PITCHER PARTNERS

Medium-term investment considerations

An exercise in conjunctions

Pitcher Partners Investment Services Pty Ltd

One of the unique benefits enjoyed by Pitcher Partners Investments Services is that we have access to experts across a range of specialities that now, more than ever, can help our clients to navigate a path through these unprecedented times.

In addition to the strong relationships we enjoy with fund managers, economists and investment strategists, we have interviewed partners from across our Melbourne firm to gain their expertise and insights, adding context and colour to the sometimes-narrow view of investment markets. In preparing this note we consider a range of topics that will have an impact on investment markets over the medium term.

The following touches on a range of pertinent considerations as we look to a world beyond the pandemic. We do hope that this note helps you develop your thoughts as you work with your adviser to set your medium-term investment plan.

Adam Stanley

Chris Gibson, CFA

Setting the scene

Home-schooling a seven-year-old has retaught me a thing or two. No investment outlook article would be complete without a liberal dose of: and, but, for, nor, or, so, and yet. Our starting position remains that the pandemic will impact markets and society for many years to come so we need to adjust our expectations accordingly. On the upside Australia, as the world's largest island nation, is well placed to maintain tight border controls allowing a staged re-opening of the domestic economy.

But we acknowledge that Australia is also highly integrated into a global market that is less well placed to return to a 'new normal'. And we must not forget that many Australian companies were already finding business conditions challenging prior to the pandemic and the devastating summer bushfires. In referring to a new normal we acknowledge it is likely many sectors will continue to be challenged even after current trade and movement restrictions are lifted, with lower total employment persisting for an extended period.

Clive Crook, a Bloomberg Columnist and former editor of The Economist rightly observed with typical English pragmatism, "A gentle reminder: COVID-19 is in fact happening – and the new risks it has introduced are large and notably skewed, as they say, to the downside".

Strap yourself in for a bumpy ride but please don't fret too much. The data is ugly, however, much of it is already 'out there' or expected over the horizon and as such, should already be factored into market expectations.

We are seeing some early steps to our new normal and investors, market analysts and CEOs, being the positive beasts that they are, are no doubt itching to break out the classic refrain of 'green shoots' just as soon as possible.

May 2020

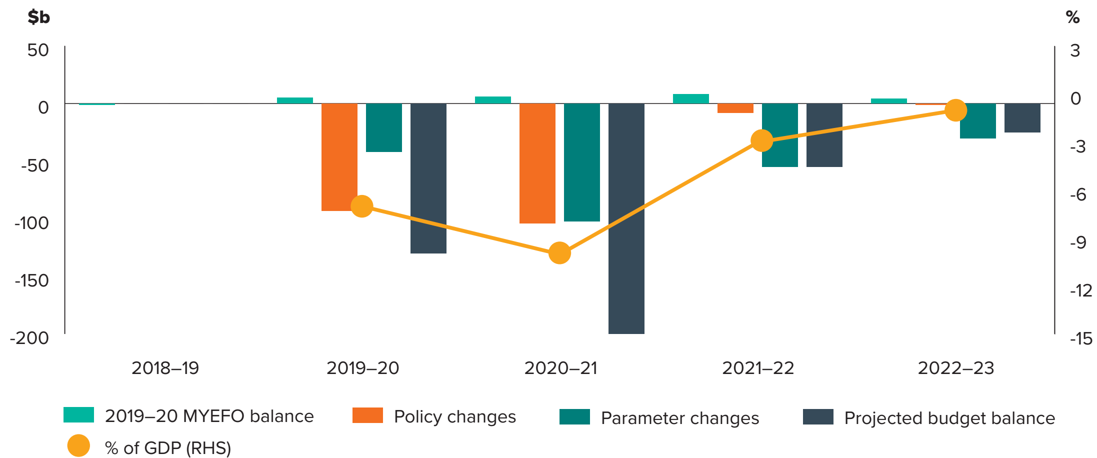
Pitcher Partners Investment Services Pty Ltd
ACN 052 941 036 ABN 24 052 941 036 AFSL 229887

> "With $320 billion, or 16.4 per cent of GDP in financial support, our focus is getting the country through the crisis."
>
> **JOSH FRYDENBERG,** TREASURER

Debt and deficit

Treasurer Josh Frydenberg has delayed the FY21 budget until October. On the 12th of May he provided an update on the state of the government's finances. The Treasurer stated, "With $320 billion, or 16.4 per cent of GDP in financial support, our focus is getting the country through the crisis."

Underlying cash budget balance projections



Source: Australian Treasury, AMP Capital

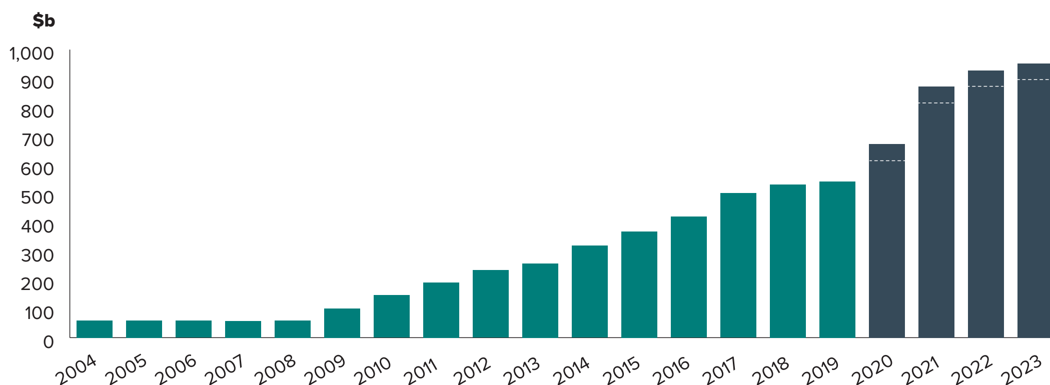
The budget will be hit hard by:

- increased government support for individuals and businesses (JobSeeker/JobKeeper – but see below);
- reduced company taxes;
- reduced personal income taxes; and
- many other factors.

