vaccine news, imagine how much stronger the moves would be if an inoculation received full approval from a western nation or two.

Vaccines should spur investors to focus on those sectors that would benefit from the release of pent-up demand for travel, entertainment and other pursuits that lockdowns stymie. Even though the road back for such industries will be a long one, stock markets will race to price in recoveries.

Effective Vaccine	Country	Sector	Style	Asset class
Relative Winners	EU, Japan, Australia, EM	Transport, materials, consumer staples, consumer services such as hotels, restaurants and leisure and education, consumer discretionary	Small, Cyclical	Equities, Commodities
Relative Losers	US	IT, Healthcare, Food	Large, Defensives	Bonds, Gold

2. Inflation spike

20%

chance

Inflation spike

What if the US Federal Reserve actually succeeds in generating inflation?

The aggressive monetary and fiscal stimulus in response to the coronavirus crisis could trigger a burst of inflation. Money supply growth has soared hitting 8.4% in Australia (versus a long run average of 6%), 12.6% in Europe (versus a long run average of 9%), 13% in Japan (versus a long run average of 7%) and an incredible 38.1% in the US (versus a long run average of 10%).

After the global financial crisis (GFC) there was a school of thought that quantitative easing and low rates would generate substantial levels of consumer price inflation; that never materialized. Much of the liquidity provided by the central bank found its way into asset price inflation (and vintage Ferrari price inflation) but not into consumer price inflation.

Will this time be any different? There are reasons to think that perhaps that will be the case. In the aftermath of the GFC, domestic non-financial private-sector credit declined in nominal terms, not reaching its prior peak for five years. This de-leveraging likely blunted the inflationary impact of government borrowing and the Fed's financing of it. This time around, de-leveraging may not occur to the same extent given the absence of imbalances going into the recession.

It remains to be seen what happens to global and local supply chains, but it's hard to see them moving in anything but a more cost-heavy direction. Meanwhile, one of the missing links of inflation over the past decade has been the absence of the expected household formation from the millennial age cohort. If that trend reverses, it should provide a nice tailwind to a nominal growth rebound.

It has now been formally announced that the US Federal Reserve is going to adjust its strategy to countenance higher inflation in the future. This commitment to allow inflation to move past the 2% target to make up for years of undershooting may ultimately send inflation higher. Certainly, that is the intention of the move.

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Depending on how large the spike in inflation is, it could result in the central banks withdrawing monetary stimulus. This would put upward pressure on bond yields and likely cause the yield curve to steepen. This would be a positive development for banks as their net interest margins are positively correlated to the steepness of the yield curve.

Inflation spike	Country	Sector	Style	Asset class
Relative Winners	EU, Japan, Australia, EM	Banks, Gold, REITs, Utilities, Energy, Cons staples,	Value	Cash
Relative Losers	US	IT, Healthcare	Growth	Bonds

3. Double dip recession

10% chance

Double dip recession

The most likely cause of a double-dip recession would be another severe breakout of the pandemic causing a surge in hospitalisations, forcing governments to resort to generalised lockdowns again.

Economic activity would once again grind to a halt as tighter social distancing measures are enforced. Governments would be forced to pump further stimulus into the economy, raising government debt levels even further.

The stimulus is likely to be less effective given even more business are likely to fail under this scenario.

Financial markets would have a serious correction that would likely take longer to recover from given the effect a new outbreak would have on business and consumer confidence. The economic scarring would be deeper and take longer to heal.

The financial market winners would likely be once again IT and healthcare but given already elevated valuations it is difficult to imagine significant gains. Equities overall is likely to be a relative loser under this scenario.

Double dip recession	Country	Sector	Style	Asset class
Relative Winners	US	IT, Healthcare, Food	Growth, large, defensives	Bonds, cash, Gold,
Relative Losers	EU, Jap, Aust, EM	Transport, materials, consumer staples, consumer services such as hotels, restaurants and leisure and education, consumer discretionary	Value, small, cyclicals	Equities,

4. Biden wins the election

55%

chance

Biden wins

A win on November 3 for Joe Biden and the Democrats would not be as significant as a win for the Democrats in the Senate as well. This would mean the Democrats take control of the White House and Congress.

