

# Investment news

Pitcher Partners Investment Services Pty Ltd

## Kellie Davidson – Partner

The last time we wrote to you it appeared that COVID-19 infection rates may have been peaking as containment measures around the globe looked to be having the desired effect. The resulting economic impact was the great unknown and economists and strategists were scrambling to recast their projections for a recession or depression.

In financial markets, what may have been a small bounce to the end of March has become one of the fastest and steepest rebounds on record. Fast forward to today and containment measures have been eased in many regions and economies are recovering – in fact, many financial markets have fully recovered, and the Nasdaq has reached new all-time highs.

However, we are being reminded that there is no room for complacency. Victoria, like many regions globally, is seeing rising primary and secondary infection waves. Governments, including our own, will have to make some very big decisions around whether, or how, they will continue their massive stimulus and support packages, many of which are due to expire during this current quarter.

It would be remiss not to highlight that the end of this quarter marks the end of the 2020 financial year, which is commonly used as a major yardstick despite being a single point in time. Global equities were the top performer for the 12 months to June 30, led almost entirely by U.S. equities (technology and bio-tech stocks, the Nasdaq was up 33.4% in \$US terms) and to a lesser extent by Japan. Fixed-income markets were positive again, driven by unorthodox and highly accommodative monetary policy settings. Listed property markets and Australian equities were negative, reflecting lower growth and broader COVID-19 impacts going forward. On a multi-asset basis, growth orientated benchmarks underperformed the more conservative options.





## Investment market performance summary – 30 June 2020

Indices	Current	3 months	1 year
ASX 200	5,897.9	16.2%	-10.9%
ASX 200 (Acc)	64,892.9	16.5%	-7.7%
US S&P 500	3,100.3	20.0%	5.4%
Japan Nikkei	22,288.1	17.8%	4.8%
UK FTSE 100	6,169.7	8.8%	-16.9%
MSCI World	2,201.8	18.8%	1.1%
German Dax	12,310.9	23.9%	-0.7%
French CAC	4,936.0	12.3%	-10.9%
HK Hang Seng	24,427.2	3.5%	-14.4%
Shanghai Comp	2,984.7	8.5%	0.2%
ASX 200 Prop (Acc)	45,624.9	19.9%	-21.3%
Global Prop	2,300.0	8.6%	-17.6%
Australian Bonds	10,601.6	0.5%	4.2%
International Bonds	1,096.1	2.3%	5.2%
Commodities			
Gold (oz)	1,781.0	12.9%	26.3%
Oil (Barrel)	39.3	91.7%	-32.8%
Iron Ore (Tonne)	100.1	24.1%	-11.2%
Aluminium	1,619.5	6.1%	-10.0%
Copper	6,015.0	21.5%	0.4%
Lead	1,774.0	1.9%	-8.2%
CRB Index	138.0	13.3%	-23.8%
Currency			
AUD/USD	0.6903	12.6%	-1.7%
AUD/EUR	0.6145	10.5%	-0.4%
AUD/GBP	0.5567	12.7%	0.7%
AUD/JPY	74.5050	13.0%	-1.6%
AUD/RMB	4.8780	12.3%	1.3%

Source: Bloomberg.

July 2020

As you might expect, articles from the research team this quarter have a distinct COVID-19 flavour with content covering:

-  How economies are progressing in real-time,
-  How different industries are impacted and responding in the current environment,
-  A broader overview of fixed-income markets, and
-  The continued rise of online shopping.

Our Investment Strategy Committee meets next week to discuss and review our views on the major asset classes. We will share our latest thoughts and positioning with you in a separate communication after that meeting.

Lastly, we conclude this report with congratulations and a warm welcome to the Pitcher Partners partnership to David Bedford. David joined us in 2018 from JBWere and has consistently exhibited a high degree of professionalism, care and commitment to you our clients, and our business practice through his time here to date.

We hope you and your families are taking care through these tough times and look forward to speaking with you all in the coming months.

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## ***Confidence versus COVID: Where do things stand currently?***

### **Duncan Niven – Director of Research**

With equity markets pricing in a relatively smooth and swift recovery across many countries, the story is less linear when looking at the fundamentals – especially from both a macro and health perspective.

While economies are recovering, the recently imposed stage 3 restrictions within metropolitan Melbourne and Mitchell Shire, coupled with rising infection and fatality rates in some areas of emerging markets and several southern states in the US, highlight that any recovery can be fragile and is likely to remain so in the absence of a vaccine.

The magnitude and speed of the impacts of COVID-19 that hit earlier this year haven't been seen across markets and economies in several decades. Adding to the challenge is the ability to monitor these impacts effectively to determine the timing of a potential rebound. The usual monthly and quarterly economic data releases, such as inflation or GDP, are lagging indicators. By the time these data points are released, while useful as a milestone, it's not providing a real-time reflection of the current macro environment.

For example, why do we need to wait for the Australian Q2 2020 data release to be published in September for us to realise and react to the fact we are in a recession here in Australia? Fortunately, advancements in technology have provided an array of high-frequency data sources – payroll numbers, jobless claims, traffic volumes, online restaurant bookings, search engine results and consumer purchasing habits amongst others – that, whilst perhaps micro in nature, are helping to paint a more accurate real-time picture of how consumers and businesses around the world are behaving and reacting in this environment.

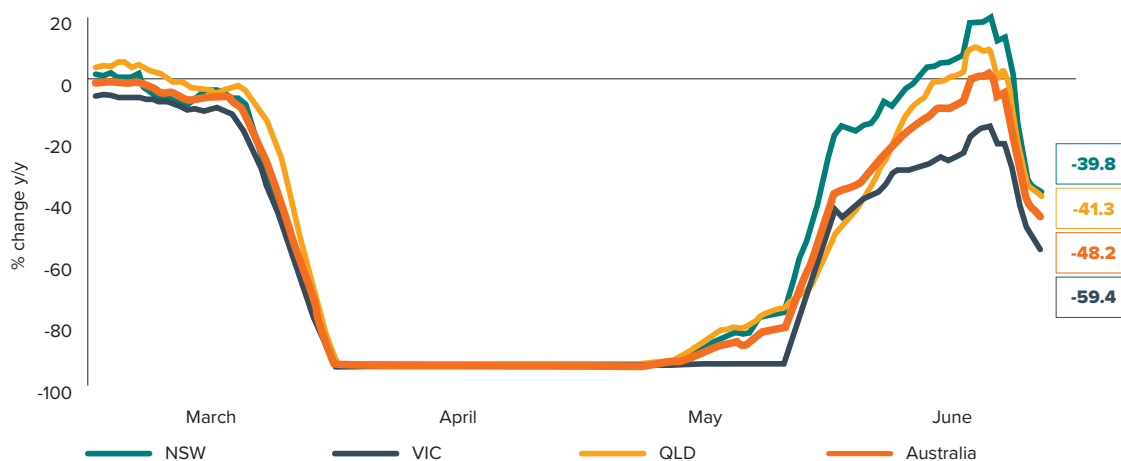
High-frequency data sources can provide us confidence and evidence that policy measures and other factors are making an impact and economic recovery is occurring. It can also highlight the sectors or communities that may be suffering from medium- or longer-term effects, such as areas with a large tourism or education sector.