Federal parliament has lifted the national debt ceiling to $800 billion for this year (total face value of government debt stood at $618 billion on May 8).

With gross Australian federal government debt likely to approach $1 trillion over the next few years it seems that the massive debt pile we have taken on – to offset the unprecedented shock of locking down an economy – will continue being paid off long after my seven-year-old joins the workforce.

Gross Australian government debt on issue



Source: Commonwealth of Australia (Australian Office of Financial Management), PPIS Research estimates

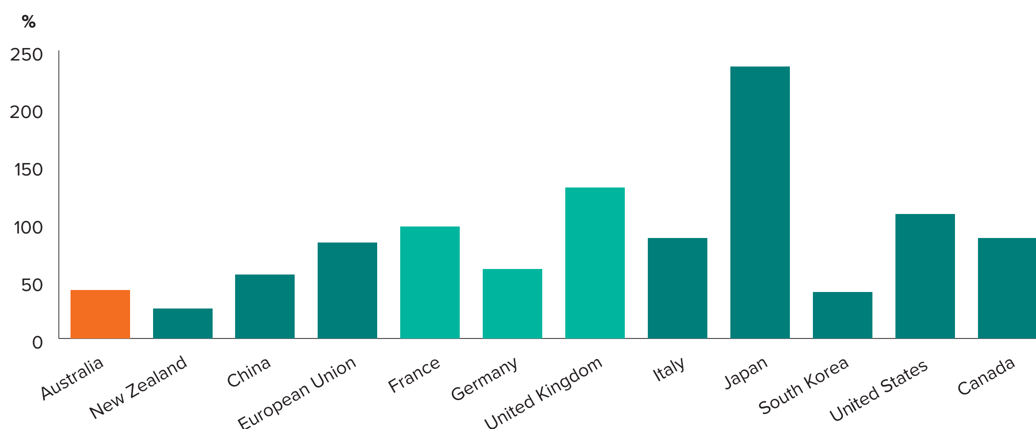
The $60 billion whoopsie! (It's a good thing)

On May 22, the Government acknowledged a $60 billion forecasting error in relation to its pandemic support. Many applications had been completed incorrectly (eg. noting the dollars sought in the 'number of employees affected' box). This reduction in the amount to be borrowed has been recast as a 'windfall' and is quickly being politicised. How this plays out is yet to be seen.

Similarly, state governments are rapidly instigating support and stimulus packages, which will greatly increase their debt for many years.

However, this is not a uniquely Australian challenge. Many governments around the world are running their largest budget deficits since World War II. Australia's starting debt to GDP position of sub-50% is much lower than many of our peers. This should provide a comparative advantage in terms of borrowing costs and ability to service principal and interest payments.

Gross debt as a % of GDP (2019)



Source: International Monetary Fund

"The Treasury can make up for people's lost wages, but people need the things wages buy. So replacing lost wages and revenues will not be enough for long: the economy has to produce goods and services."

HOWARD MARKS, US DEBT INVESTOR

Government support and stimulus

"The Treasury can make up for people's lost wages, but people need the things wages buy. So replacing lost wages and revenues will not be enough for long: the economy has to produce goods and services." US distressed debt investor Howard Marks, April 2020.

Governments at all levels are acutely aware that the billions of dollars in income support measures currently in place must remain a temporary solution. The most important step the governments can make will be allowing the re-opening of large swathes of the service and manufacturing sectors. This is beginning to occur but how effective it will be remains a key unknown.

Fidelity fund manager, Kate Howitt frames the issue well. Freezing something is supposed to keep it fresh, yet nothing is ever quite the same when it is taken out of the freezer. How will our defrosted economy behave? Early indications are that consumers largely continue to limit their spending after a short-lived 'relief rally', as economic reality sets in and employment conditions take time to improve. This poses challenges for many economies, including our own, that are heavily skewed toward consumption.

With the aim of avoiding a soggy mess, state governments have begun embarking on additional infrastructure programs to prop up activity, particularly in construction.

Partner in Pitcher Partners' Consulting practice, Matthew Wilson highlights that, "Here in Victoria, Premier Daniel Andrews has announced a $2.8 billion building blitz, with $1.2 billion targeted at schools. With both metropolitan and regional areas being a focus through an additional student capacity of 21,000, this helps to support population growth which is essential to a strong future economic environment"

We expect substantial government support of the economy will continue for some time.

> “The proven path for paying back debt is not through higher taxes, which curtails aspiration and investment, but by growing the economy through productivity enhancing reforms.”
>
> **JOSH FRYDENBERG,** TREASURER

Taxes

“The proven path for paying back debt is not through higher taxes, which curtails aspiration and investment, but by growing the economy through productivity enhancing reforms.” Josh Frydenberg, Treasurer, 8 May 2020.

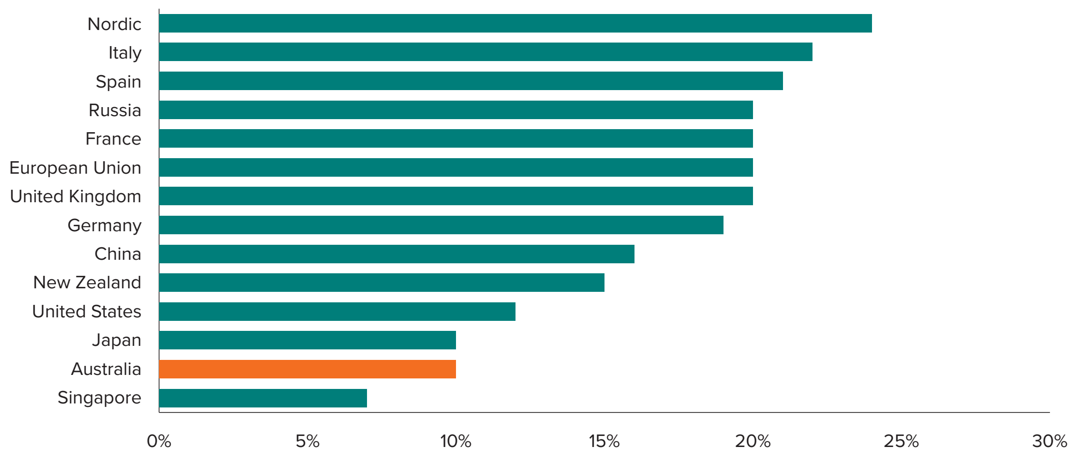
Raising taxes in the short term would be a further handbrake on economic activity and we expect will be studiously avoided.

