ISSUE 92

PITCHER PARTNERS

Investment news

Pitcher Partners Investment Services Pty Ltd

Kellie Davidson – Partner

2020 continued its whirlwind run of tragedy, euphoria, frustration, happiness and disappointment over the September quarter.

We saw many major developed and emerging market economies begin their path to economic recovery, having officially posted their steepest decline in GDP post World War II during Q2. Whilst some countries have seemingly managed to contain the spread of COVID-19, which has now tragically cost the lives of more than 1 million people around the globe, the re-emergence of a "second wave" of infections has in many areas, including the Americas and Europe, surpassed those levels witnessed in the first half of the year, triggering new containment strategies from many countries.

Progress was made with respect to various early phase vaccine trials around the world, but an effective solution remains a way off, with many pinning their hopes of a solution being found in 2021.

Within Australia, the stage four lockdown in Victoria has pushed back the market expectations of a major economic recovery into 2021. The 2020–21 Federal Budget announced in early October was one of the most stimulatory budgets the country has ever seen to 'supercharge' the economic recovery once lockdown measures are relaxed further across the country. The equities reporting season was a real mixed bag, with earnings quality generally low and a heavy reduction in the number of companies offering no earnings guidance.

Investment market performance summary – 30 September 2020

Indices	Current	3 months	1 year
ASX 200	5,815.9	-1.4%	-13.0%
ASX 200 (Acc)	64,608.1	-0.4%	-10.2%
US S&P 500	3,363.0	8.5%	13.0%
Japan Nikkei	23,185.1	4.0%	6.6%
UK FTSE 100	5,866.1	-4.9%	-20.8%
MSCI World	2,367.3	7.5%	8.6%
German Dax	12,760.7	3.7%	2.7%
French CAC	4,803.4	-2.7%	-15.4%
HK Hang Seng	23,459.1	-4.0%	-10.1%
Shanghai Comp	3,218.1	7.8%	10.8%
ASX 200 Prop (Acc)	48,801.1	7.0%	-16.6%
Global Prop	2,314.2	0.6%	-21.5%
Australian Bonds	10,710.0	1.0%	3.2%
International Bonds	1,103.6	0.7%	3.5%
Commodities			
Gold (oz)	1,885.8	5.9%	28.1%
Oil (Barrel)	40.2	2.4%	-25.6%
Iron Ore (Tonne)	120.2	22.7%	29.3%
Aluminium	1,765.0	9.0%	2.5%
Copper	6,672.0	10.9%	16.5%
Lead	1,824.5	2.8%	-14.5%
CRB Index	148.5	7.6%	-14.6%
Currency			
AUD/USD	0.7162	3.8%	6.1%
AUD/EUR	0.6111	-0.6%	-1.3%
AUD/GBP	0.5544	-0.4%	1.0%
AUD/JPY	75.5420	1.4%	3.6%
AUD/RMB	4.8680	-0.2%	0.9%

Source: Bloomberg.

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With respect to the performance of financial markets over the quarter, global equities continued to surge ahead, however the bulk of those gains were driven by the seemingly relentless surge of US technology and other growth stocks. In USD terms, some markets briefly reached their previous peaks before retreating toward the end of the quarter due to concerns over slowing economic momentum, the impending US Presidential Election and rising COVID infection levels. Australian equities posted a small negative return for the period however this too masked the two paced nature of the market, with a strong rally in growth and small cap stocks outperforming traditional cyclical and defensive sectors.

Within fixed income, yield curves steepened at the beginning of the quarter before the risk off mode late in the period saw yields contract and both our local and offshore benchmarks posted a positive return for the period. Credit spreads continued to tighten further, providing the opportunity for some attractive returns despite a pick-up in volatility in September.

The rise in the $AUD against the $US constrained offshore returns for investors who were predominantly unhedged over the quarter.

The articles in this Pitcher Partners quarterly update discuss two topical events. We share our views on the implications of the upcoming US Presidential Election and the outlook of the Australian office property sector, an area that has come under increasing pressure given the enforced trend of working from home measures.

We sincerely hope you and your families are keeping well in this challenging environment. We look forward to catching up with you before the end of the year.