Within the rest of this note, we provide some commentary on how Australia is faring and how the recent lockdown within areas of Victoria might impact the country's recovery. We also provide some information around how China (political challenges aside), and the US are going, where secondary infection waves are at worrying levels across several states, increasing the likelihood of increased restrictions and a broader lockdown.

## Australia

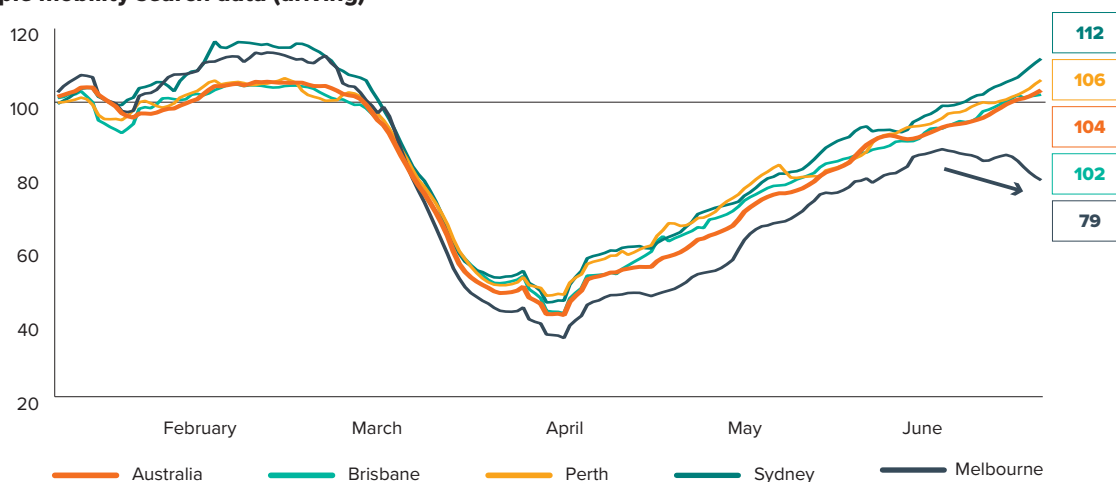
Until the recent spike in COVID-19 infections across Melbourne, Q3 2020 GDP was looking like it could surprise and exceed the market's expectations. Retail sales had surged (perhaps some pent-up demand), traffic levels had increased, mobility measures had lifted and online restaurant bookings had increased.

### Restaurant bookings – OpenTable\*



Source: NAB, OpenTable \* Smoothed using weekly moving average

### Apple mobility search data (driving)\*



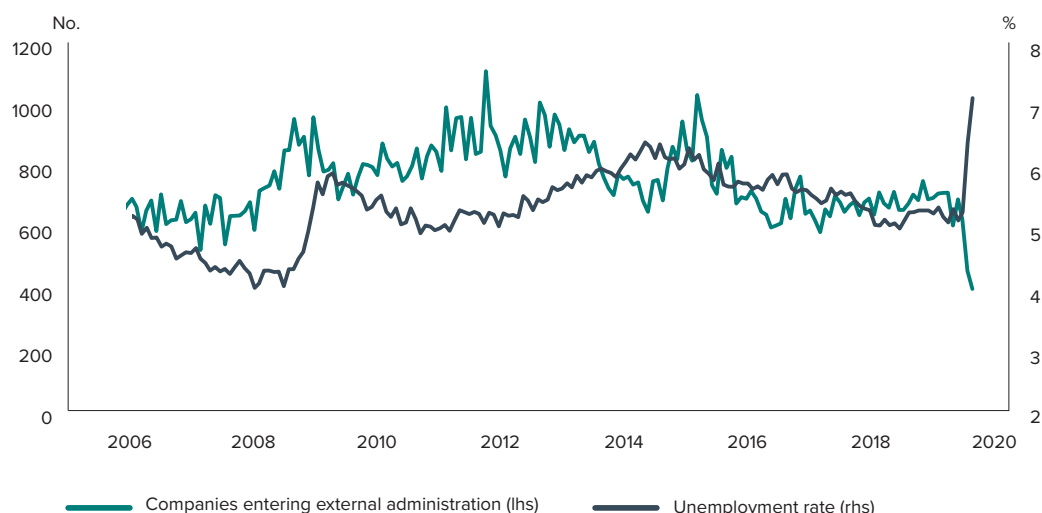
Source: NAB, OpenTable \* Smoothed using weekly moving average

The lockdown in metropolitan Melbourne and Mitchell Shire hopefully won't destabilise the broader economy but it will impact the numbers. Across Victoria, around 5.1 million people are under stage 3 restrictions (20% of the national population). The state also contributes just under a quarter of Australia's total GDP. This proportion of GDP may lower over the next six to 12 months if other states are successful at maintaining zero or low infection rates, relax restrictions further, and, as a result, see a strong recovery in their respective economies. There will, however, be some indirect spill over effects.

Economists are forecasting that Victoria will shave 1.1% from Q3 GDP and 0.3% from annual GDP growth. Reflecting this hit to the economy, we are likely to see some form of policy response from the Government. Many small to medium-sized businesses and workers will be facing another extremely challenging period, with business and consumer confidence possibly taking a long time to recover from this second wave of infections.

There is already a heightened focus on how the JobKeeper and JobSeeker programs will be managed, given the current high degree of reliance on this form of fiscal support. Treasurer Josh Frydenberg has already hinted at bringing forward personal income tax rate cuts and that there will be further income support measures after the end of Q3 – although payments are likely to be lower than the current support payments (current JobSeeker payments are close to minimum wage levels per fortnight). We also note that banks and some other lenders have announced they will extend repayment deferrals for affected individuals.

Whilst this level of co-ordinated public and private support has been adept in supporting many people and businesses through this time; we note that sadly, it's inevitable that some businesses won't survive into next year. With companies entering administration down 40% from this time last year as businesses and employees receive unprecedented support, it indicates that we may not be seeing the full effects of COVID-19 on business solvency, yet.



Source: ABS, ASIC, Morgan Stanley Research

Lastly, in terms of a comment around COVID-19, Australia's case numbers remain very low relative to other developed countries, and we maintain ample capacity around health care facilities. Using our recent history as a guide, we hope to see case numbers under control within the next one to two weeks – we remain wary of how cases unfold in NSW. Containment measures are very painful for many people and organisations, but necessary. To put the recent spike in cases across Victoria into perspective, consider the state of Florida. It has a similar population to Australia, and it was generating a daily caseload of around 200 in late-March – the same level which Victoria is near, but across a much smaller population. Fast forward to today, and Florida's total caseload is now over 240k, and there have been over 2.5k deaths.

