Strategic Wealth Market Update

strategicwealth

28th August 2020

Strategic Wealth Investment Committee

We are past the midpoint of the six week Stage 4 lockdown in Victoria and with the number of new daily cases reducing, there is hope that we have the Covid-19 virus outbreak relatively under control and can look forward to enjoying the freedoms experienced by other states.

But the Covid-19 crisis is far from over and we are seeing significant infection outbreaks in the developing countries and second waves of infections occurring in developed countries. The virus has wreaked havoc on the global economy and employment levels and continues to do so.

Work on vaccines is progressing and there are positive signs for a number of candidates, although their effectiveness and safety requires further study before being rolled out to the broader population.

Against this backdrop of high uncertainty, global share markets have ‘range-traded’ since June. The US market, led by their strong exposure to technology stocks has performed the strongest and is back to pre-crisis levels. Other countries, including Australia, remain below their March 2020 highs. The presidential election in the US further complicates the outlook with the polls suggesting a close and uncertain outcome.

So what is the outlook for the share market and property markets?

The Strategic Wealth Investment Committee continues to believe that there will be some form of pull back in the sharemarket in the second half of this year. A pull back would be an opportunity to acquire shares at more attractive pricing, particularly for long term investors.

As noted before, there remains a misalignment between the global economic conditions and the sharemarket. But we also acknowledge that there are many factors that could change that outlook and the market may continue to move sideways and even up over the remainder of the year.

On a medium to longer term outlook, we hold a positive view on the outlook for the sharemarket as the global economy recovers and businesses rebuild.

Property in Australia has also been impacted by the Covid-19 crisis. Lower immigration, higher unemployment and lower job security are strong headwinds for many sectors of the property market. Additionally, consumer preferences are shifting and these changes may have a longer term impact on the housing, retail and office markets.

To help you further understand the issues and outlook for the sharemarket and property market, I have attached two articles recently published by Shane Oliver, who is the Head of Investment Strategy and Chief Economist at AMP. Shane’s articles are well written and they will provide you with another viewpoint on the outlook for these two important markets.

I hope you enjoy reading the articles and as usual, please contact us if you have any questions on the articles or your personal situation.

Take care.

Kind regards,

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AMP CAPITAL

Three reasons why the coronavirus crisis might fix Australia's housing affordability crisis

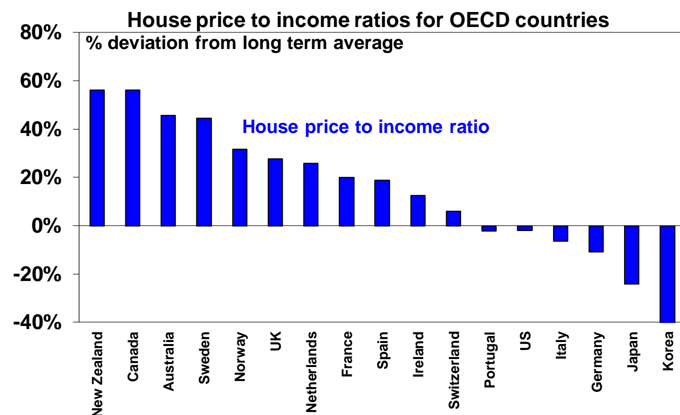
12 AUGUST 2020
EDITION 30

Key points

- For more than a decade now Australia has had a chronic problem with poor housing affordability.
- While various things may have played a role the key driver of poor affordability in Australia has been a surge in population growth and an inadequate housing supply response.
- The coronavirus hit to the economy is driving yet another cyclical downturn in property prices. But it could have a more lasting effect in improving affordability via a long tail of unemployment, lower for longer levels of immigration and a shift to working from home.