US election: Implications for investors and financial markets

Duncan Niven – Director of Research

The theatrical performance that is the 2020 US Presidential Election race is just weeks away before its potentially dramatic conclusion, perhaps even with the potential of an encore performance depending on how close the result gets.

With such a dramatic event, it's easy to get absorbed into the 'noise', yet we encourage investors to focus on the substance over the media spin. Regardless of the outcome of the election, we believe the economic recovery will likely continue to provide attractive investment opportunities for investors.

Our main disclaimer here is that we do not profess to be political experts, nor do we believe we have any informational advantage in predicting what is likely to happen over the next month, however hopefully this article can give you a sense of:

1. The current momentum in polling
2. What happens in the event of a contested election
3. The differences in policy between Trump and Biden
4. The potential investment implications for Global and Australian investors.

Regardless of the result, we expect there will be an entertaining, media spectacle in the few weeks ahead.

What are the polls currently telling us about the likely outcomes?

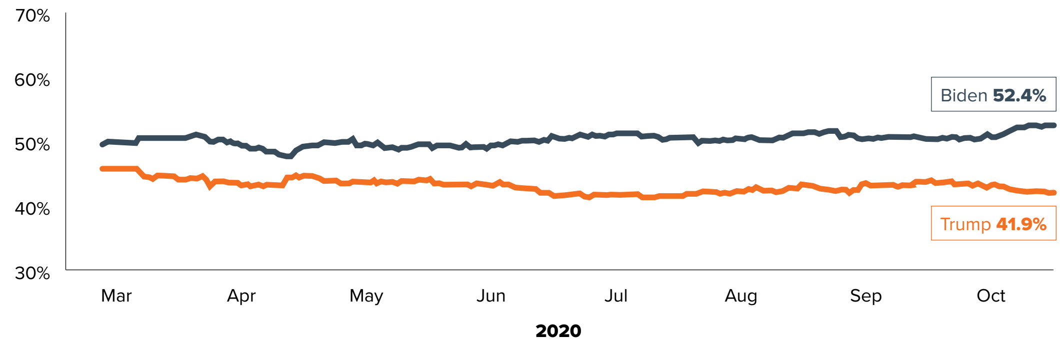
Fair or unfair (usually unfair) voter views of any resident are often shaded by the state of the economy and equity markets. Since 1924, when there has been no recession in the two years prior to the election, the incumbent has been re-elected 100% of the time. On the four occasions when there has been a recession in the two years prior to the election, the incumbent has been voted out of office three times.

On entering 2020, the US appeared to be on the path to continued economic expansion until it was thrown into a recession as many states went into lock down. While the recession was deep and abrupt, given its cause and global nature it is unclear if voters will hold Trump accountable in the same way they have past presidents.

Biden has been consistently polling ahead of Trump over the past 12 months, which has also been a far steadier trend than in recent elections this decade.

Who's ahead in the national polls?

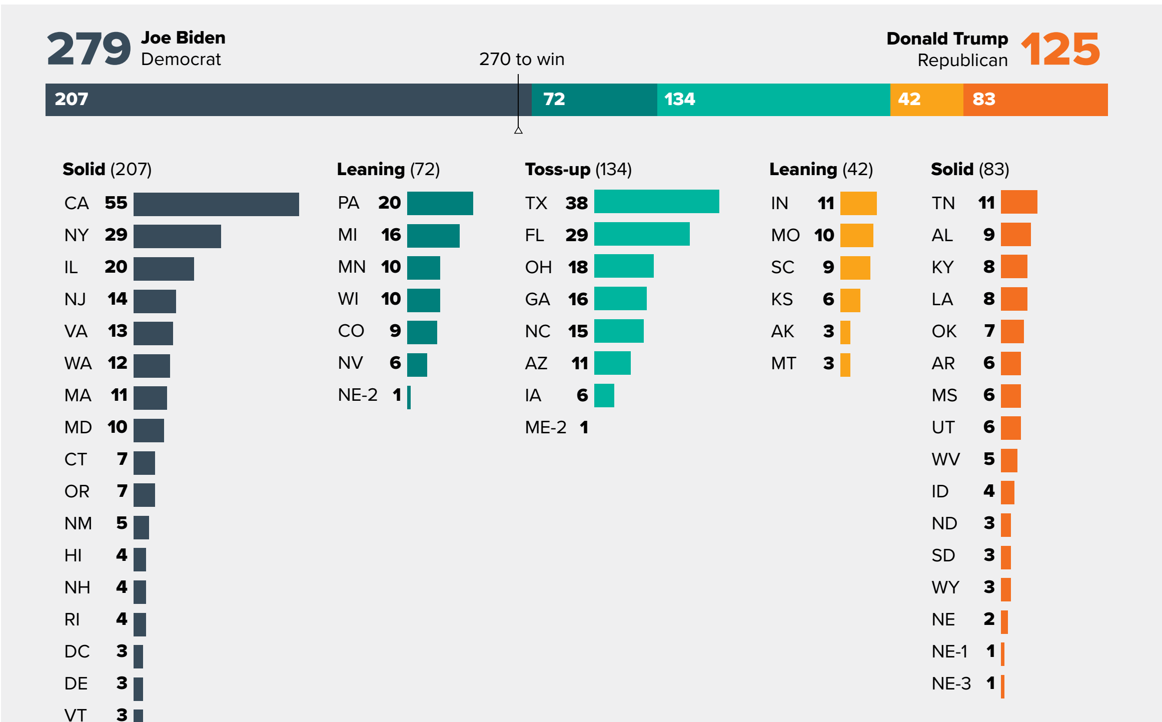
An updating average of 2020 presidential electio polls, accounting for each poll's quality, sample size and recency