Should Joe Biden prevail over Donald Trump - as current polling suggests - gold may be in the thick of the action as the White House incumbent could contest the result. Trump, of course, has repeatedly warned the election would be “rigged” if voters are permitted to mail in ballots, instead of going to polling places amid the pandemic.

Expectations of a Biden victory may be a short-term bullish factor for the US dollar, though a win might revive risk appetite while lowering tension with China, both adding downward pressure on the currency.

Investors looking for U.S. equity upside from a Joe Biden presidency should be focusing on investments in green energy technology and the U.S. infrastructure complex.

Beyond a change in the White House, the chance of a Democratic straight flush through both the House and Senate races could make the first 100 days of a Biden presidency very lucrative for investors in sectors that may be of the highest priority for a new government looking to boost an economy out of the Covid-19 induced Doldrums. "Green deals" and unfinished infrastructure funding plans present low-hanging fruit for a single-party government.

Presumably, if the Democratic Party gets control of both the White House and Congress, it could increase the risk of rolling back the corporate tax cuts Trump delivered. Though given current circumstances, that seems unlikely at least in the first one or two years of the new term.

Positive news flows on vaccines and the prospect of a win for Joe Biden would be a relative negative for the tech sector. Some of the money leaving tech could shift into selective value sectors, EM sovereign debt and haven assets such as gold and Treasuries.

Emerging markets would probably benefit the most from a Biden victory with a split congress (i.e. the Senate remains Republican controlled). This assessment is based on:

- the assumption that Biden reduces geopolitical uncertainty
- the likelihood that Biden would negotiate to roll back tariffs on China, in return for market opening
- the relatively poor relative performance of EM assets following Trump’s election. Note that Mexican and Brazilian stocks, bonds and FX consistently fared the worst in the month following the 2016 election.

The benefits of a Biden Presidency, however, would be offset (but probably not overwhelmed) in the event the Democrats win a clean sweep. In the extreme case, with Democrats winning the Senate by a large margin the outcome would be bad for EM. The risks of significantly higher corporate taxes and re-regulation would probably be overwhelmingly negative.

Biden wins	Country	Sector	Style	Asset class
Relative Winners	EM, EU, China, Aust	Infrastructure, renewables	Cyclical	Gold, AUD
Relative Losers	US	IT, Healthcare	Defensives	USD

5. Trump wins the election

45% chance

Trump wins

President Trump trails his Democratic opponent in the national polls, but then that was the case four years ago, so few would count him out this time around.

Most emerging markets did poorly following the result of the 2016 U.S presidential election. Back in 2016, from election day through until early December, only 2 stock markets in our survey of 17 outperformed the SPX (which rose 5.4%) - Russia (13%) and Poland (7.1%). In FX, the U.S. dollar rose against everything except the RUB and COP. Treasury yields rose 58bps. Mexico and Brazilian stocks and FX fared the worst.

On tax policy, a Trump victory that was not expected would likely see a relief rally in US equities as investors anticipate stable, lower taxes for a second Trump term.

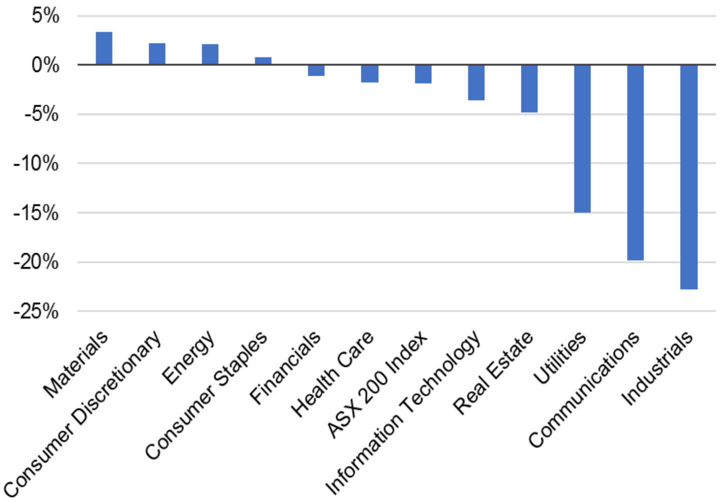
On global trade, if President Trump is re-elected, the stand-off with China will likely worsen and tariffs may increase again. That would slow the global economy and, in turn, hurt equities especially emerging markets. Tariffs on European goods, or lumber and aluminium tariffs with Canada would create additional uncertainty. With a second term won, Trump may take an even more aggressive stance against trading partners. A further roll-back of globalisation and free trade would put upward pressure on supply chain costs and so benefit gold as a hedge against inflation.