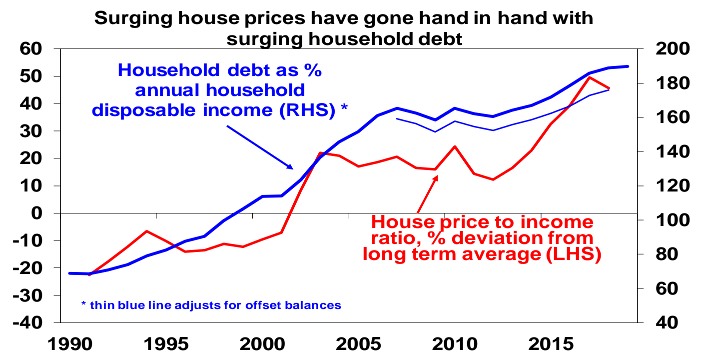
Introduction

For years Australia has suffered from poor housing affordability. According to the 2020 Demographia Housing Affordability Survey the multiple of median house prices to median annual incomes is 5.9 times in Australia compared to 3.9 times in Canada, 4.5 times in the UK & 3.6 times in the US. Consistent with this the ratio of house prices to incomes relative to its long-term average is at the high end of OECD countries.



Source: OECD, AMP Capital

It wasn't always so - Australia was once seen as a country with relatively cheap and affordable housing. Having a house on a quarter acre block was an essential part of the "Aussie dream". But that changed last decade as average house prices went higher and higher relative to average incomes and this went hand in hand with a surge in household debt relative to income. See the next chart. There have been several cyclical downswings in property prices that have brought short term relief in terms of affordability – around the GFC when average capital city dwelling prices fell 7.6% based on CoreLogic data, around 2011 when prices fell 6.2% and in 2017-19 when prices dipped 10.2% - but they have been short lived with prices quickly bouncing back.



Source: OECD, AMP Capital

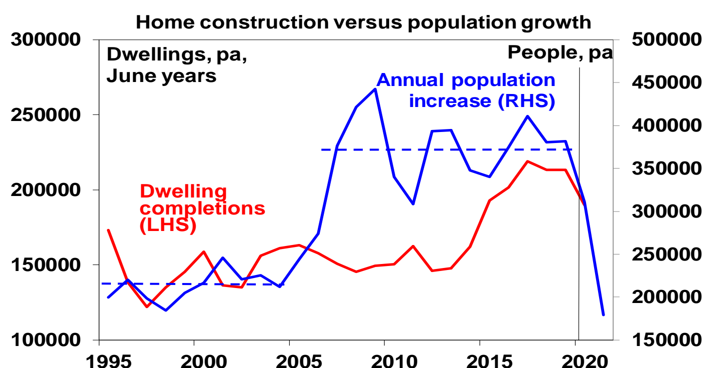
The coronavirus shock may have a more lasting impact. It has brought lots of pain and suffering on a human level but also on an economic level. And it has caused much disruption to the property market in the short term with more likely to come. But it may have a lasting positive legacy in relation to property - that is more affordable housing in Australia.

Why is Australian housing so expensive?

To understand why this may be the case its necessary to consider what has caused poor housing affordability in Australia in the first place. It's been popular to blame tax concessions, foreign buying, government related housing infrastructure charges and stamp duty and low interest rates and easy credit. But none of these really explain it.

Lots of other countries have a variety of housing tax concessions too, but with much cheaper housing. Foreign buying is a relatively small part of the overall market and has declined in recent years. Infrastructure associated with housing is hardly unique to Australia. Stamp duty adds to the cost of transactions and is a silly tax, but if anything may have kept prices lower than they otherwise would be (when supply is constrained). The shift from high interest rates to low interest rates enabling bigger loans has enabled ever more expensive housing – but other countries have also seen ultra-low interest rates in recent decades and yet have much cheaper housing.

Rather the basic problem has been a surge in population growth from mid-last decade and an inadequate supply response (thanks partly to tight development controls and lagging infrastructure). Since 2006, annual population growth averaged about 150,000 people above what it was over the decade to the mid-2000s. This required the supply of an extra 50,000 new homes per year. See the next chart. Unfortunately, this was slow in coming. But with an insufficient supply response to surging demand, prices were able to stay elevated. And so poor housing affordability got locked in.



Source: ABS, AMP Capital

Each cyclical downturn in house prices has brought hope of a solution, but it was invariably dashed as the fundamental supply demand imbalance remained or re-established itself. The same looked to be applying more recently with average house prices surging 10% between June last year.