Source: FiveThirtyEight.com

The national polls are indicative of a broad level of support for a 'Blue wave' victory. However, the message is less clear within the swing states, where any advantages across both parties sit within a standard margin of error.

If the election were held today, the latest polls suggest this outcome in the electoral college:



Note: State where the difference in poll numbers between Biden and Trump is less than 5 percentage points are classified as "toss-up" states.
Source: Financial Times, 14 October 2020

With roughly 2 weeks to go, Biden is polling narrowly ahead of Trump in key battleground states, though he has seen his lead narrow in some of these. In Michigan, Pennsylvania, and Wisconsin where Trump won by very small margins in 2016, polls show Biden leading by six points. The race is even closer in the crucial state of Florida. Some of the closest races, though, are in states that Trump won more convincingly in 2016 (North Carolina and Georgia, who have historically voted Republican in 9/10 last 10 elections).

Oher toss-up states include Arizona, a state only one Democratic presidential candidate has won in the past 70 years, and Texas, where Trump's polling advantage has remained below five percentage points for much of the summer.

Based on the current data, a clean sweep of the Democrats winning control of Congress cannot be ruled out, however it seems extremely unlikely for the Republicans to do so at this point.

What could cause these trends to change or the toss-up states to swing?

Historical approval ratings during presidential re-election campaigns

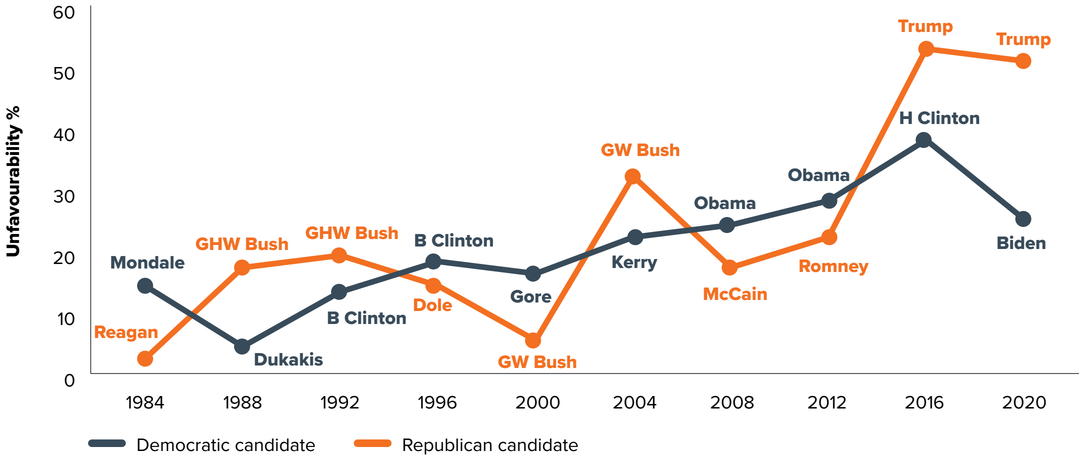
Year	President	Net approval	Re-elected?
June 1972	Richard M Nixon	23	Yes
June 1976	Gerald R Ford	5	No
September 1980	Jimmy E Carter	-18	No
October 1984	Ronald W Reagan	25	Yes
October 1992	George HW Bush	-22	No
October 1996	Bill J Clinton	18	Yes
October 2004	George W Bush	1	Yes
October 2012	Barack H Obama	5	Yes
September 2020	Donald J Trump	-14	?