## USA

Over the last few weeks, the COVID-19 situation in the US has worsened to the point where the country is now a notable outlier among advanced economies, performing poorly on most key measures, including:

- New cases growing rapidly
- The prevalence of COVID-19 symptoms rising
- The estimated effective reproductive number ( $R_t$ ) stands at 1.10 nationally, meaning that case growth is accelerating
- The positive test rate is well above 10% in some states, and available hospital capacity is diminishing.

President Donald Trump continues to favour re-opening the economy ahead of any broad victory over COVID-19. The situation is particularly evident for many southern states which, as the table below indicates, shows the weakest quartile of US states across a variety of COVID-19 issues metrics. The worst affected states are the ones that have not successfully implemented any of the measures recommended by the Centers for Disease Control and Prevention (CDC).

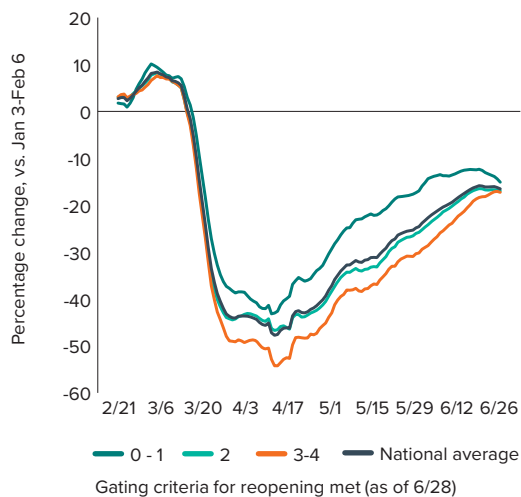
Category	Symptoms		Cases			Testing			Hospitalization					Fatalities		Number of gating criteria met
	Doctor visits for COVID-like illness (CLI)		New identified cases per million		Rt - reproductive number	Positive test rate	Change in + test rate, pp (14 day)	Change in test volume	Hospital ICU capacity available (%)	Total Hospital capacity available (%)	Hospitalized for Covid-19 (per mn)	Growth in hospitalizations (14-day)	Covid-19 patient share of hospital capacity	Fatalities per million per day	Change in fatalities (14-day)	
Gating Criteria	Declining over 14 days		Declining over 14 days			10%			> 30%							0-4
Units	%	14-day chg (pp)	Cases per mn	14-day chg	Ratio	%	14-day chg (pp)	14-day chg (%)	%	%	#	14-day chg (%)	%	#	14-day chg (%)	Score
Florida	11.2	+5.5pp	429	+255	1.17	19.2%	+4.3pp	58%	30%	27%	N/A	N/A	15%	2.2	29%	0
Arizona	10.7	+5.2pp	478	+102	1.10	27.1%	+3.9pp	11%	20%	23%	470	+39%	24%	4.6	9%	0
Georgia	7.1	+3.5pp	263	+138	1.12	13.9%	+1.5pp	50%	19%	30%	209	+95%	13%	1.3	-23%	0
South Carolina	9.5	+4.6pp	303	+101	1.06	17.5%	-6.7pp	31%	26%	26%	273	+59%	13%	3.3	79%	0
Texas	11.9	+4.3pp	258	+108	1.15	16.6%	+3.6pp	41%	30%	31%	331	+103%	16%	1.8	106%	0
Nevada	5.1	+3.4pp	240	+124	1.12	12.2%	+1.8pp	73%	22%	23%	284	+88%	13%	1.9	100%	0
Alabama	5.8	+1.0pp	233	+94	1.08	15.4%	+4.6pp	24%	17%	26%	226	+60%	10%	2.5	-15%	0
Tennessee	6.3	+2.8pp	222	+116	1.05	8.1%	+0.1pp	67%	25%	35%	170	+57%	5%	1.6	31%	1
Kansas	6.0	+4.3pp	123	+60	1.18	10.6%	+3.9pp	23%	51%	54%	N/A	N/A	3%	0.6	-8%	1
Arkansas	8.0	+3.1pp	191	+13	0.97	7.8%	+0.2pp	-36%	30%	41%	119	+26%	7%	1.3	-35%	1
Delaware	3.3	+1.7pp	139	+74	1.26	6.6%	+2.5pp	79%	35%	28%	59	-39%	3%	0.9	-92%	1
Idaho	1.2	+0.3pp	206	+145	1.31	12.9%	+5.1pp	71%	51%	50%	28	+22%	3%	0.5	N/A	1

Source: Goldman Sachs Global Investment Research

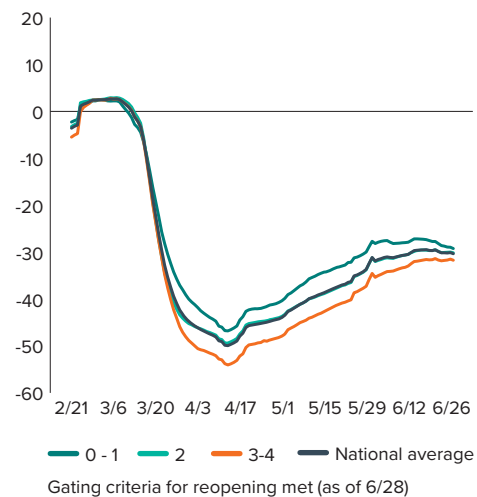
The US economy is recovering, though. Traditional economic data releases such as jobless claims, whilst elevated, are declining, while high-frequency data shows mobility returning to communities. The pace of this recovery, however, is essentially beginning to flatten. The public health issues have driven a slowing in some of the mobility charts, as indicated below (with states categorised by those meeting different levels of the CDC gating criteria for reopening). Other anecdotal data we have seen recently is that New York transport demand is about 50% lower than pre-outbreak levels. Further, outdoor dining within New York has fallen 95% compared to this time last year, according to restaurant booking platform, OpenTable.

### Activity Declined in States with the Worst Virus Outbreaks in Late June and Stalled in Others

Google Mobility Index: Retail/Recreation



Google Mobility Index: Workplace



Google LLC "Google Covid-19 Community Mobility Reports" <https://www.google.com/covid19/mobility/> Accessed: 6/30/2020

Source: Google, Goldman Sachs Global Investment Research

Can the US economy continue to recover without a full-scale lockdown? We feel the risks are rising, but the answer is not definitive, yet.

First, policy and behavioural changes offer opportunities for controlling the virus at a lower economic cost than a broader lockdown. Some policies that have been re-instated include, restricting bars, cafes and restaurants to take-away only, while many other indoor activities are restricted. These policies are showing up in the recent declines in mobility, indicated in the mobility index data. Other recent changes include mask usage, which has lifted substantially within many areas of the 'Sun Belt states'. Time will tell if these changes drive down infection rates.