But as fund manager Ray Dalio points out: There isn't any acknowledging that the government doesn’t have this money that it is giving out, that the government is just us collectively rather than some rich entity, and that someone has to pay for this.

Australian government deficits on the scale now forecast will need to be funded and ultimately repaid. Australia already has relatively high income and corporate tax rates compared to other developed countries. Increased direct taxation cannot be ruled out but is unlikely.

Might this be a chance for the federal and state governments to come together to review (increase) the GST? This might be more politically palatable as it is a progressive tax and should impact higher income (spending) households more than lower income households.

VAT/GST indicative standard rate



Source: PPIS Research; Government websites

On the ground, we suspect that Scott Morrison and Josh Frydenberg will be feeling a lot like Principal Skinner over the coming months as every lobby group in the country does their best Edna Krabappel impersonation, attempting to draw public support and government funding for their industry.

"The pandemic [...] is impacting whole economies. It isn't a financial crisis at this point but a brutal assault on real economies."

STEPHEN BARTHOLOMEUSZ, FAIRFAX COLUMNIST

GDP

Fairfax Columnist Stephen Bartholomeusz paints a bleak picture of the impending hit to global GDP. "The pandemic [...] is impacting whole economies. It isn't a financial crisis at this point but a brutal assault on real economies. Businesses large and small and households are being smashed by the lockdowns – large slabs of the economy have lost their cash flows and incomes – and, despite massive relief packages from governments, many of them will never recover."

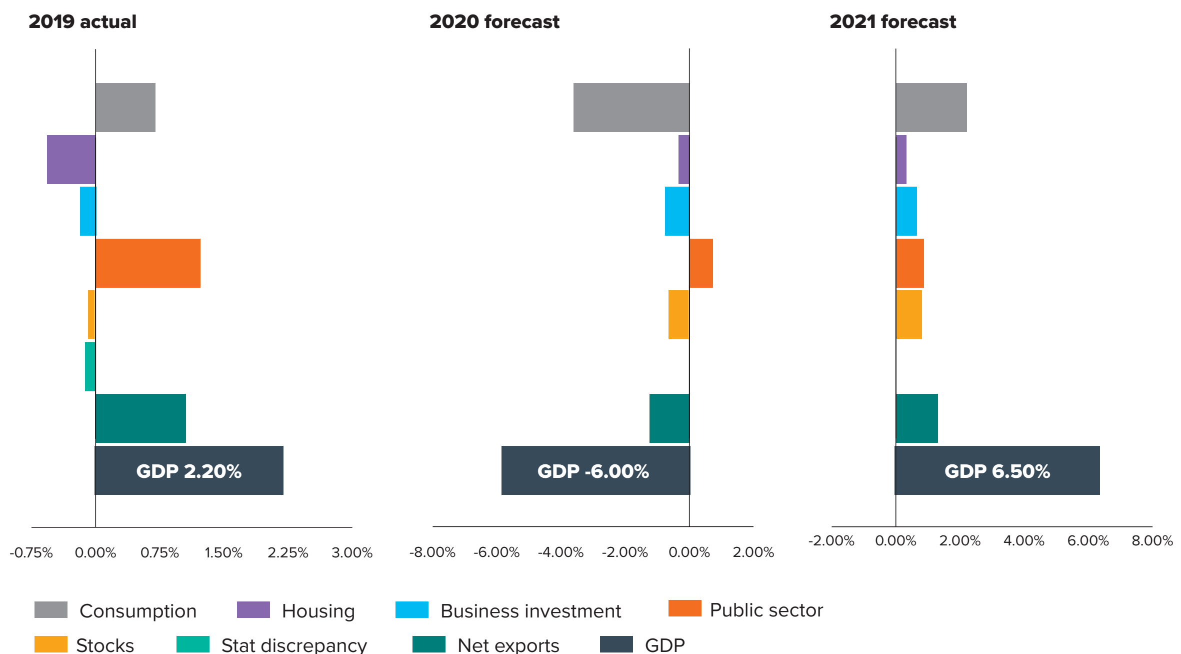
Australia

Australia's world record run of economic growth will almost certainly come to an end this year. Estimates suggest the economy could shrink around -6% by Christmas. The longer people aren't working (be that through JobKeeper or JobSeeker), the more cautious they will be in their spending even when they return to work – potentially creating a downward economic spiral.

Asset manager Janus Henderson Investors has provided an estimate of the impact across key drivers of Australia's GDP