Source: Amundi, American Presidency Project, RealClearPolitics for 2020 election. Data as of 21 September 2020

Another factor that may cause turbulence over the coming weeks is the replacement of Supreme Court Justice Ruth Bader Ginsburg, who sadly passed away this year. This gives Trump an opportunity to galvanise a loyal core base of 'evangelical voters', since conservative court appointments is the single most important issue to them. His rush in seeking to appoint the conservative Amy Coney Barrett could well thrust the issues of gay rights, abortion, and Obamacare into the limelight. Trump's campaign strategy appears to have shifted toward galvanising his existing voter base and this move plays a key part. Having said that, Trump has obviously stirred a lot of political opposition amongst Democrats since he has been in power and is likely to find further opposition through a reinvigorated Democrat supporter base (that was perhaps less enthused for Hilary Clinton) eager to oust him from power.

Being unpopular however has not proven itself to be a deterrent from assuming the role of president. Trump was indeed even more unpopular (as judged by the chart below) in the 2016 election while similar instances have occurred during the Bush (two), Clinton and Obama campaigns.

Unfavourability ratings of presidential candidates (1984–2020)



Source: Roper Center, IBD/TIPP, WSJ/NBC News

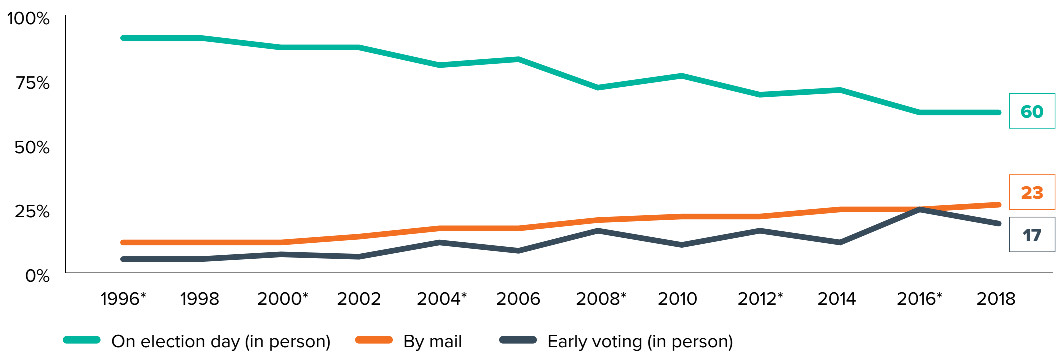
What happens if we get a contested election result?

It's possible we may see a record voting turnout with a high number to be voting by mail, a method encouraged by many states due to the ongoing pandemic. Amundi Investors estimate that postal votes could account for one-third of all votes cast.

Increasing number of voters are "mailing-in"

The pandemic will likely lead to a jump in the already-upward trending number of mail-in voters.

Voting method (% of survey responders)



* Presidential election year. In 2018, 0.7% of responders did not know and/or did not say what voting method they used. Data from 1996 through 2018