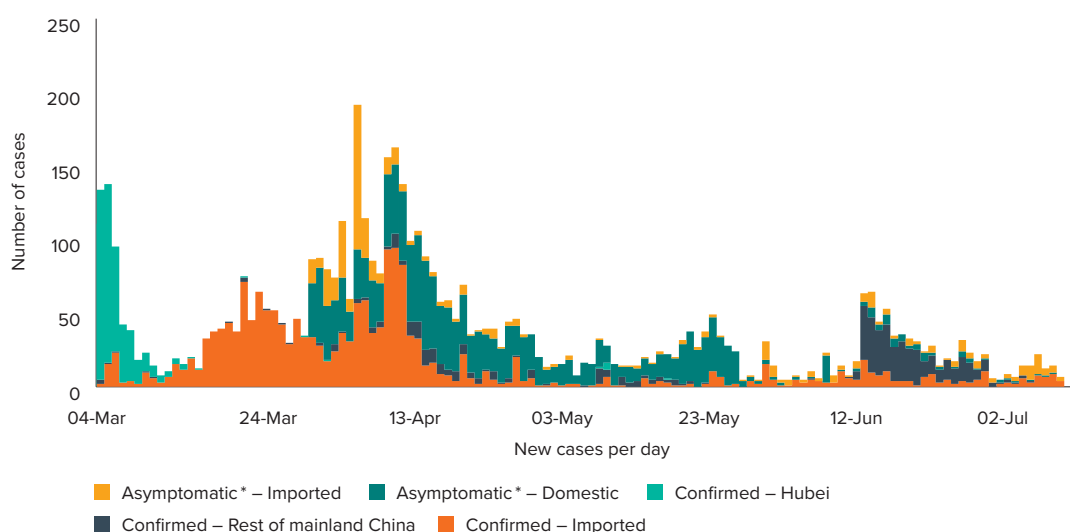
Second, several states such as Colorado, Indiana, and Minnesota reopened relatively early with a rising number of new cases, yet managed to control the spread of the virus. Admittedly, state-by-state comparisons are dependent on a variety of factors, including those that are political and human, but it can be done.

Third, the sheer appetite for broad lockdowns appears significantly lower than in March and April, and states will continue to try less disruptive but potentially effective policies. Many municipalities are going to face a severe funding crisis into next year and are likely to be compelled to do what they can to avoid a full lockdown. While confirmed new cases have reached new highs, the effective reproduction rate, hospitalisations, and fatalities are below the levels seen earlier. In recent weeks, however, it's looked like these levels may be tested. Nevertheless, large risks remain, and further lockdowns cannot be ruled out, especially in areas where hospital ICU capacity levels are reaching dangerous lows.

Currently, the 'street' view in the US has been to push back the timing and quantum of the economic recovery, downgrading Q3 expectations modestly and deferring that into 2021. Out of the major economies battling this virus, we believe the US represents the greatest threat in terms of economic and financial risk to client portfolios at this time, especially when we consider how quickly equity markets have recovered to date, with the Nasdaq recently reaching its all-time high.

## China

Given it was impacted earlier than many other countries, and setting aside its political challenges, China has led the way in terms of navigating its way through the different stages of infection and economic recovery. China has continued to see some sporadic outbreaks of COVID-19 within some rural areas and Beijing, the Government has been quick to lockdown those centres as the infections occur. In recent days, at the time of writing this report, no new cases have been reported.



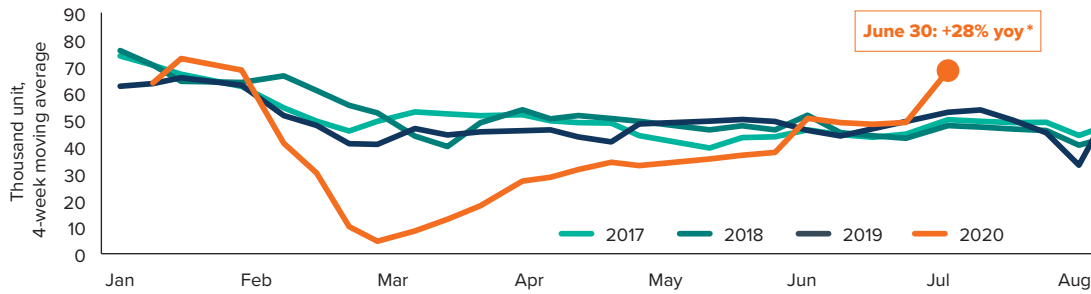
\*Asymptomatic cases are excluded from confirmed cases in China; NHC started the daily release of domestic and imported asymptomatic cases on Apr 1

Source: CEIC, NHC

From an economic perspective, activity is clearly picking up across traditional and high-frequency data, however it is still behind 2019 levels. Car sales, property sales (still seasonal) and traffic congestion are demonstrating things are getting back to normal in China, but dining levels (including takeaway) and airline capacity are, as expected, considerably low. If we extrapolate those trends here in Australia, we still have a long road to recovery ahead of us.

**Passenger car sales increased in end June**

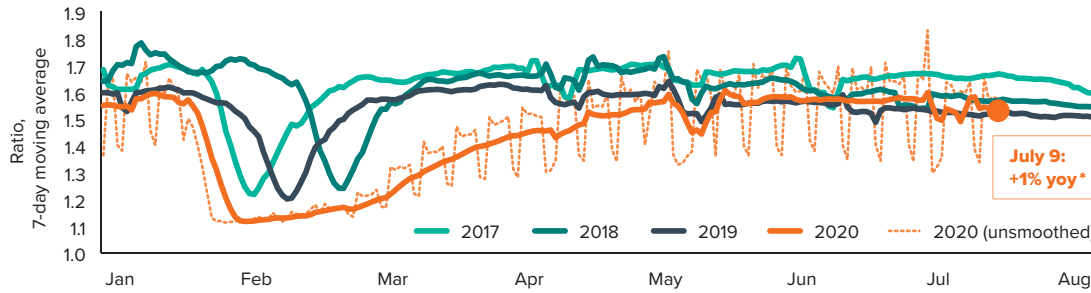
**Daily passenger car retail sales volume**



Source: Wind \* Percentage change relative to 2019

**Intra-city traffic congestion remained close to 2019 levels**

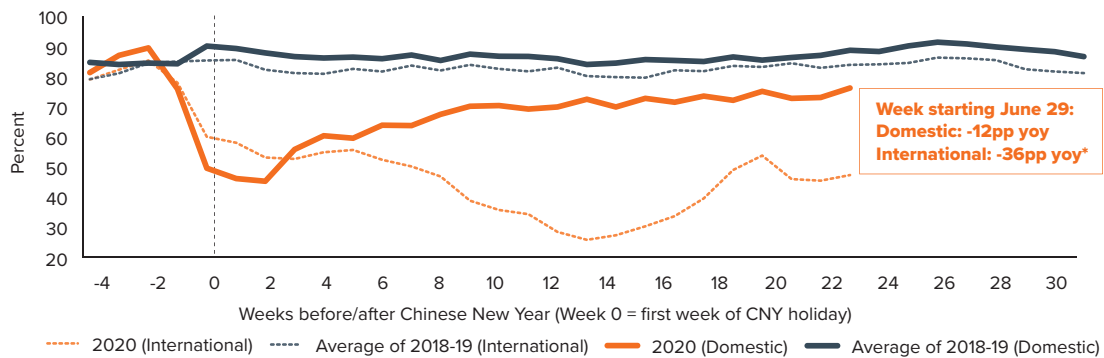
**Traffic congestion index in major cities in China<sup>^</sup>** (ratio of actual travel time to 'free flow' travel time, higher = more congested)