Lockdown triggers deep recession

Severe output losses in H1 as we navigate the lockdown phase

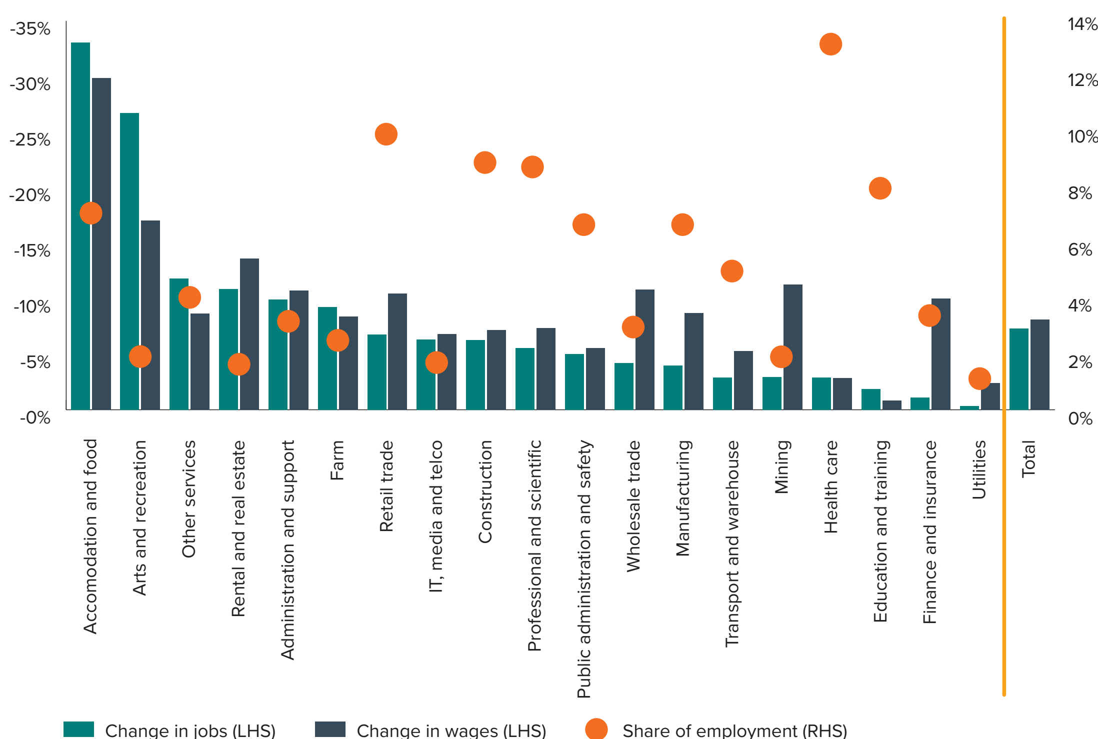


Source: Janus Henderson Investors, ABS, last actual December quarter 2019

The chart below, from fund manager Ophir Asset Management provides an estimate of the jobs lost by sector overlaid with that sector's share of the total workforce.

Job losses and share of total workforce by sector

% change (14 March to 4 April)



Source: Ophir (ABS, UBS)

Ophir's chart also provides an insight into the sectors of our economy that are likely finding business conditions particularly challenging. Once again, the government has implemented supportive measures to protect distressed businesses that should be viable but for the current trading and movement restrictions.

Partner in Pitcher Partners' Insolvency practice, Andrew Yeo, points to a range of temporary measures implemented to protect businesses. A number of amendments to the Corporations Act and the Bankruptcy Act, have protected businesses from being pursued under usual insolvent trading rules for a period of six months up to 25 September 2020, so long as the business is incurring debts in the usual course of business (and the insolvent trading isn't considered "egregious").

However, Andrew cautions, "Psychologically it helps, and has initially stemmed the flow of insolvencies. But mechanically it doesn't have as much protection as many directors think." The director's personal guarantee hasn't gone away and the ATO never forgets – they will be back to collect their outstanding money at some point.

Unfortunately, it appears that in many cases businesses have had a stay of execution, at best.

But as we regularly repeat. There is always an opportunity. James Beaumont is a Partner in Pitcher Partners' Corporate Finance practice. He works with large private businesses, as well as private equity investors. James says, "The bottom of the M&A market feels as though it has come and passed. Whilst April and the first half of May have been quiet for the majority of Dealmakers, renewed optimism following the lifting of restrictions appears to have buoyed corporates and investors – paving the way for increased deal activity in the second half of 2020. We anticipate a buyer's market in the short term as increased volatility and uncertainty is likely to lead to lower valuations."

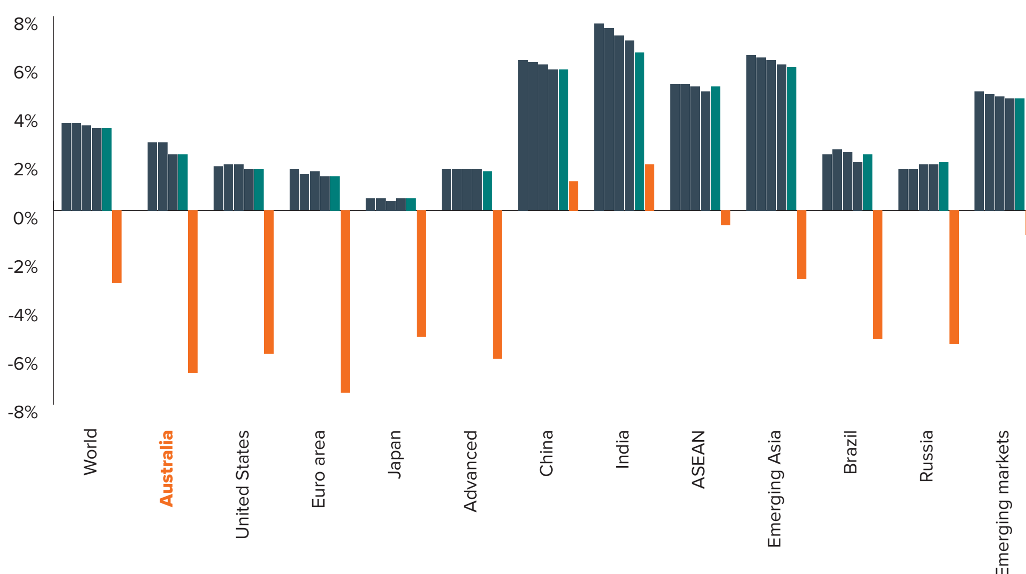
Global

Newspaper, The Economist, reports that global international trade could fall by 10% to 30% this year. Harvard Professors, Carmen Reinhart and Kenneth Rogoff (authors of 'This Time Is Different: Eight Centuries of Financial Folly) observed that up to the GFC, economies had taken an average of four years to regain the levels achieved prior to a recession. It took 10 years after the Great Depression. PIMCO is one of a chorus of global managers predicting that globalisation will be dialled back.

The International Monetary Fund (IMF) tracks the global economic outlook. As can be seen below, conditions had been softening in virtually all regions in the lead up to the pandemic. In its first attempt at quantifying the pandemic's economic impact in early April, the IMF estimated a global contraction of 3%, with developed economies to suffer much greater falls. The IMF has since indicated that its initial assessment is likely to prove too conservative.