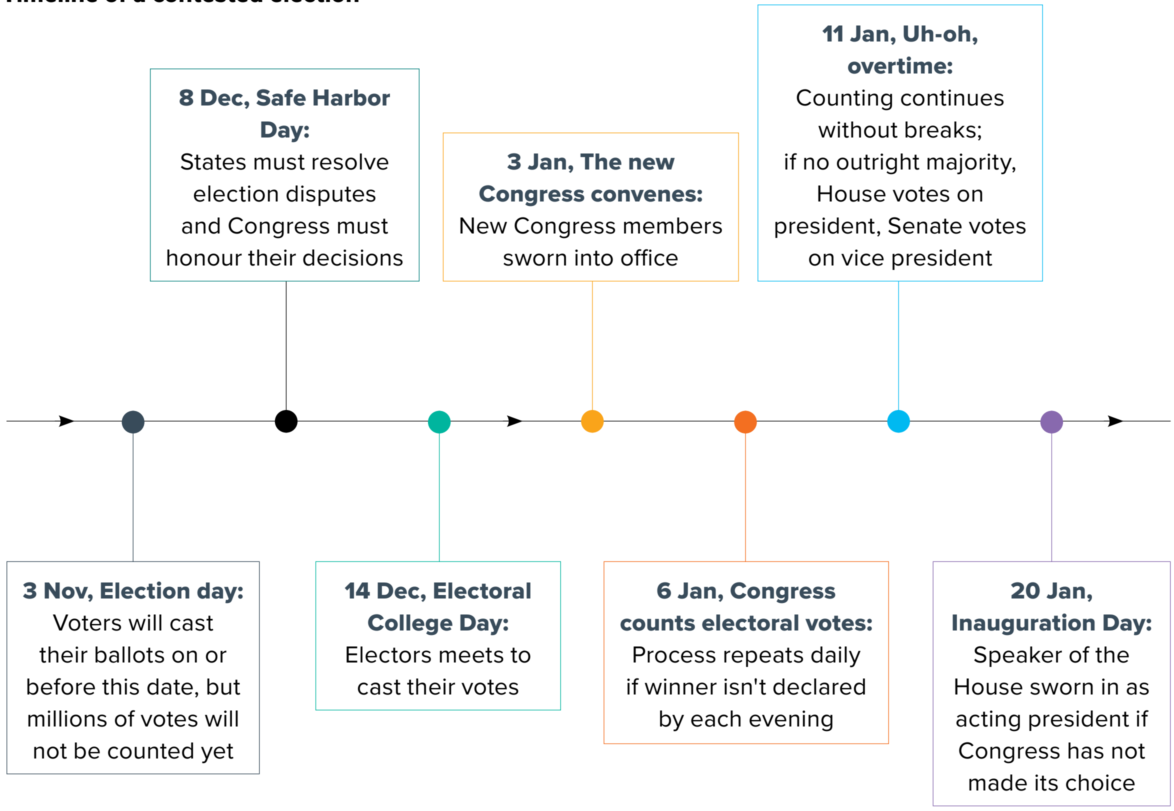
Source: Northern Trust Asset Management, Jenner & Block LLP, US CEnsus Bureau, Current Population Survey

Surveys (Amundi, Politico, Cook Report) have led to estimate that among Biden supporters, about a quarter of voters expect to vote on election day compared with approximately two thirds of Trump voters.

This begs the question of whether there are adequate resources in place around the country to handle the number of votes by mail. Mail-in ballots can represent a fraught issue, with the challenges of counting of split ballots and the accuracy of filling out the ballot itself. Regarding Trump, he is likely to bring more voters to the polls who do not normally vote in elections. This assisted his path to victory in 2016.

The conjecture around mail-in ballots and the potential for some narrow margins of victory is that Trump appears set on challenging the election should Biden be declared the winner. Fear has also increased around the potential for civil unrest on the day or days preceding the election if it is contested. Some states are preparing themselves for any eventuality of this. While Trump talks about the possibility of years of litigation, the reality is that due to the US Constitution, the president will be known by inauguration day 2021 regardless of any litigation.

Timeline of a contested election



Source: Northern trust Asset Management, Jenner & Block LLP

We assume a higher probability that the winner of the presidential election may not be known on 3 November, unless there is a landslide victory by Biden. Some states have had difficulty handling even the modest number of ballots cast in their primaries (compared to the number typically cast in general elections). In New York, for instance, thousands of mail-in ballots were disqualified during the Democratic primary, calling into question the integrity of the election. The possibility of similar scenarios playing out across the US is a frightening prospect and unfortunately one that can't be ruled out.

What are the actual key policy differences between Trump and Biden?

There are three main themes in Trump's campaign: Law and order, China, and Biden's fitness for office. Biden is campaigning on economic policy ("Build Back Better"), healthcare, racial justice, climate change and morality.