Source: Wind \* Percentage change relative to 2019 ^ Population weighted; covering 100 major cities in China

**Airline capacity utilisation still remains well below normal levels**

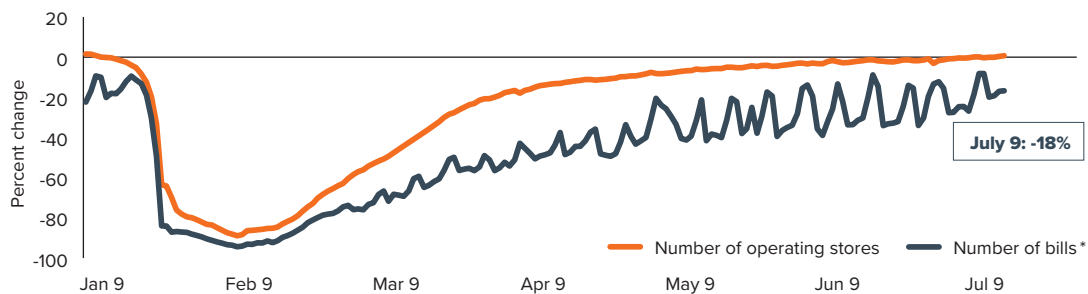
**Airline passenger load factor**



Source: Travelsky \* Percentage change in load factors relative to the same week after CNY in 2018-19

**The number of dining bills (including takeout) has been around 9–21% below the pre-outbreak level over the past week**

**Change in restaurant activity relative to Jan 1, 2020**



Source: Hualala \* Including takeout bills

In aggregate, we are in a delicately position globally. While economies are recovering, secondary outbreaks of the virus are occurring as containment measures are getting eased. We are now witnessing how the differing attitudes, culture and public policy approaches around the world will fare toward dealing with COVID-19, its impact on lives and the ongoing economic cost. These impacts will become more distinct over the coming days and weeks.

# Looking past the COVID-19 experience

## **Alastair Francis – Senior Investment Analyst**

As our daily lives transform back to some sense of normality, investors have begun to consider the broader ramifications of the COVID-19 pandemic on the economy, industries and businesses.

For many, the enforced change led to a far quicker and smoother transition (mostly) to a new regime than what may have been orchestrated by a more planned, prolonged and painful restructure. So, with the dramatic changes, which government policies, industry structures, corporate workflows and consumer behaviour will remain the same?

The recent PPIS note by Chris Gibson – *Medium-term investment considerations. An exercise in conjunctions* – spoke to the more macro-economic ramifications for Australia.

In this note we look to explore more of the changes at an industry or company level that are worthy of consideration in any investment thesis.

For consumers, the fallout from the COVID-19 pandemic will lead to many structural changes that will have a number of enduring impacts. Sadly, the job that many people held previously may no longer exist whether it has been due to the demise of an unsustainable business model (e.g. certain tourism-related offerings) or an enterprise barely surviving but for the JobKeeper stimulus package (e.g. some niche retailers), which is due to end in September.

The hit to consumer's disposable incomes and potentially rising levels of indebtedness may lead to increased levels of bad and doubtful debts for many businesses in the short term. Over time however, the extended financing arrangements offered to borrowers in order to survive can translate positively into larger loan books for the banks.

For many, there is no denying that previous spending habits will be compromised with discretionary consumption expected to take a hit as lifestyles are adjusted, for example, the lasting impact on the new car industry or the hospitality and leisure space.

For businesses that have had a near-death experience, balance sheets may be restructured for long term stability by holding higher levels of liquidity (cash or undrawn banking facilities) or inventories (reducing international supply chain risks) and manufacturing enterprises might consider shifting their operations back home for similar reasons.

Given the staggered progression of the pandemic globally, many enterprises may seek greater levels of diversification within customer and supplier bases, i.e. less reliance on China, and business practices might be re-aligned to accommodate more efficient workflows. As an example, we view face-to-face introductions in building new relationships as key, however a lot of 'business as usual' travel may revert to more regular online engagement. This may see changes to airlines and airport operations (though we expect overall passenger numbers to return to prior levels in time).

For those businesses that relied on rented premises, the community lockdown forced tenants and landlords to the negotiating table as both parties arranged a hastily restructured rental agreement. In the shopping malls and retail strips of the capital cities, the enduring impact will be a loss of tenants (e.g. Target) and reduced demand for space with reformatted floorplates (e.g. department stores). As landlords adjust rent structures, some commercial property valuations are expected to fall.

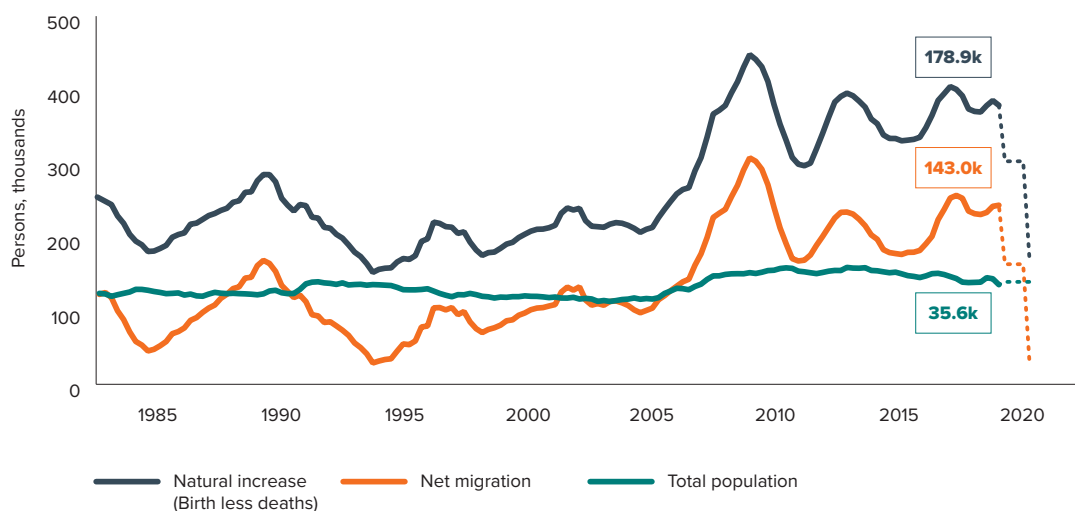


For many employers, the value of the online world was never more apparent than when they discovered staff could work effectively from home for an extended period. In the future, regular long commutes for staff may not be required as employers are happy to accommodate productive staff members with the option of working from home, thereby reducing the need for CBD office space. These arrangements would be a win-win that expands the world of choice for both parties.