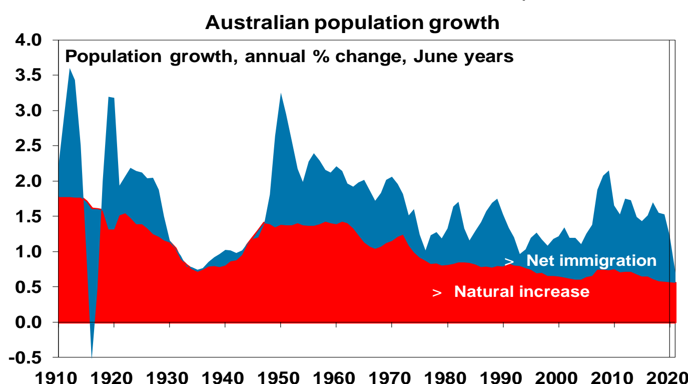
The longer-term impact of coronavirus

The coronavirus shock has the potential to change this dynamic of cyclical fluctuations around ongoing poor affordability. It has already triggered a renewed downturn in property prices with capital city prices down 2% on average since April, with Melbourne prices down around 4%. JobKeeper and the bank payment holiday are preventing faster falls at present. But further declines in national prices are likely, as high unemployment, the depressed rental market and the collapse in immigration impact. We now see average capital city prices falling 10-15% from their April high out to mid-next year with Melbourne most at risk and likely to see a 15-20% decline.

Past experience would suggest that this may be just another cyclical downturn and once coronavirus comes under control and the economy rebounds it will be back to normal with poor affordability. Particularly with record low interest rates making it feasible to borrow up big. However, the coronavirus shock has the potential to change this for three reasons.

- First, the hit to economy from coronavirus is bigger than anything seen in the post war period. While most of the activity hit by lockdowns should bounce back once the virus is brought under control some things will take longer to recover (eg, travel & tourism), some will be permanently changed for ever (with eg, a big shift to on-line shopping, education, health care & watching sports) and businesses will use the uncertainty to accelerate cost savings. All of which will mean a long tail of unemployment. JobKeeper has shielded Australia from what otherwise would have been 15% unemployment in April and 11% unemployment now. But officially measured unemployment is still likely to hit 10% by year end and will probably have only fallen to around 9% by end 2021. This will likely result in more forced property sales and act as a drag on home prices, as income support measures & the bank payment holiday wind down.
- Second, immigration has been a big driver of property prices and it's taken a huge hit and may take a long while to recover. Thanks to travel bans, net immigration is likely to have fallen to just below 170,000 in 2019-20 and to around 35,000 this financial year from 240,000 last financial year. This is a huge hit which will take population growth in 2020-21 to just 0.7%, its lowest since 1917. See next chart.

  This will reduce annual underlying demand for homes to around 120,000 dwellings, compared to underlying demand last year of around 200,000. This could result in a significant oversupply of dwellings, and in turn could reverse the years of undersupply that has maintained very high house prices since mid-last decade. (See the population versus dwelling completions chart above.) A big cut to immigration is not something many other countries have to deal with, so their experience is not directly translatable to Australia. Of course, if this is just for a year, it wouldn't have much lasting impact. And the return of expat Australians may provide a short-term offset. But with unemployment likely to remain high for some time, it will be hard politically for the Government to quickly ramp up immigration to previous levels, even once it is safe to do so from a coronavirus perspective. After the early 1990s recession net immigration stayed low at around 90,000 pa until the mid-2000s. All of which points to a long period of constrained housing demand and hence more constrained house prices.