Biden is planning another fiscal stimulus package to address immediate economic issues tied to the pandemic, which based on the protracted and failed negotiations in recent months, is likely to surpass what plans Trump has in store. He has plans for a major infrastructure investment and supports a modified version of the Green New Deal and other climate change matters. He also plans to boost Obamacare and prescription drug reform. Trump is likely to continue with a de-regulation agenda. Both candidates will have to deal with the long-term issue of rising inequality, with Biden more prescriptive around rising taxes on the top 1% of income earners.

Taxes

In 2017, one of Trump's first major policy moves was to cut taxes for both individuals and corporations in an effort to stimulate economic growth. The Trump administration is seeking to extend the Tax Cuts and Jobs Act and has floated the idea of cutting the payroll tax.

Biden has made it clear through his campaign that the 2017 tax cuts were too generous to corporations and the wealthy. He has pledged to reverse some of those cuts by raising the marginal tax rate on the highest income earners (to ~40%), subjecting wages above $400,000 to a social security tax and resetting the top corporate income tax rate back to its original level of 28%.

Trade

Trump has taken a particularly aggressive stance on trade with its major global partners and has focussed on bringing back manufacturing jobs previously moved overseas. The trade war with China has been the centrepiece of the Trump's trade policy during his first term, highlighting difficulties the US has had in procuring medical supplies during the pandemic to reinforce his argument. His America First mantra will likely continue to pressure countries which have a high trade deficit with the US, or those he believes are unfairly taxing American companies overseas.

Vice President Biden has released a 10-year, US$1.3 trillion, made-in-America infrastructure plan. He has pledged to spend US$700 billion on American-made products and industrial research, which he says would employ at least five million people. Whilst Biden has been critical of Trump's trade war with China, there is still bi-partisan support for seeking a better trade deal with China – but Biden's path to achieve that may be less confrontational that the approach by Trump.

Pushing the big red button

Another idiosyncrasy of the 2020 campaign has been the effort among Democratic lawmakers to do away with the Senate filibuster, which is essentially a "big red button" used to block or delay legislation. In the belief they will win back control of the senate, many Democrats have called for the elimination of the filibuster for legislation.

The elimination of the filibuster could have major effects in the future. Sweeping legislative changes would become possible with less attention paid to the objections of the minority. It could well make US politics more volatile as a result.

What are the investment implications for global and Australian investors?

Regardless of the winner, we expect the current impasse around the next round of fiscal stimulus will be resolved and further support will be made in 2021 to the US economy. The quantum and velocity of that is still up in the air and given the contrasting domestic policy stance from both parties, there are some potentially divergent outcomes that global and Australian investors need to be mindful of. Monetary policy, in our view, can be relied upon to be highly accommodative for some time.

If we were to rely purely on what the opinion polls and public opinion tell us, one could argue that the following three scenarios are most likely to occur at this point in time;

- A Biden victory and the Democrats takes control of congress (Senate and the House of Representatives)
- A Trump victory with the balance of power in congress unchanged (Republicans control Senate, Democrats control the house)
- A Biden victory, but with Republicans controlling the Senate.

We estimate these scenarios could have the following impacts on financial markets:

	Blue wave victory	Trump victory/ Status Quo	Biden win, Republicans control senate
US risk assets	– on higher taxes + on fiscal stimulus	+	+ no tax hike, less tariffs – little fiscal support
Ex-US risk assets	+	–	+
US Dollar	–	+	–
US interest rate duration	–	=	+

Source: PPIS Research

A blue wave victory will still likely be supportive for equities as the benefits of a greater fiscal stimulus package than Trump should offset the likelihood of higher taxes. Rising regulation could see greater divergence in the performance of certain sectors/industries. The higher spending could well have greater inflationary implications down the track and consequently, be negative for the bond markets.

A Trump victory could well keep the financial markets in a similar holding pattern to those currently in the short term. US Equities in particular may continue to be the recipient of lower taxes and ongoing de-regulation, whereas a more limited fiscal stimulus being passed through into 2021 (due to a divided congress) could well be less inflationary in the next 24 months or so.

More uncertainty will arise if Biden wins but the Republicans retain control of the Senate – this will create the widest divergence of views around future policy effectiveness, however it may still present a more 'consultative' approach to global trade negotiations.