Perhaps another positive longer-term trend will be families looking outside the traditional suburbs, increasing demand into regional areas as many attempt to escape the more congested city precincts (a sea or tree change for some). But this may be a win-win-loss from a CBD landlords' perspective.

One of the pleasing outcomes for all Australians was the resilience of the NBN during the crisis as it was truly tested in a manner that no one likely envisaged. From the workday being structured around one of the many forms of video conferencing apps, to the online classrooms, through to the streamed respite for many at day's end (likely with multiple devices within the one home), we have heard very few complaints around reliability. Increased broadband and data capabilities will likely benefit all telecommunications companies.

Although somewhat at a macro level, the deeper implications around population growth going forward has important ramifications for the more domestically focussed industries, e.g. residential development and infrastructure spending. Historically, Australia's GDP growth would not have been as strong without the elevated levels of net migration.



\* Forecasts derived from the government's comments on net migration

Source: Australian Bureau of Statistics, National Australia Bank



### **Population growth – rolling 4 quarter sum\***

Given the success that Australia has had in managing the pandemic, this can only enhance its reputation as an attractive place for immigrants and for foreign students at a tertiary level. However, in the near term the outcome will be determined by the timing of the opening of our international borders, political resolutions and the level of local unemployment.

The healthcare space is another good example of where the onset of the pandemic has forced change not only on the hospital industry i.e. increased ICU (Intensive Care Unit) patient capacity but also for the primary healthcare providers. The local general practice clinics have rapidly adopted telehealth offerings for initial patient consults along with case managing follow-up diagnostic testing (pathology and imaging).

With senior management and boards mindful of the structural changes that will come, corporate Australia's response can only be implemented with stable coordinated government policy.

The rapid implementation of the national cabinet to oversee the relationship between federal, state and territory Governments has certainly been an early success. Further encouraging signs was the Prime Minister promoting federation reform that includes industrial relations, skills training, deregulation, tax reform and housing construction. A September deadline has been set for unions, businesses and the governments to provide their reports.

The outlook for the economy has dramatically turned around for the better from the dark days of late-March with many, but perhaps not all, aspects of life slowly returning to the previous "normal". In the short-term however, consumers, businesses and governments will likely have to manage an unusual recession but, in the longer term, some of the recent enforced change could lead to a better overall outcome.

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## ***COVID-19: Navigating the current Australian fixed-income environment***

### **Louise Hollingsworth – Senior Investment Analyst**

Over the last few months, we have witnessed extreme market volatility as the global economy responds to the COVID-19 pandemic. Australia is now gradually easing lockdown restrictions as infection rates slow in each state, with the exception of Victoria, where cases are on the rise again. While any progress toward normality would likely inspire a sense of cautious optimism, overall uncertainty remains high. Here, we will look at how COVID-19 has impacted the Australian fixed-income market outlook and what investors need to be aware of when investing in these unprecedented times.

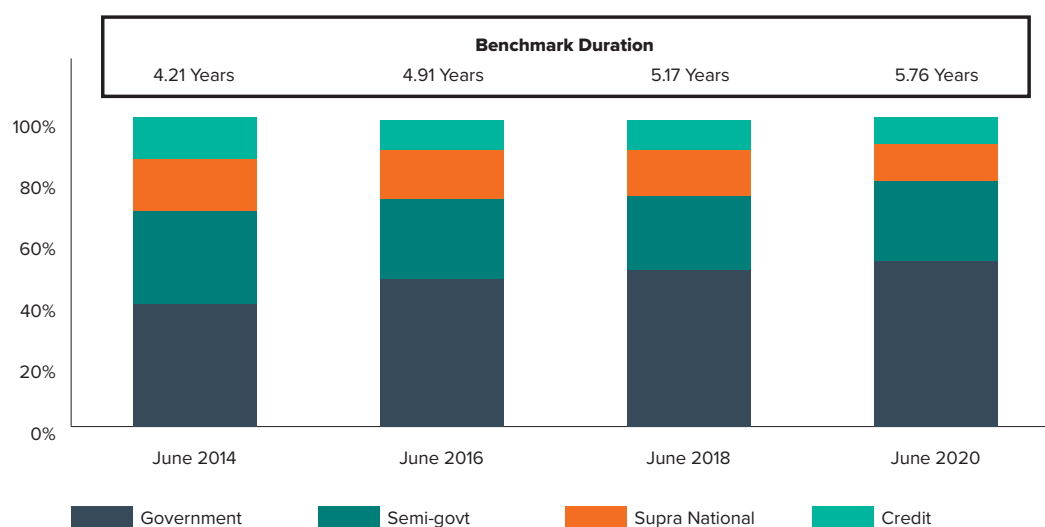
### ***Unprecedented fiscal response***

Like other countries, Australia has rolled out enormous fiscal stimulus packages to keep businesses alive as the COVID-19 pandemic shuts down large parts of the economy. The unprecedented borrowing by the government needed to be able to fund these packages has triggered concerns about oversupply and whether financial markets can cope with the massive issuance. So far, however, the debt issuances have been met with strong demand by both domestic and foreign buyers. Last month, the Australian Office of Financial Management (AOFM), which manages Australia's government's debt, issued \$19 billion of a 10-year bond after receiving over \$53 billion in bids. Both the issue size and demand size were record amounts. The success of the deal was an international vote of confidence in the Australian economy and means the pressure on the AOFM to meet an estimated \$250 billion ramp-up in bond sales has eased significantly.