On global relations, a win by President Trump may help aerospace and defense contractors. If the president does decide to continue on a global decoupling agenda and withdraw U.S leadership from the world, the theme of USD decline might gain more traction but this would be offset by dollar strength on weaker global growth.

Trump wins	Country	Sector	Style	Asset class
Relative Winners	US	Aerospace, defence, infrastructure	Growth	USD, gold
Relative Losers	EM, China, Aust, EU	Semiconductors, materials, IT	Value	AUD

Australian Equities

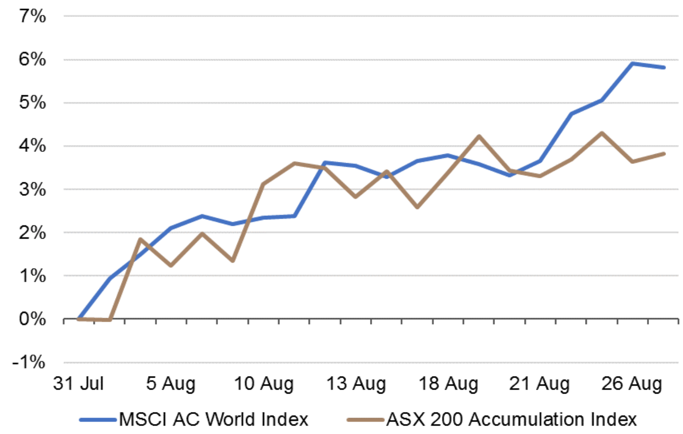
Chart 1: ASX 200: Sector EPS revisions



Source: Bloomberg

Forward EPS revisions have varied across the sectors of the Australian market this month, with estimates revised following companies reporting annual results. Industrials, communications and utilities have fared the worst in terms of negative revisions, which have a drag on the broader ASX 200 Index. At the other end of the spectrum, consumer discretionary stocks have reported better than expected results, while materials have been boosted by robust commodity prices.

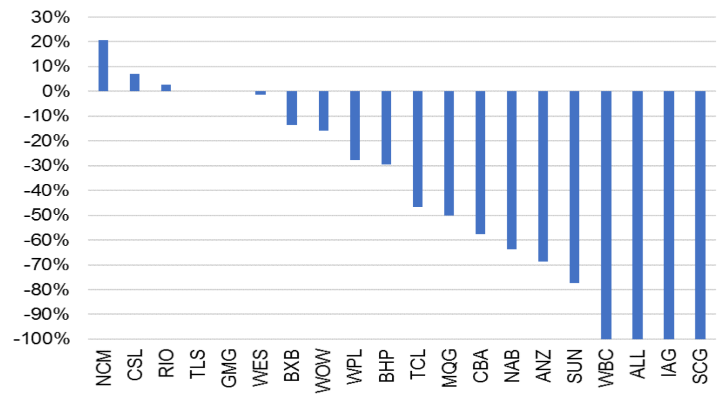
Chart 2: MSCI AC World and ASX 200 Accumulation



Source: Bloomberg

While the ASX 200 Accumulation Index has tracked higher through August, which has resulted in the fifth consecutive month of gains in the current recovery period, the returns have lagged that of overseas equities. Despite commodity price strength supporting the resources sector, a sub-par reporting season has contributed to the underperformance.