From an Australian investor's perspective, the US share market lists some of the more compelling growth opportunities globally and we don't see that diminishing materially under either administration. We have a selection of active managers waiting to take advantage of any rotation from growth into value stocks. The outlook for currency is obviously of interest, however we maintain our view that on the back of a gradual global economic recovery, we should expect to see the $US dollar weaken and we don't see cause to adjust our view at this stage. Within fixed income and credit markets, we expect our preferred active managers to continue to pre-empt and adjust to any policy dynamics affecting the shape of the yield curve and credit markets going forward.

History has shown that financial markets do rapidly adjust to a new environment and barring any protracted uncertainty around the balance of power, which admittedly cannot be fully discounted, any associated volatility will likely wear off in the short term. As such, we remain focussed on the medium to long-term effects.

Summary

There will be a lot of noise as we run into early November and final stages of this election. Biden is building momentum, but we think there is potential this election will be a close-run race and finish.

We encourage investors to focus on the policy outcomes rather than the 'party' itself. We believe there is adequate policy support to improve the growth momentum of the US regardless of any transition of power or control and that the investment merits of US equities and credit in particular remain valid for many investors today.

Any short-term volatility associated with a contested election or other lack of clarity is unlikely to warrant any wholesale changes to investor portfolios in our view. Whilst we await the release of a COVID-19 vaccine, we do expect global economic momentum to gather pace in 2021 which should be constructive for risk assets.

Artist's impression: Imagining the office 2.0

Alistair Francis – Senior Investment Analyst

With the recent change of office employees shifting to working from home during the COVID-19 pandemic, debate has intensified on the outlook for global commercial office demand. Due to the changing nature of the virus and varying restrictions across Australian states, we are a long way from having a definitive solution and we should expect the outcome to differ across various geographies.

The topic of the future of the global office market is critically important for many real estate investors. MSCI* data shows that offices constitute almost 40% of global core real estate and have the highest weighting in many regions.

In the near term, potential shifts in office demand will hinge on broader factors. We view the management of public transport logistics as a key issue for many city centres and their office buildings, particularly around peak times of travels. Governments need to balance safety concerns with reopening goals, which will play a major role in determining corporate plans.

The development of an effective vaccine or treatment for COVID-19 will, when it comes, clearly be a game-changer in the evolution of the pandemic, effects on employment and the confidence of workers wishing to return to workplaces and offices.

* MSCI – Morgan Stanley Capital International – a leading data provider in the property space.

Accelerating an existing trend

"I don't believe BlackRock will be ever return to 100 percent in the office. Maybe there will be 60 percent or 70 percent and that could be a rotation of people, but I don't believe we'll ever have a full cadre of people in the office."

LARRY FINK, CHIEF EXECUTIVE, BLACKROCK INC.

The optimisation of office space has been underway for more than a decade and with it, the shift towards flexible hours and strategies to encourage working from home. Rather than resisting this trend, senior executives, and decision makers (HR, Operations) have embraced it. The experiences between businesses globally often comes down to recognising a difference in organisational cultures and employment sectors. Whilst the social attitudes and labour laws have been progressive in many European countries, namely the Netherlands and Sweden, Japan has yet to shake its "salaryman" stereotype. Flexible working arrangements have naturally evolved in industries that are dominated by technical roles with less client engagement, where working from home is preferred. Silicon Valley has drawn in IT specialists from around the world and lead the way in working remotely.