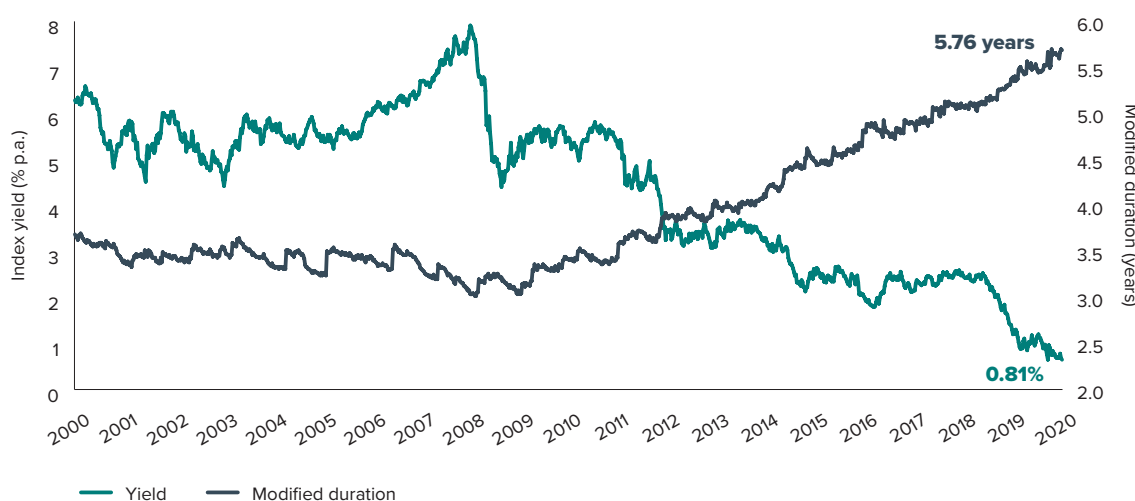
# Duration compensation in a low rate environment

While the strong demand has cooled concerns over whether the market can absorb the increased supply, investors also need to be wary of how longer-dated government debt issuances increase interest rate risk – also known as duration risk – embedded in benchmarks such as the Bloomberg Ausbond Composite Bond Index. As shown in Chart 1, today, almost 80% of the index is made up of government and semi-government bonds. Longer-dated bonds carry higher duration risk, meaning the price (capital) paid for these bonds is more sensitive to interest rate movements compared to shorter-dated bonds. A bond with greater duration will be more exposed to capital losses if yields were to rise. From Chart 2, the duration level of the Ausbond Composite Bond Index has been increasing while the yield has declined to record low levels. This means that investors have been increasingly exposing themselves to more duration risk for less return. Today if yields were to rise, even by just 0.25%, investors would see a capital loss of 1.44%. Of course, duration risk works both ways. If bond yields fall sharply, duration exposure can deliver large capital gains, which is exactly what happened across global bond markets throughout 2019.

**Composition of the Bloomberg AusBond Composite 0+ Yr Index**



**Bloomberg Ausbond Composite Index – Modified duration and bond yield**



## ***From conventional to unconventional monetary policies***

In 2019, Australian bonds delivered their best performance in five years, with the Bloomberg Ausbond Composite Index returning 7.3% over the year. Three interest rate cuts buoyed returns from Australian fixed-income securities. The RBA lowered rates in June, July and October by 0.25% each time, taking the cash rate to an all-time low of 0.75%. The fall in yields resulted in large capital gains for fixed-income investors who had exposure to duration. This year, the rate cuts continued with the RBA cutting the official cash rate to 0.50% in March and again to 0.25% in April as it sought to contain the economic fallout from the then escalating COVID-19 crisis. The RBA also rolled out its first unconventional monetary policy tool, yield curve control (YCC), setting a target for the yield on three-year Australian Government bonds “of around 0.25%”, to help lower funding costs across the economy.

RBA Governor Philip Lowe recently said that while the outlook for Australia’s economy has improved since the peak of the COVID-19 crisis in April, the RBA may have to keep interest rates unchanged for many years to get the economy back to full employment. The RBA is still firm on its stance against negative rates, and that the effective lower bound, which is the point beyond which further monetary policy in the same direction is counterproductive, remains at the current 0.25%. However, Australia is at the mercy of the global economy. If other major economies pursue policies such as negative rates, the RBA may be forced to engage in further unconventional monetary policy to shield our economy from a strengthening currency.

## ***Liquidity risks when hunting for yield***

Liquidity in fixed-income markets has changed considerably since the GFC. Bond markets are heavily reliant on banks acting as intermediaries to facilitate buying and selling by investors. However, incentives for banks to provide that liquidity has significantly changed along with banking regulations and balance sheet constraints that have been implemented since the GFC. Banks are now less willing and able to use their balance sheet capacity to support riskier corporate bond trading. Liquidity also varies depending on the type of fixed-income security. Riskier sectors such as loans and private debt tend to be less liquid than safer sectors such as government bonds. With interest rates at unprecedented lows, investors are increasingly investing in riskier sectors that are at risk of becoming illiquid in adverse market conditions. In March, the liquidity in global fixed-income markets froze up as global economies went into lockdown. The Australian credit market was also severely affected and experienced considerable strain as investors rushed to sell bonds into a market where there was hardly any liquidity. Australian bond funds increased their exit fees quite significantly as they battled to liquidate securities in frozen fixed-income markets.

## ***Unviable companies propped up by government support***

There are concerns the Federal government's bailout package of wage subsidies, asset write-offs and loan guarantees as well as changed insolvency laws is propping up unviable businesses that won't survive once government support is removed. These “zombie companies” characterised as highly leveraged, too weak to grow and unable to repay the principal of their outstanding debt, have been able to survive up to this point mostly thanks to cheap borrowing costs (and the temporary relaxation of some insolvency laws). However, the economic shut-down may push already struggling businesses to the brink, and for many, the COVID-19 financial impact will be terminal. A concern for fixed-income investors is for those who hold the debt issued by unviable companies. Virgin Australia was the first major corporate casualty of COVID-19. Already unprofitable and highly leveraged pre-COVID-19, Virgin issued a \$325 million bond on the ASX in November 2019 to partially fund the acquisition of its Velocity loyalty programme. Virgin is now in voluntary administration after it was unable to service its debts while the COVID-19 pandemic forced the grounding of most of its fleet and starved it of cash. Virgin bondholders now fear they may walk away empty-handed.

## ***Implications for portfolio construction***

The spread of COVID-19 has created uncertainty around the outlook for global economic growth and led to heightened market volatility. What the recovery will look like and how long it will take, are both highly debated topics and remains largely unclear at this stage. Policymakers around the world have acted with unprecedented speed and force, rolling out enormous fiscal stimulus packages and pulling monetary policy levers not seen before to keep global economies alive. The investment environment has changed, and uncertainty will likely prevail for an extended period. Investors should remain mindful of their time horizon and risk tolerance as they navigate this changing environment and persistent volatility. The COVID-19 pandemic will likely produce some very attractive investment opportunities, but caution is warranted, as not every company will survive this crisis.

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## ***Will we be a nation of virtual shoppers?***

**Tina Wilson – Senior Investment Analyst**

The COVID-19 pandemic has brought many changes to our lives. As investors work through the myriad of longer-term impacts, the most important debate for consumer-focussed businesses centres on the key long-lasting changes to purchasing behaviour and the resulting industry trends.

### ***Accelerating move to online shopping***

Some of the changes to people's shopping behaviours due to COVID-19 are an acceleration of the trends and changes that have been in motion over recent years. One of these changes is the shift to online shopping. Growth in online sales is not a new story, there was much debate on the topic for the retail sector when Amazon launched in Australia in early 2018, causing whole sector valuation changes.

In Australia, online penetration in retail (excluding grocery) has been growing steadily, with its growth rate reaching more than 2% year-on-year at the peak in late 2018. This growth rate had decelerated somewhat in 2019 but has accelerated strongly since the onset of COVID-19 earlier this year.