Source: ABS, AMP Capital

- Finally, a mass shift to working from home potentially has huge implications for residential property prices. Prior to coronavirus, working from home was only slowly creeping in. Now coronavirus driven lockdowns and social distancing has shown that its feasible for most white-collar workers and can be good for productivity. Of course, full time working from home does come with costs in terms of team cohesion, corporate culture, the development of younger workers and less opportunities for spontaneously exchanging ideas. So, some sort of hybrid may become the norm – some at home all the time, some in the office all the time, but most doing half and half. And working from home works best in houses where there's lots of room as opposed to apartments. All of which could revolutionise residential property demand - and from what I am hearing anecdotally maybe already is. Which will mean less demand for property close to the CBD, greater demand for property in suburbs, with a decent community and environment and increased property demand in regional centres. All of which could break down the dominance of the city with its expensive property. This would turn the trend of recent decades favouring more condensed living close to the city on its head. Some office property (and possibly also some retail property impacted by the shift to online retailing) could be repurposed for residential use, thereby boosting housing supply. By fostering decentralisation, a shift away from cities to regional communities could dramatically improve housing affordability over time.

Concluding comment

We are still fighting the war against coronavirus but it's likely, as we have seen with various shocks in the past, we will get over it, and go back to something more normal. But not everything will go back to normal. A lasting impact could be more affordable housing in Australia. It's not our base case that this will come in the form of a property crash (and that would be a bad outcome for the economy anyway via negative wealth effects) but it could come in the form of much softer property price gains over time (after the initial hit into next year).

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AMP CAPITAL

Seven reasons why the trend in shares will likely remain up, albeit with bumps along the way

24 AUGUST 2020
EDITION 31

Key points

> Shares have had a strong run up from their March lows with US shares now at a record high.

> While shares are vulnerable through the seasonally weak months ahead in the run up to the US election, the positives – including good progress in developing vaccines, the downtrend in the US dollar, signs of recovery and low interest rates – are likely to see shares push higher on a six to 12 month view.

> This is likely to see US shares start to underperform.

Introduction

Share markets have had a spectacular rebound from their March lows. The rebound has been led by the US share market which is up 52% and has just risen above its February record high, making it the fastest recovery after a 30% or more fall on record. Other share markets have lagged but are still well up from their lows. This includes the Australian share market which recently rose to its highest level since early March.

The rebound in share markets

Share market	% fall from high to March low	% rise from March low	% distance from high
US	-34	+52	+0.3
Eurozone	-38	+37	-15
Japan	-31	+38	-5
UK	-35	+20	-22
Global (MSCI)	-33	+45	-3
Australia	-37	+35	-15

Source: Bloomberg, AMP Capital

A common concern remains that the rebound is irrational. How can shares be so strong when June quarter GDP collapsed - by an average of -10% in developed countries and an estimated -7% in Australia - and coronavirus continues to reap havoc?

But as the investor Sir John Templeton once said: "bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria" and we have certainly seen the run up since March occur against the backdrop of a lot of pessimism. The plunge in shares into March led the coronavirus hit on the way down and surprised many at the severity of the fall and now it's led on the way up despite lots of worries. It's also worth noting that shares have spent much of the period since early June rangebound (and apart from the US share market, many still are) and this has helped correct the excessive speed of the run up into June that left shares technically overbought & due for a consolidation or correction.

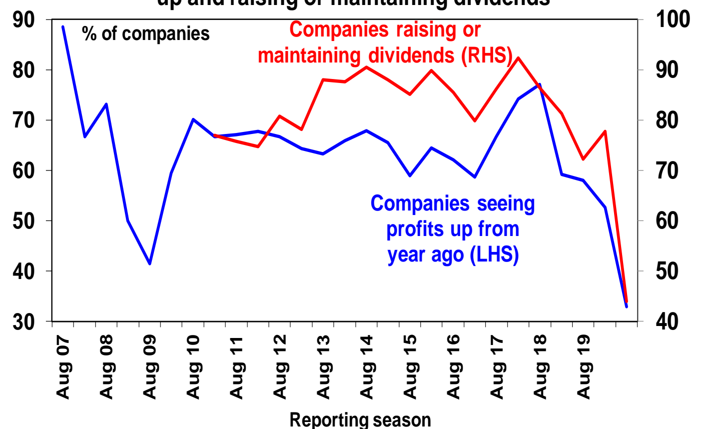
More fundamentally though, the positives for shares continue to outweigh the negatives. Let's start with the negatives.

The negatives

Several negatives continue to hang over shares and are often cited as the main reason to expect sharp falls ahead.