International Monetary Fund 2020 GDP forecasts

(January 2019 to April 2020)



Source: International Monetary Fund

Interest rates and inflation

In the very near term, we are likely to see a period of deflation – i.e reduction in prices. Reflecting the steep increase in unemployment, we expect a large drop in demand for some goods and services such as fuel and rents. Retail sales fell ~16% in April, post an initial surge in March, which was driven by panic buying.

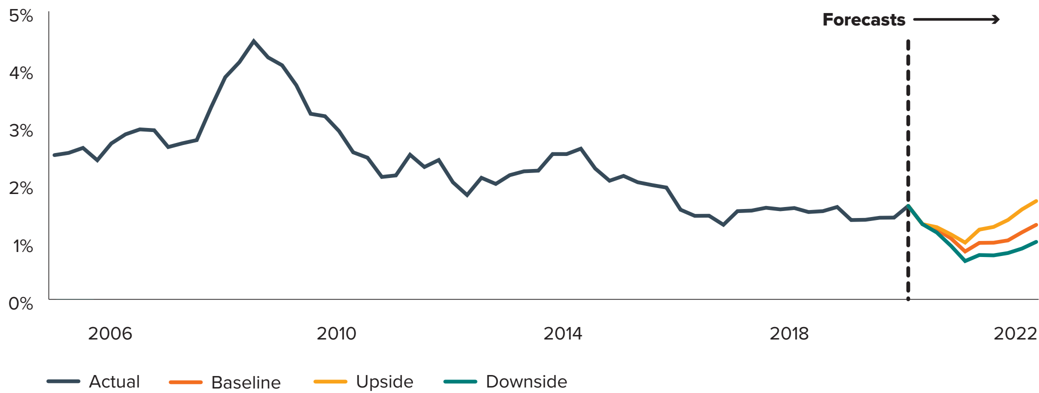
A selection of government policies will also lead to temporary reductions in pricing, including childcare, which has been made free until June. Though, it won't be all one way in the near term. There has been substantial disruption to supply chains limiting the delivery of many essential goods, which remain in high demand. Combined with a recent increase in the Australian dollar, this is likely to result in some upward pricing pressure on select goods/services.

Longer term, the sharp increase in money supply is expected to result in higher inflation. Any uptick (in aggregate) will likely be gradual, reflecting downward pressures in the form of wage freezes, subdued consumer demand and cost cutting measures from businesses. However, the sharp increase in money supply and ongoing stimulus programs should lead to a recovery in the coming years.

The RBA provided its forecast of inflation in its recent statement of monetary policy, according to its baseline, downside and upside scenarios for the economy.

Trimmed mean inflation

Forecast scenarios, year ended

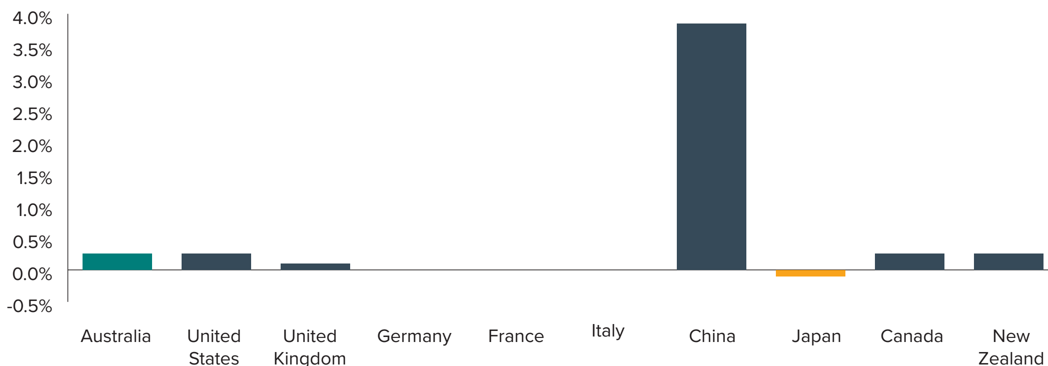


Source: ABS, RBA

Reflecting the depth of economic retrenchment, markets are of the view that interest rates are going to stay very low for a very long time. We have seen negative rates in mainland Europe for some time, with the current focus/debate centring around whether the Bank of England will adopt this policy stance, and also the U.S Federal Reserve refuting the market's view of a similar scenario in the U.S. The RBA has indicated current policy settings will remain in force for the foreseeable future.

This low, anchored interest rate setting will remain until such time as economies are demonstrating unassisted growth and are delivering a sustainable level of inflation closer to that of central banks' target ranges. Interest rates sit below 1.5% as far as the eye can see (excluding China)!

Official cash rate



Source: Trading Economics

Note: Germany, France and Italy have official cash rate targets of 0%

Property: Commercial demand and housing construction

Commercial

Countless column inches have been dedicated to predicting the end of the office as we know it. Working from home is currently the norm for many firms (including Pitcher Partners). Some of the big tech firms are stating they will keep staff at home until at least October.

Will working from home become part of our new normal? And if so, what will the demand for new and premium office space look like over the next decade and beyond?

Surely, executives must be tempted by the idea of reduced rent based on a smaller physical footprint. But how will this be balanced with retaining a singular company culture and the basic human desire for social interaction?

Housing

The housing market is currently working through a reasonable pipeline of new builds. However, we have seen an almost complete stop in new building approvals since March. This does not bode well for what is a very important industry as it is likely to start biting right around the time the Federal Government's support packages are due to be unwound.