Chart 3: ASX 20: Dividend change year on year

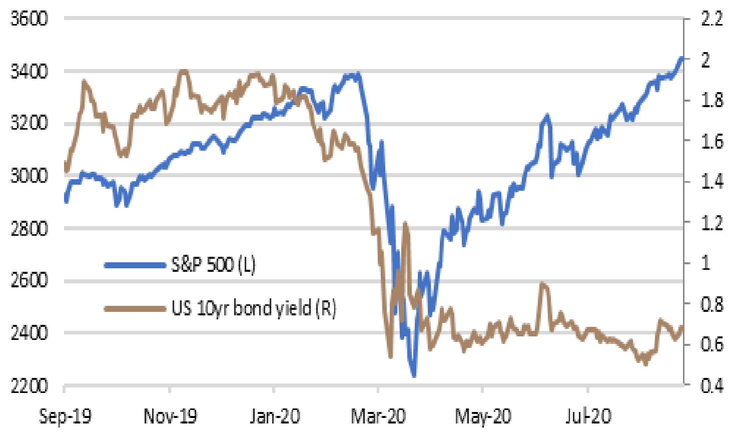


Source: IRESS

Dividends were always going to be a key focus of companies in this reporting period and even the largest companies listed on the ASX couldn't escape the significant hit to distributions. Of ASX 20 stocks, only three increased their dividend, while a further two were able to declare an unchanged dividend. Meanwhile, four companies - Westpac, Aristocrat Leisure, IAG and Scentre Group - all opted for a conservative approach by not declaring a dividend in this period.

International Equities

Chart 4: Bonds can't ignore the push higher from equities forever



Source: Bloomberg

The S&P 500 finished August in the black for a fifth straight month on optimism a vaccine for the virus may be around the corner. If markets are right about a V-shaped recovery founded on fast-track approval of vaccines or newer, effective treatments, then Treasury yields are likely to snap out of their current doldrums. While that has not happened so far, stocks can't continue to rally endlessly and yields stay put. When yields snap out of their stupor, the correction will be quick and sharp, which may then allow the curve to settle into a new orbit (witness how the 10-year yield has bobbed around 0.65% for months now). When a new equilibrium is found in rates, the higher yields will warrant a re-assessment of the required return on stocks.

Chart 5: EM equities battling to erase 2020 losses

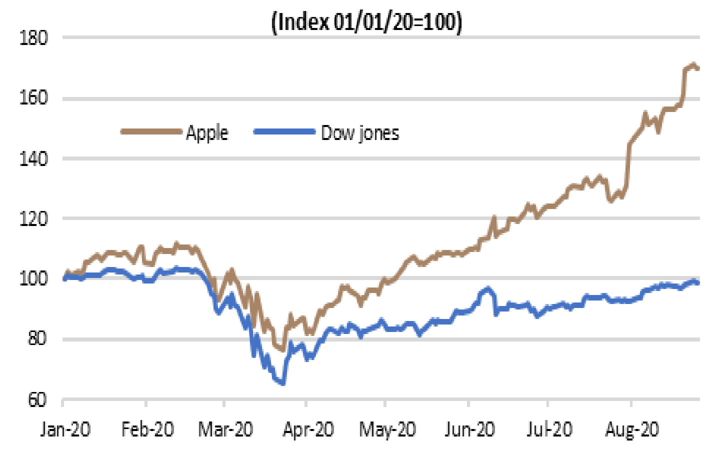
Source: Bloomberg

Emerging market equities are struggling to erase their 2020 losses. Hopes of a vaccine may be enough to do it given how badly hit emerging markets were by the virus.

Analysts have upgraded earnings estimates in emerging markets by 6.6% since March. But they'll have to raise them another 33% even to justify the current stock prices, based on average valuation.

Can it happen now? Such growth in profit projections were seen during 2009-2011 and 2016-2018. But those spikes were backed by economic growth rates ranging from 4% to 7%. This year, emerging economies are projected to shrink 1%, then recover to 5% next year.