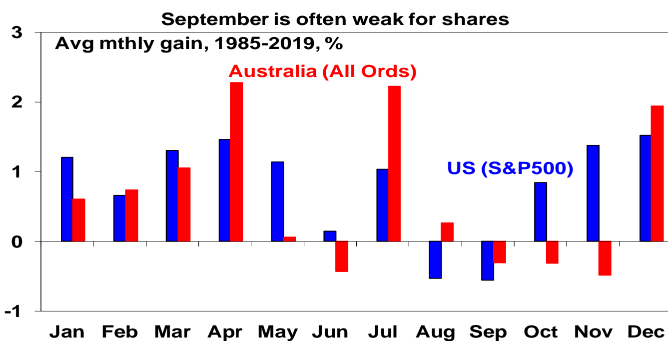
- First, coronavirus has yet to come under control globally, particularly in emerging countries, and most developed countries have seen second waves. This poses the threat of a return to debilitating lockdowns and people behaving more cautiously. So far it's seen the global reopening stall. In Victoria it's been reversed, which will likely delay the recovery in Australian GDP into the December quarter.
- Second, this is occurring at a time of a massive hit to economic activity and profits, and very high underlying unemployment. The US June quarter earnings reporting season saw earnings fall 32% year on year and 2019-20 earnings in Australia are expected to have fallen 22%, resulting in the worst slump since the 1990s recession, with 67% of companies to have reported June half earnings so far seeing a decline in earnings and 56% cutting dividends.

Proportion of Australian companies seeing profits up and raising or maintaining dividends



Source: AMP Capital

- Third, the recovery going forward may be slow as some things will take longer to recover (eg, travel), some things may never fully come back (eg, a big shift to on-line shopping, working from home, education & health care) and businesses will use the uncertainty to accelerate cost savings. All of which will mean a long tail of unemployment and economic activity below its pre-coronavirus path.
- Fourth, we are now in a seasonally weak time of the year for shares, with August and September being the weakest months of the year on average for US shares. And consistent with this, the recent rise in the US share market to new highs has come on narrow participation amongst stocks suggesting the risk of another short-term correction.

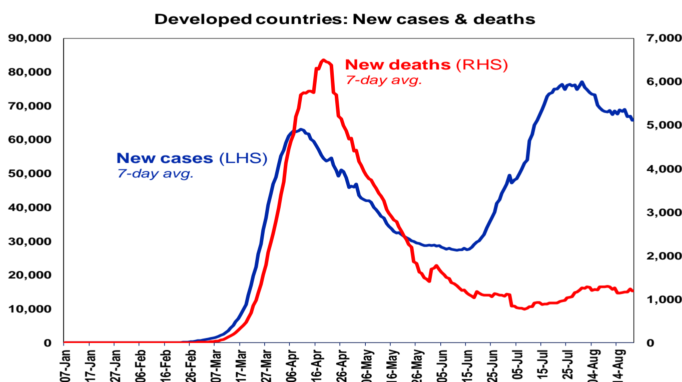


- Fifth, the run up to the US election has the potential to drive increased share market volatility if it looks likely that Biden will win and raise taxes, and if Trump decides he has nothing to lose and ramps up tensions with China & Europe.
- Finally, shares are expensive on traditional metrics like PEs and more esoteric measures like the ratio of share market capitalisation to GDP and the market value of companies relative to the book value of their assets.

The positives

However, there are a bunch of positives providing an offset.

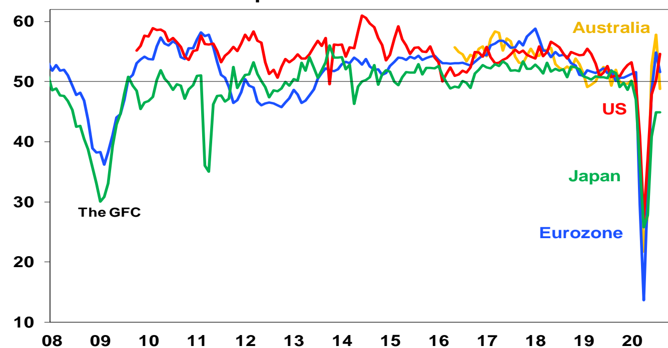
- First, the second wave of new coronavirus cases in developed countries has been far less deadly than the first. This likely reflects more young people being infected, better testing, better protections for older people and better treatments. This in turn has seen most countries avoid a return to a full lockdown and limited the hit to confidence.