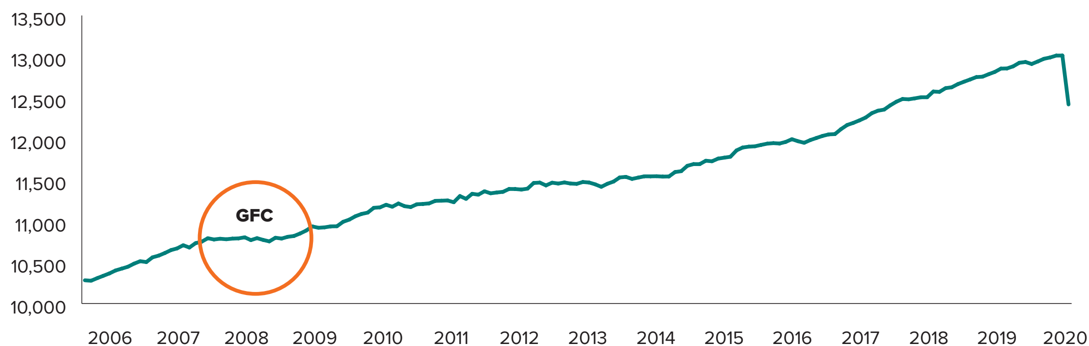
Michael Langhammer is a Partner in Pitcher Partner's Business Assurance & Advisory practice and has 20 years' experience working with the property industry. Langhammer believes the initial steps announced by the Victorian Government will provide some buffer, "We were very pleased to see the launch of the Victorian Government's Building Works package. The package will provide much needed stimulus and an increase in confidence for the middle market property industry across the state, at a time when the impacts of COVID-19 are hitting hard."

He went on to say that, "The package appears well targeted and we are pleased this announcement has been described as the "first part' of the Package. We are hopeful that future announcements will go further and pick up on a number of initiatives for which we have been advocating: stamp duty concessions for purchasers of new housing; reintroduction of off the plan stamp duty concessions for all classes of purchasers; infill medium density and urban housing renewal projects that could be supported by a state government affordable housing commitment; and expansion of first home buyer initiatives. A strong start. We look forward to further announcements."

Unemployment

There are now one million unemployed Australians, 30 million in the US and tens of millions more around the world. Chester Asset Management estimates around 27% of the Australian workforce is employed in trade (retail or wholesale), hospitality or other services (including travel, arts and entertainment). That's over 3 million jobs created through an economy with a high disposable income. This is not counting the 1.1 million employed in construction. The future of the Australian workforce, Chester suspects, looks structurally different in 2–3 years as disposable income structurally changes.

Total employed people (seasonally adjusted)



Source: Australian Bureau of Statistics

We will be watching the level of bankruptcies in the private sector over the coming year as this might see those workers currently temporarily stood down and unemployed move into long term unemployed.

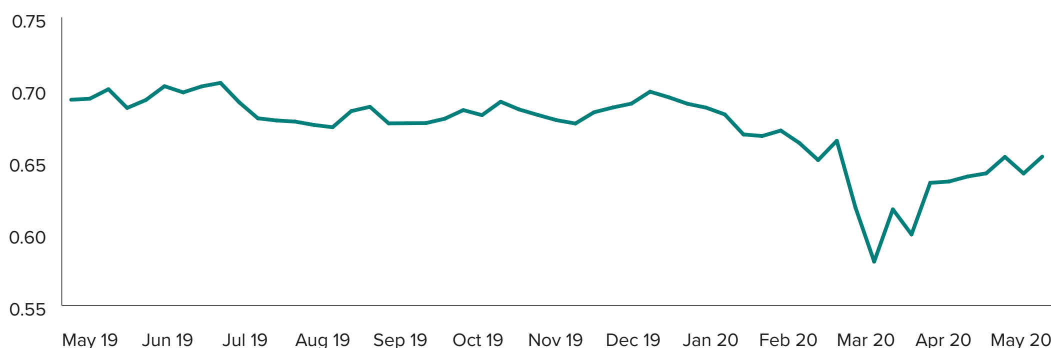
The JobSeeker package has ensured that the unemployment rate of Australia has not reached the high teens witnessed in the darkest recessionary periods of Australia's economic history. This package is temporary however and we believe that, at its scheduled end in September, further employment or income support is likely to be required for the economy to continue to rebuild.

Australian dollar

While every country is expanding its monetary base via quantitative easing (QE) programs to support large deficits, simplistically the direction of a currency is an outcome of supply and demand. Additionally, central banks and governments often seek a lower exchange rate as an easy tool to improve the relative value of the goods they can export. It also helps to support asset prices in that currency.

The logic is simple: the massive expansion of central bank balance sheets around the world must eventually dilute the value of their currencies – most importantly the US dollar – leading to inflation of hard assets (Bloomberg).

AUD/USD – can Australia win the currency devaluation war?



Source: IRESS

While economic theory is valid, how does this prevail when most major economies will be in the same boat? We also note this will be occurring at a time when trade disputes are increasing as well.

The USD has rallied in the face of economic uncertainty this year and reflecting the sheer weight of numbers, this may lead to a gradual upward bias to the AUD over the medium term as the global economy (and China in particular) recovers, with our large exposure to minerals, LNG and education exports.

> “Social distancing is impossible in a metal tube, be it an airplane or the London Underground.”
>
> **MICHAEL O'LEARY,** RYANAIR CEO

Transport needs

“Social distancing is impossible in a metal tube, be it an airplane or the London Underground.” RyanAir CEO Michael O’Leary.

New South Wales Premier Gladys Berejiklian has begun re-opening her state but at the same time, asked that no more commuters use public transport during peak hours.

