

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the impact of the pandemic on asset pricing and briefly review the recent Federal budget.



## EXECUTIVE SUMMARY

- While the stock market has recovered some of the losses recorded at the start of the year, further progress appears conditional on the development of a vaccine.
- The unique nature of the pandemic has created an unusual situation where companies which would usually struggle during a recession have achieved record profits.
- The stock market lost ground over the most recent three-month period, falling by around 1.39%. The market remains around 16% below the pre-virus peak.





## Still no clear picture

**I**t has now been just over six months since the onset of the COVID-19 pandemic, and while life is slowing returning to (a new) normal, the medium-term outlook for the economy and stock markets remains cloudy. In essence, the answer to nearly every economic and investing question one can ask can be answered with the same response – it depends on when or if we have a vaccine.

The unique nature of the pandemic and its subsequent impact on the economy and life in general has meant that many of the usual relationships and rules no longer apply. For example, who would have expected that Harvey Norman, a company which has been on the wrong end of an ongoing battle with the shift to online retailing, would experience its best sales and profits in history? The usual investment approach to a company like Harvey Norman, heading into a recession, is to run a mile. The current economic recession, however, is unlike any other in Australia's history. Never before have companies such as Harvey Norman, or JB Hi-Fi or any other discretionary retailer, performed well during a recession. The usual pattern is that consumers tighten their belts as the recession bites, with spending on non-essential items the first to be cut from household budgets. It's hardly appropriate, after all, to be spending a few thousand dollars on a new television when you have just lost your job. Except in this recession, where direct government payments to individuals in lieu of wages, has allowed the spending to keep going. We may be in a recession, but it certainly doesn't seem like it when you look at the level of retail sales in the economy, which are just one indicator of the government's largesse.

That said, the government cannot indefinitely keep paying the wages of employees who have been adversely impacted by the pandemic. At some stage, the income support measures have to end, which is the reasoning behind the tapered end of the JobKeeper payments and other programs. By the end of March 2021, in theory, the majority of income support payments linked to the pandemic will have ended, with new measures, as outlined in the Federal budget, designed to encourage corporate investment and job growth. This suggests that the first half of next year will provide a true insight into the longer-term impact of the pandemic on the economy. To a certain extent, the Federal government has papered over the cracks within the economy, literally using dollar bills. The income support programs have fulfilled their mandate in terms of providing an income to those workers impacted by the pandemic, thereby putting a floor under household consumption. The end of these programs is likely to have a negative impact on businesses such as Harvey Norman, who are likely to see a sudden reduction in government-funded purchases.

The next stage in the economic evolution of the pandemic depends on the question posed in the introduction to this section: when (or if) is a vaccine freely available? While there is evidence that we are able to live with the virus (witness New South Wales' ability to keep the virus under control while still allowing a gradual relaxation of restrictions), it is fair to say that life will not fully return to pre-pandemic conditions without the availability of a reliable and safe vaccine. Regarding the likelihood of a vaccine being found which effectively eliminates the virus, we leave these questions to the medical experts. We profess to be no more informed than anyone else regarding the possibility or otherwise of the eventual development of a successful vaccine. However, in regard to investment outcomes, much does depend on the answer to this question. Consider a company such as GPT Group, for example. GPT owns a number of well-positioned CBD office blocks, such as Australia Square, pictured below:



Australia Square is in the middle of the Sydney CBD, spanning George St, Bond St and Pitt St. The building is 40 storeys tall and offers over 51,000 square metres of office space. Major tenants include Origin Energy, ninemsn and law firm HWL Ebsworth. The building is valued at \$576 million and has an occupancy rate of 94.60%. However, due to restrictions associated with the pandemic, the building is in fact largely empty, as employees work wholly or partially from home.



There is a view that ‘Work from Home’ (or WFH) will become an entrenched part of life; that large office buildings like Australia Square may be unnecessary as companies find it more cost effective to continue to let employees work from home. This view partly explains the performance of the GPT share price since the onset of the pandemic, which is trading around 34% below its pre-pandemic price. However, should a vaccine be discovered in a relatively short space of time, one would expect most employees to soon be back at their desks, wholly justifying the \$576 million valuation of Australia Square. As this example demonstrates, the value of the building and hence the valuation of the building owner depends more on the discovery (or otherwise) of a vaccine, and less on the actual merits of the building. Unsurprisingly, companies such as GPT and Dexus, also an owner of many similar buildings, are at the forefront of calls for employees to return to the workplace.