Source: ourworldindata.org; AMP Capital

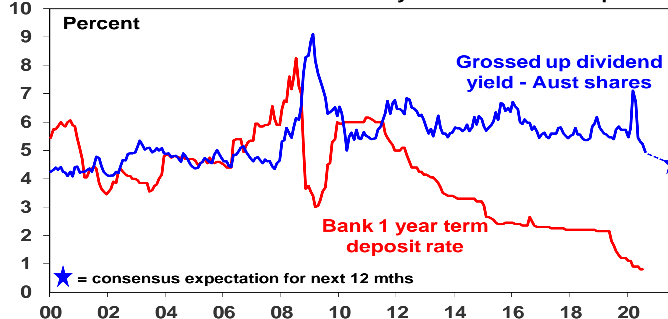
A decline in new cases in the US has enabled the recovery there in high-frequency economic indicators like credit card spending and mobility to resume after a pause in July.

- Second, there has been good progress in terms of vaccines and treatments. Several vaccines have seen promising results and are in Phase 3 trials to see if they provide protection. Note though that mass deployment is unlikely till next year & they may not provide complete protection (more like a flu vaccine than a measles vaccine) and may have to be combined with treatments (of which there has also been positive developments with Remdesivir and a steroid).
- Third, easy monetary and fiscal policy is continuing to support economies, incomes and jobs in contrast to the situation when the first wave started in developed countries in late February. This is different to normal recessions where it takes longer for policy makers to swing into action.
- Fourth, the fall in the "safe haven" US dollar and rising commodity prices (with metal prices back to their pre-coronavirus levels) is a sign of global reflation and recovery.
- Fifth, a range of economic indicators have seen a Deep V rebound starting in China and then in developed countries, suggesting significant pent up demand and that people still want to spend. This is most evident in business conditions PMIs. While developed country PMIs were mixed in August (with Australia and Europe down, Japan flat and the US and UK up) they remain consistent with recovery and have enabled share markets to look through the June quarter slump in earnings (which itself has been less bad than feared). On balance we see a gradual economic recovery from here as some things take longer to return to normal.



Source: Bloomberg, AMP Capital

- Sixth, the plunge in interest rates and bond yields have increased the present value of shares, which explains why PE ratios are so high. So shares remain attractive despite lower earnings and dividends because the alternatives like bank deposit rates are even less attractive.



Source: RBA; Bloomberg, AMP Capital

- Finally, investors are still cautious which is positive from a contrarian perspective. Despite day traders piling into some stocks retail investor sentiment is soft & there has continued to be fund flows out of equities in the US into bonds.

Concluding comment

On balance the positives dominate in our view. Shares remain vulnerable to short-term setbacks given uncertainties around coronavirus, the speed of economic recovery, the US election and US/China tensions. But the positives should keep any pull back to being a correction and on a 6 to 12-month view shares are expected to see reasonable returns.

But will the US share market continue to outperform?

As evident in the first table, US shares have outperformed since the March low. They have also outperformed year to date with US shares up 5.2%, but Eurozone shares down 13%, Japanese shares down 3.1% & Australian shares down 8.5%. The strong outperformance by the US share market reflects its relatively low exposure to cyclical sectors (like manufacturing, materials & financials) that were hit hard by coronavirus and a greater exposure to growth sectors like IT and health that benefit from coronavirus and very low interest rates. As the global economy gradually recovers and interest rates bottom, this will benefit cyclical sectors relative to IT and health which have become expensive and this will likely see US shares underperform relative to non-US shares, including Australian shares.

In terms of the US election, a Trump victory would likely benefit US shares (tax hikes averted) but a Biden victory would benefit non-US shares (more harmonious foreign and trade relations).

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