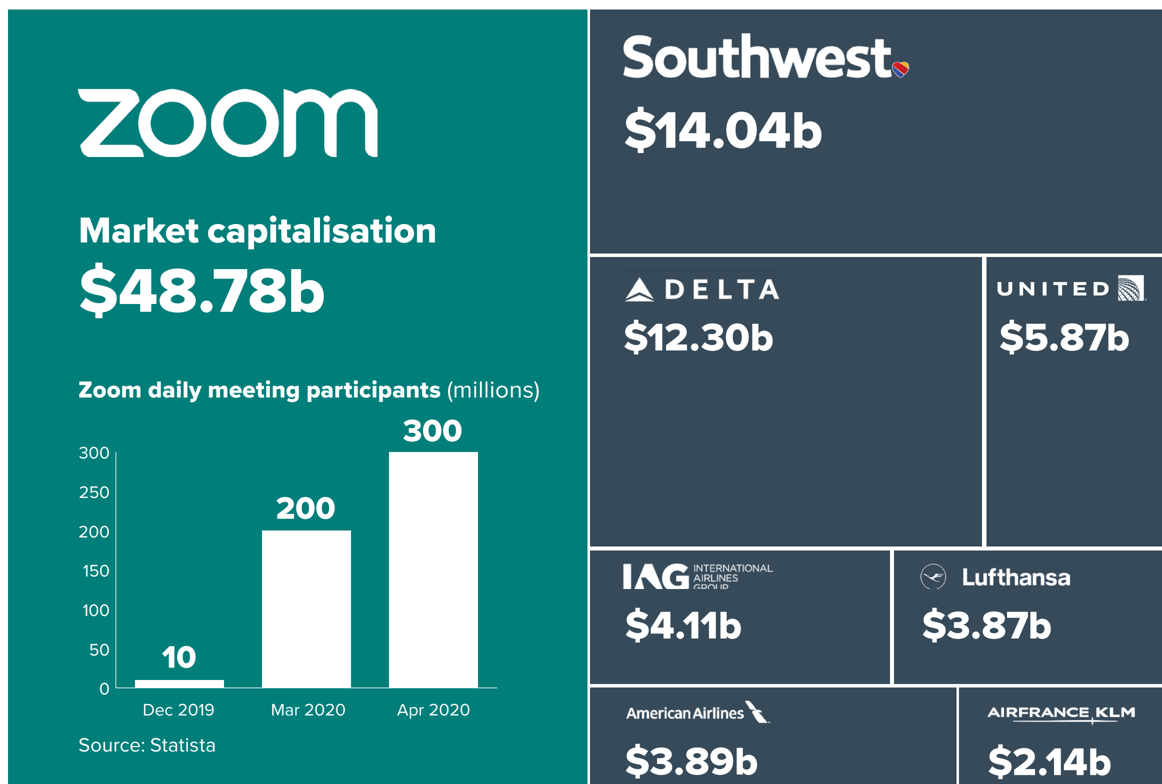
If we’re in the office less, do we need less trains, trams and buses? And how does this extend to the Melbourne-Sydney air route and international business travel?

Sydney Airport reported passengers were down 97% in April, a stat also recorded by London’s Heathrow. The Economist observes that the global airline industry is currently operating at a passenger level equivalent to 1978. Airbus has cut production by a third and Emirates is not expecting a recovery until 2022.

Virgin Australia has been an early casualty. We were also interested to see the comparison on the following page from Visual Capitalist, which highlights that video-conferencing service Zoom Communications now has a market capitalisation greater than the world’s seven largest publicly traded airlines combined.

Toll roads may be a net beneficiary, at least in the medium term. Offices that are re-opening are encouraging their staff to drive to avoid public transport.

Market capitalisation of Zoom Vs top airlines



Source: Visual Capitalist

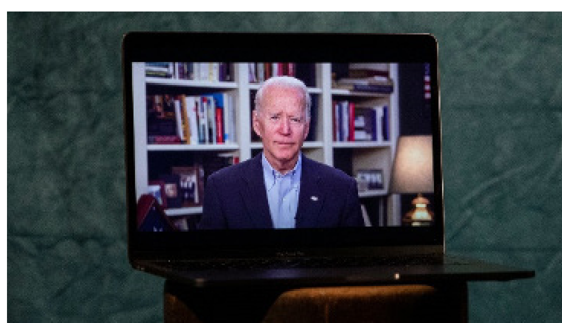
Total airlines $46.21b

U S A! U S A!

On the election

A couple of years ago we wrote on the likelihood of a second Trump White House and, frankly, that was looking quite likely up to February*. But history shows that sitting Presidents with low approval ratings struggle more in economic downturns (see presidents Ford, Carter and H W Bush).

Of course, there are more unknowns this time around. Trump retains a financial lead over presumptive Democrat nominee, Joe Biden. Biden retains a polling lead of 5–6 points. There are also the current optics of a president addressing the nation from his pulpit, while the alternative is campaigning via video-link from his re-purposed basement in Wilmington.



* **PPIS Qtly #83: Six more years of Trumpenomics?** A key part of being an investor is constantly reminding yourself to check the data, to remember that personal biases are a natural tendency that needs to be kept in check. We are in no way seeking to call an election outcome but to take a pragmatic look at the data. Only four Presidents elected since 1901 (out of 20) have failed to win a second term at the ballot box, though three of those four have been since 1977 ... In reality, whether the Trump Presidency has been an aberration will not be known until November 2020. The strength of the US economy at that time and the candidate put forward by the Democrats will have a large bearing on the result.

On the economy

The biggest cause of personal bankruptcy in America is an unexpected medical bill. A concerning statistic in a health-driven crisis. The nation has the most confirmed cases and deaths in the world.

The US is 65% of the MSCI index – what happens there matters for financial markets. JPMorgan says 90% of US companies are withdrawing their full year guidance as they release their latest quarterly earnings. They are also predicting that the coming recession could be twice as bad as 2009.

Californian fixed interest manager, PIMCO, highlights that the Federal Reserve has so far thrown US$3 trillion at the market and expects this will grow by another US$1–$1.5 trillion by the end of June.