The office is more than a place to push paper

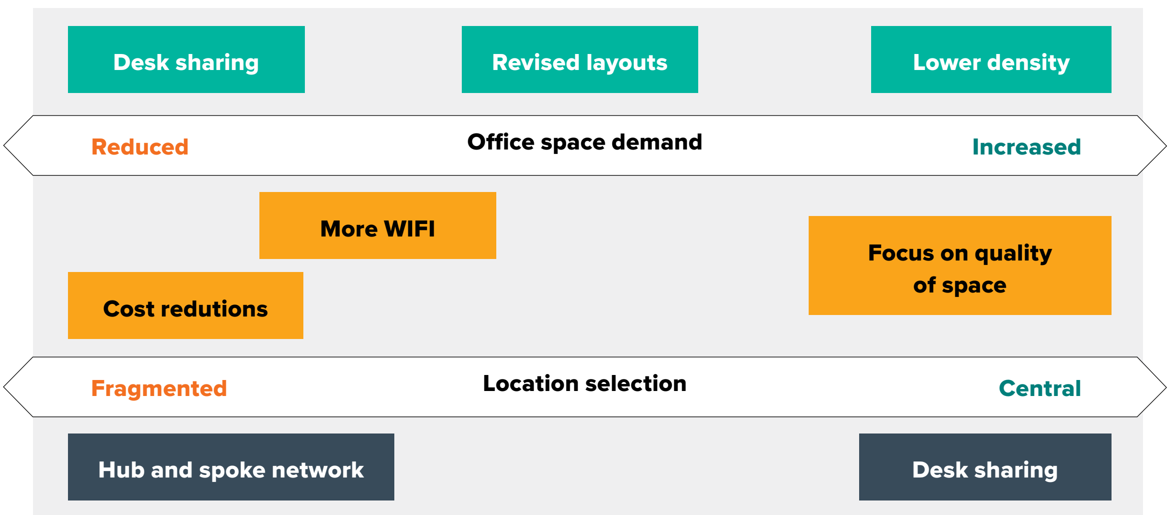
"In all candour, it's not like being together physically. And so, I can't wait for everybody to be able to come back into the office. I don't believe that we'll return to the way we were because we've found that there are some things that actually work really well virtually."

TIM COOK, CHIEF EXECUTIVE, APPLE INC.

There are other nuances to consider, such as variations between the working styles of different teams or the stage of an employee's career. Younger employees aged under 35 require more training, greater supervision and often enjoy the office social interaction that comes with working in an office environment. As such, they are less likely to want to continue working from home than those typically aged over 45 with young families and competing priorities. All of this indicates the different levels of requirement for employment flexibility and office space.

In terms of determining over the longer term the relative winners and losers within each global office market, there are a huge number of variables that will influence this. However, there are two key real estate swing factors, namely (a) the aggregate impact on the demand for office space and (b) the selection of location for offices going forward.

The chart below summarises some of the important considerations around these swing factors that could influence the future path for office markets.



Source: Invesco Real Estate, July 2020. WFH = Work From Home

Work life balance goes both ways

From the perspective of the employer, there is a balance that can be struck. The working from home flexibility can generate value for a business, not just through reducing costs and increasing employee satisfaction, but also through improving operational efficiency and organisational resilience, as well as potentially expanding the accessible talent pool.

While remote work can be effective in the short and even medium term, it cannot replace human interaction, and it can introduce a long list of risks including, workers feeling less connected, projects taking longer and increased sedentary time – taking a toll on employees' physical health and well-being. Ultimately, for a business and its organisational culture to thrive it requires human, in-person connection in the office environment.

Barclays CEO Jes Staley based in London recently commented on the importance of having workers in the office over the long-term: "We want our people back together, to make sure we ensure the evolution of our culture and our controls, and I think that will happen over time." *

One of the anticipated losers is expected to be the landlords with office space that falls below modern office standards ie the back-office locations, outer fringe business parks or those in third tier towns or suburbs. It is also expected that new developments are likely to be minimal in the near term as new construction lending will inevitably tighten until the recalibrated demand – supply equilibrium within each market is found.

Hybrids are the future. The office is dead, long live the office!

"If you'd said three months ago that 90 per cent of our employees will be working from home and the firm would be functioning fine, I'd say that is a test I'm not prepared to take because the downside of being wrong on that is massive."

JAMES GORMAN, CHIEF EXECUTIVE, MORGAN STANLEY

With the passing of time and with it, the novelty or shock of remote working, employers are beginning to think a hybrid model in the future could evolve. It embraces many attributes of the positives of working from home yet balances it with the opportunity to regularly convene teams in the office environment. An example that is being considered is where teams would agree to come together in the office for a limited time on certain days of the week for collaboration, connection, and culture. These interactions are essential ingredients for enterprise growth and risk management, along with employee development.

For real estate investors, the near-term profile of the office market globally will be shaped by the ability of governments and employers to manage the heightened risks posed by the pandemic. However, in the longer term, the working from home model will continue to evolve but employers will be mindful to balance the risks with sufficient face-to-face engagement to protect a firm's culture and growth objectives.

* BBC, "Barclays Plc: We want our people back in the office," July 29, 2020

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