Chart 6: Dow Jones vs Apple

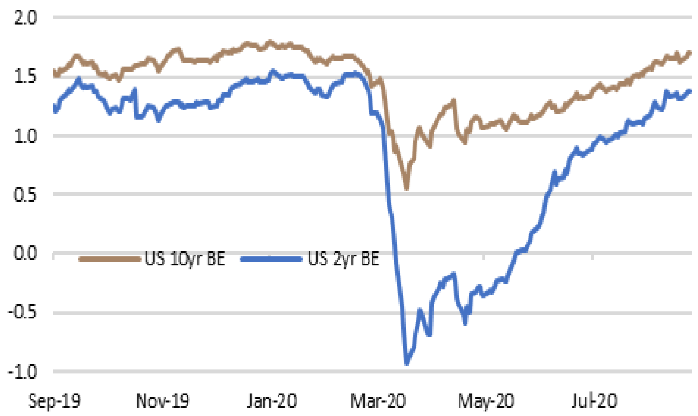


Source: Bloomberg

Apple's scheduled 4-for-1 stock split on Aug. 28 portends changes in the Dow Jones Industrial Average. Apple's 12% weighting in the index calls for a change in the divisors, to adjust to the post-split stock price. The Dow is compiled by adding the stock prices of all 30 companies, then dividing by a factor set by the owners of the index, S&P Global. The factor is adjusted when a stock splits.

The changes are also designed to steer the index, founded in 1896, to better reflect the U.S. economy. The exit of Exxon Mobil ends a run that began on Oct. 10, 1928, when Standard Oil of New Jersey joined the broad market average. Software giant Salesforce.com will assume Exxon Mobil's 1.32% weighting. The changes are effective prior to the opening of trading on Monday, Aug. 31, 2020.

Chart 7: Market is pricing in rebound in inflation in 2yrs



Source: Bloomberg

Breakeven inflation is a measure of expected inflation derived from the market.

Breakevens are the market's expectation of future inflation, not where inflation will necessarily be. But the implication is that as real rates decline, investors seeking better returns abandon bonds and buy stocks.

The problem at the moment is the drop in real yields is now because of increased inflation -- not so much a decline in Treasury yields. Inflation expectations have been rising since March, particularly at the 2-year point, which could give risk investors a headache down the road.

Chart 8: US yield curve steepening

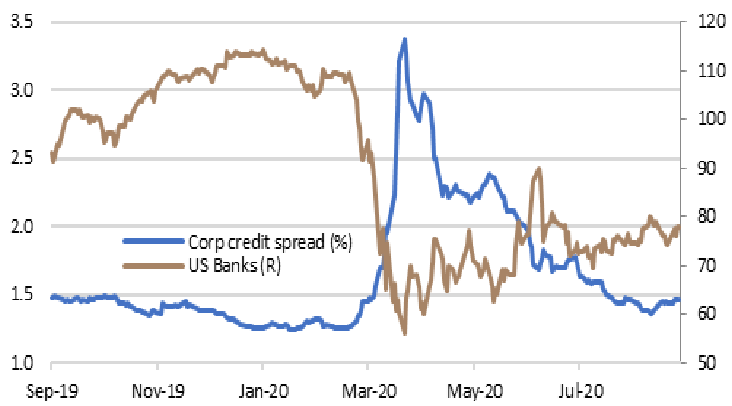
Source: Bloomberg

The 2s30s US yield curve has steepened about 30bps in August led pretty much solely by moves in 30yr.

Federal Reserve Chair Powell's historic shift to a more relaxed stance on inflation and focus on the jobs market suggests the Fed's low interest-rate policy is here to stay for longer. That gave rise to further steepening.

This lower-for-longer environment has at least two implications. First, it's conducive for anything that yields positive cash flow and income, such as stocks or corporate bonds. Second, there's better coordination between monetary and fiscal policies. The Fed keeps rates low so that the government can borrow and spend.