Since lockdown, there has been a shift towards online shopping due to a combination of store closures and health concerns. Most retailers reported material uplifts in online trading. This increase has been driven by both new customers and increased frequency (i.e. existing customers purchasing more).

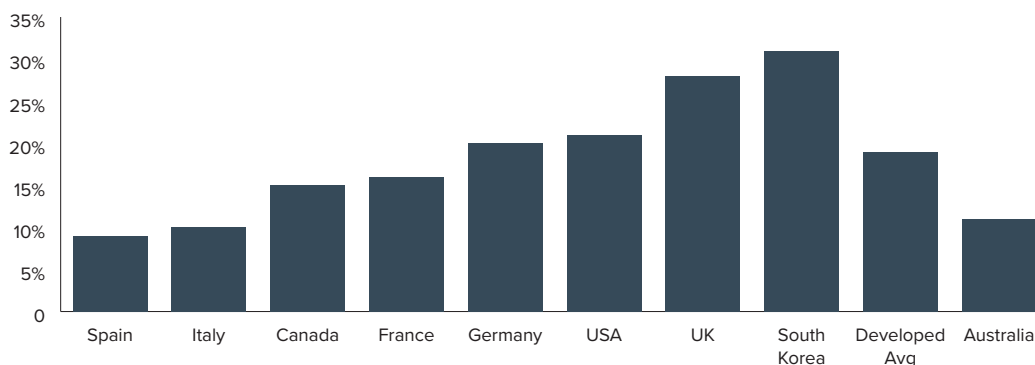
The media is full of stories of huge growth in pure-play online retailers. Many of these retailers are achieving record sales during the pandemic and reaching record high valuations, dwarfing iconic traditional retailers (Kogan.com's market cap is now roughly eight times that of the once venerable Myer). How much of this shift towards online will persist after the pandemic remains a big unknown. When people can safely move around in physical stores and shopping centres, will they be keen to do so?



## Australia's online penetration rate is low compared to overseas markets

What we know is that relative to overseas markets, Australian online shopping penetration still looks low. The chart below shows the online retail penetration (excluding grocery) of Australia compared to other developed countries at the end of March 2020.

### Online penetration (ex-grocery)



Source: ABS, NAB Online, Euromonitor, UBS Estimates

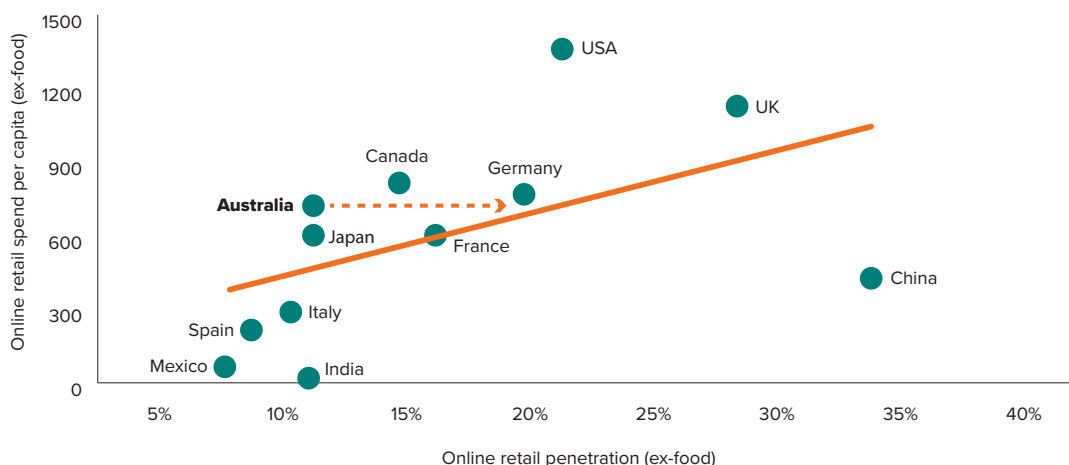
Australia currently sits at 11% compared to the average of 19% in other developed countries. China is often quoted as the “gold standard” for the adoption of online shopping, with online penetration at more than a third.

## Propensity to spend high

The other observation to make is that Australia has a high propensity to spend online, measured by dollar spend per capita (Australians who are online are spending a lot). High propensity to spend online is usually associated with higher online penetration. Australia currently has a similar level of propensity to spend as Germany, but Germany has a much higher online shopping penetration at 20% (vs. Australia 11%).

A quick ‘back of the envelope’ calculation indicates that Australians spend roughly A\$28 billion in online retail (ex-grocery) each year. If we were to increase the penetration of online spend to that of Germany, then this number would grow to over A\$40 billion.

### Australia has a high propensity to spend online and penetration should rise



Source: Euromonitor, ABS, UBS Estimates

Of course, this correlation doesn't always hold. For example, China has a much lower online dollar spend per capita, but with nearly 35% online penetration, this also reflects China's relatively lower GDP per capita.

For investors, while this growth rate is very likely to have risen faster than expected, mainly due to the COVID-19 pandemic, its impact will probably further distinguish the gap between the winners and losers within the retail sector.

# Can the retail sector as a whole turn a profit online?

There are other issues that also need to be assessed. For example, what about online profitability? Generally, online profitability becomes accretive as critical mass is gained, this is further helped by physical stores being closed and rents for remaining stores being revised downwards, through rent deductions and/or increased turnover-based rent.

What about the rate of return on online investments for different companies in the sector? Who are the winners and losers? One thing that investors can be sure of, companies are certainly responding to the change to consumer behaviour as a result of the pandemic, and an appropriate online strategy is now at the forefront of their minds. This focus on online strategy is evidenced by the strategic priorities that companies have articulated during this uncertain time.

## The pivot to digital is gathering pace

This pivot in strategic priorities is resulting in businesses turning their attention to operating more like a “digital business” relative to what they used to do. This does bring new challenges that some businesses are not prepared for across a range of areas: from customer engagement through to business operations.

### Examples include:

**Digital customer experiences:** How much of this is a factor that influences buying behaviour, and creates the desired business outcome (more transactions, and more sales)? Startups are constantly emerging and seeking to compete on this value proposition, and can create a highly competitive market environment.

**Different expectations on service:** Since the likes of Amazon entered the retail arena, customer expectations have been reset. Now businesses must understand customers who have an expectation they can “buy-but-return-quickly” if something doesn’t meet their needs. This has implications on a business’s inventory planning and logistics, which may not have had much consideration previously.

**Digital skills and capabilities:** We are seeing a new era of business skills required to make a business more successful in a digital environment. The need for traditional skills like finance, HR and IT continues but we now need to consider ways to integrate product managers, data analysts and automation experts into business models (just to name a few).

The world is destined to change to a new normal, post COVID-19 and the digital space is one that will need serious consideration if businesses are to survive and thrive in this new normal.





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