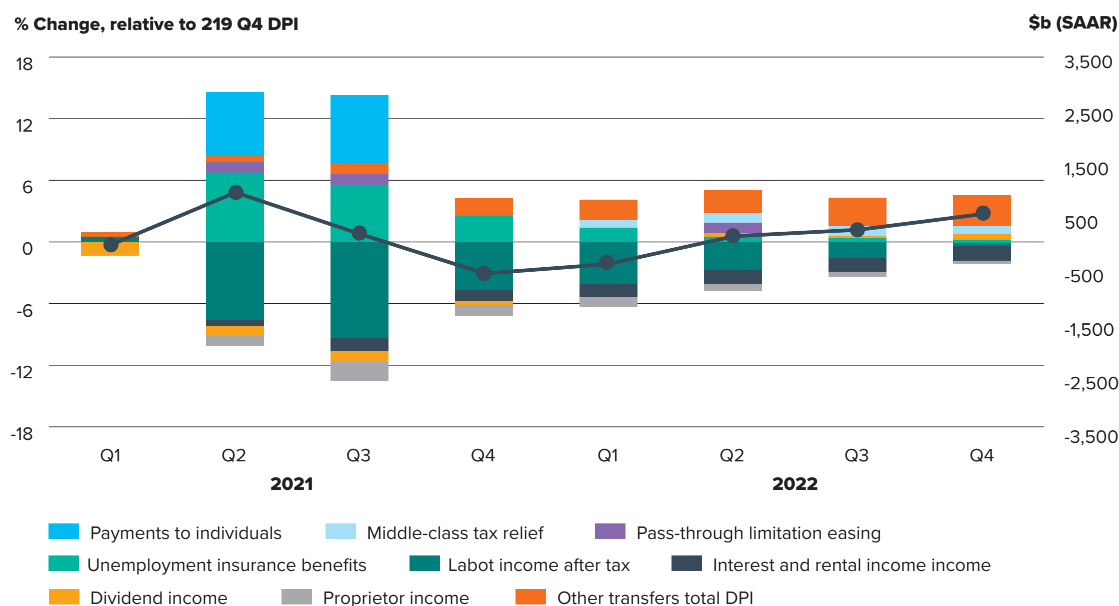
PIMCO also estimates the Fed will need to keep purchasing US$100–150 billion of corporate and government debt per month on-going to maintain those easy credit conditions.

The market is pricing in negative interest rates in the US in FY21 and 22. But this is a very low probability in PIMCO's view, with the Federal Reserve and its Chair, Jerome Powell, steadfast in the view that negative rates are off the agenda.

The government has also poured trillions of dollars into programs similar to those seen here in Australia aimed at keeping businesses afloat and people solvent. Global asset manager T Rowe Price points out that monetary stimulus announced to early May was four times that provided during the entirety of the GFC. The fiscal program was already twice what was provided during the GFC.

Private Equity House, Hamilton Lane, believes that the level of government support provided to individuals in America should fully offset the hit to income and employment through to September.

US total disposable personal income, GS forecast



Source: Hamilton Lane (Goldman Sachs)

Americans have demonstrated an ability to bounce back after crises. Will this time be the same?

Borders and migration

A large part of Australia's long track record of growth has been the consistent flow of migration to our shores.

The short-term impact of closed borders will see net migration fall well below the government's current cap of 160,000 per annum. Even with an assumed resumption of international travel in 2021, people's willingness to move continents might be diminished for an extended period. This would be detrimental to Australia's medium-term growth outlook.

On the flip side, our success in combating the virus might entice a new wave of migrants, supporting our future growth.

> "… we're experiencing unprecedented (or at least highly exceptional) developments in four areas: the pandemic, the economic contraction, the oil price collapse and the Fed/government response."
>
> **HOWARD MARKS,** DEBT INVESTOR

Conclusion

Distressed debt investor, Howard Marks, observed in a May 2020 memo to clients, "… we're experiencing unprecedented (or at least highly exceptional) developments in four areas: the pandemic, the economic contraction, the oil price collapse and the Fed/government response."

In an investment environment as tumultuous as the one we currently face almost every statement can be qualified with an: 'and' or a 'but', yet we press on in the knowledge that times will improve again (my son returned to school this week).

We spend a lot of time working with our clients to build portfolios that provide an appropriately targeted risk adjusted return, while also aiming to provide a cushioning effect against adverse volatility. A key tenet of our approach is a focus on appropriately diversifying your portfolio so that the financial pain felt in times such as these is minimised. While it will remain 'remote' for the foreseeable future, we look forward to continuing to work with you as we navigate our way through these unchartered waters. We'll meet again.

Kellie Davidson
Partner
p. +61 3 8610 5334
e. kellie.davidson@pitcher.com.au

Sue Dahn
Partner
p. +61 3 8610 5124
e. sue.dahn@pitcher.com.au

Adam Stanley
Partner
p. +61 3 8610 5517
e. adam.stanley@pitcher.com.au

Duncan Niven
Director of Research
p. +61 3 8612 9541
e. duncan.niven@pitcher.com.au

Disclaimer

This document has been prepared for the exclusive use and benefit of Pitcher Partners Investment Services Pty Ltd, our clients and our Authorised Subscribers. It must not be used or relied on by any other person, without our prior written consent. Information is sourced from third parties and Pitcher Partners believes it to be reliable at the date of publication, although we cannot guarantee accuracy and reliability, nor do we accept responsibility for errors and omissions. The information, including opinions, estimates and forecasts contained herein are as of the date of publication and are subject to change without notice. Pitcher Partners is under no obligation to correct any inaccuracy or update the information. Any financial product advice contained in this document is general advice only and does not take into account your objectives, financial situations or needs. If you wish to acquire a financial product, we recommend you seek advice from a Pitcher Partners Investment Services' representative, and where applicable, consider the relevant offer document prior to making any financial decision. Before acting on anything contained in this document, you should speak to your Pitcher Partners Investment Services' representative and consider the appropriateness of the information or general advice having regard to your objectives, financial situation, or needs. If you act on anything contained in this document without seeking personal advice you do so at your own risk. To the maximum extent permitted by law, neither we, nor any of our representatives, will be liable for any loss, damage, liability, or claim whatsoever suffered or incurred by you or any other person arising directly or indirectly out of the use or reliance on this information, or any changes made to this document without our prior written consent.

Pitcher Partners Investment Services Pty. Ltd. ABN 24 052 941 036 AFS LICENCE NO. 229887

Pitcher Partners is an association of independent firms. Liability limited by a scheme approved under Professional Standards Legislation. Pitcher Partners is a member of the global network of Baker Tilly International Limited, the members of which are separate and independent legal entities.

pitcher.com.au