Chart 9: Financial repression at work

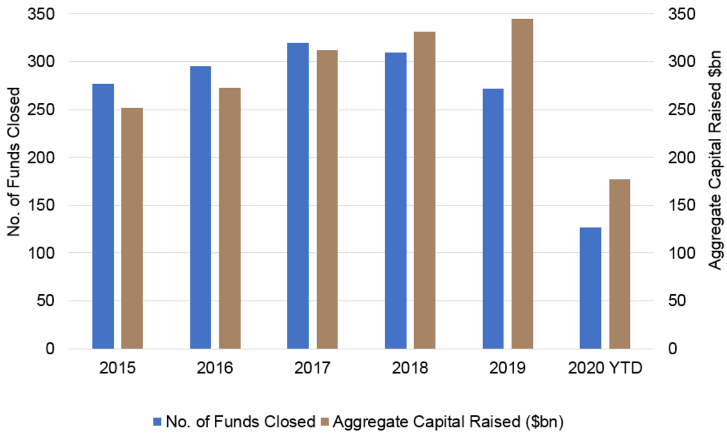


Source: Bloomberg

The Fed is taking an ever-greater role in the U.S. economy and that's raising concerns it is skewing the playing field to the benefit of larger companies. This chart features an indicator of financial repression (the spread of BBB-rated corporate debt over Treasuries) compared to U.S. bank stocks. Spreads on corporate bonds are touching fresh lows while banking stocks have largely moved sideways and are lagging the broader index. Whatever's happening in credit, it is not coming courtesy of banks. It's almost certainly coming courtesy of the central bank as it acts as lender of last resort to compress risk premiums as investors scramble for yield.

Alternatives

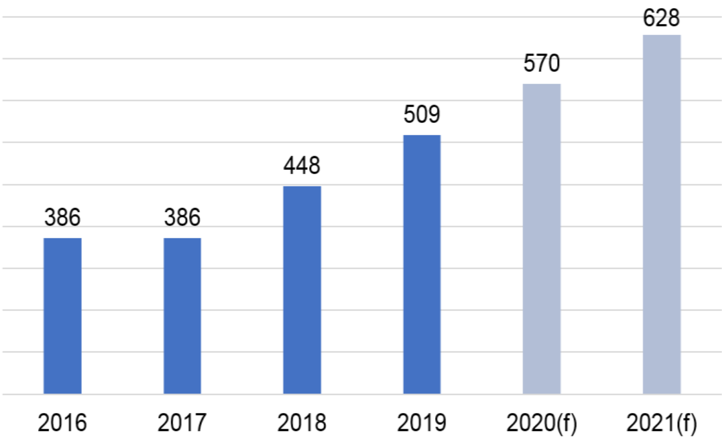
Chart 10: ESG-Committed private capital fundraising, 2015-2020 YTD



Source: Preqin

The integration of ESG into the investment process is becoming a standard part of General Partners (GP) mandates within private markets. The cumulative number of funds with ESG commitments raised between 2015 and H1 2020 now stands at 1,601 with total committed capital of $1.69tn. Private equity, responding to the increasing focus on sustainable investing, are now seeing ESG questionnaires from investors all over the world. Average ESG committed fund sizes also continue to grow with 2020 average fund size $1.4bn vs $900m in 2015.

Chart 11: Number of hyperscale data centres



Source: KKR

The growth in data infrastructure continues to accelerate with additional tailwinds coming from the shift to online following government imposed lockdowns globally. Demand for cloud storage will continue to balloon, devices that are part of the Internet of Things, the impending 5G wireless networks and the prospect of self-driving vehicles will require considerable spend on infrastructure, particularly in dense urban areas where low latency will be critical to future success.

Chart 12: Iron Ore price falls from recent high

Source: Bloomberg

Iron ore prices recorded their first weekly fall in five weeks as prices stalled on a turnaround in supply from the world's second largest exporter, Brazil. Prices had soared in recent weeks on the back of robust demand from China, and also supply side issues from the South American nation as it struggled to contain the outbreak of Covid-19. Both BHP and Vale, two of the world's largest iron ore producers suggested it will be hard to maintain current price levels. The metal is up 41% year to date.

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