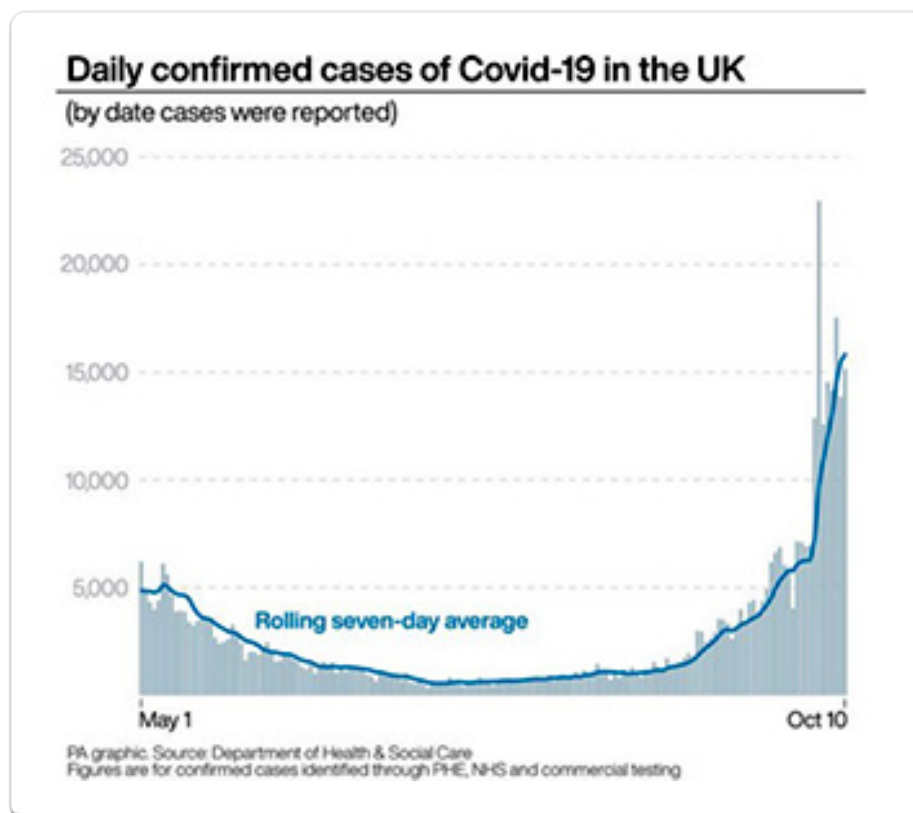
The GPT/Australia Square example depicts the current dilemma facing investors – do you invest in companies which have been negatively impacted by the pandemic, in the hope of generating above-normal returns once a vaccine is found? Or do you take the position that a vaccine may take a considerable time to be made available (if ever), and thus should avoid companies such as GPT? This is the type of dilemma which troubles investors as the decision to invest is not dependent on fundamentals – is this a good asset or business? – but rather, it depends on the outcome of a process (discovering a vaccine) which is entirely unrelated to the investment itself. This same logic applies to many other potential investments: investors taking a position in Qantas, for example, are essentially betting that a vaccine will be discovered and made available before the airline runs out of money. Making an investment in Qantas now, therefore has little to do with the fundamentals of the company (revenue, costs, profits) and is solely a view on the outcome of the vaccine discovery process.

In regard to addressing the impact of this dilemma on portfolio construction, our approach is to try and avoid adopting a position that relies either on the immediate discovery a vaccine, or the potential situation where a successful vaccine is never discovered. There are many companies whose business model is not hostage to the outcome of the vaccine discovery process. Health related businesses such as CSL and Resmed, to name just two examples, are companies whom we expect to prosper regardless of the timeframe relating to the development of a vaccine. Of course, CSL is a significant manufacturer of vaccines in its own right and has been engaged by the government to produce any potential COVID-19 vaccine, however we see this as simply ‘icing on the top’ and not the key driver behind the company’s future fortunes. In any event, given the importance of a COVID-19 vaccine, it is unlikely that the government (or the public) would countenance a situation where a company was generating outsize profits from the manufacture or distribution of the vaccine. Mining companies, non-discretionary retailers such as Coles and Woolworths and, to a certain extent, even the banks, are all businesses whose near-term fortunes are not tied directly to the outcome of the vaccine discovery process.

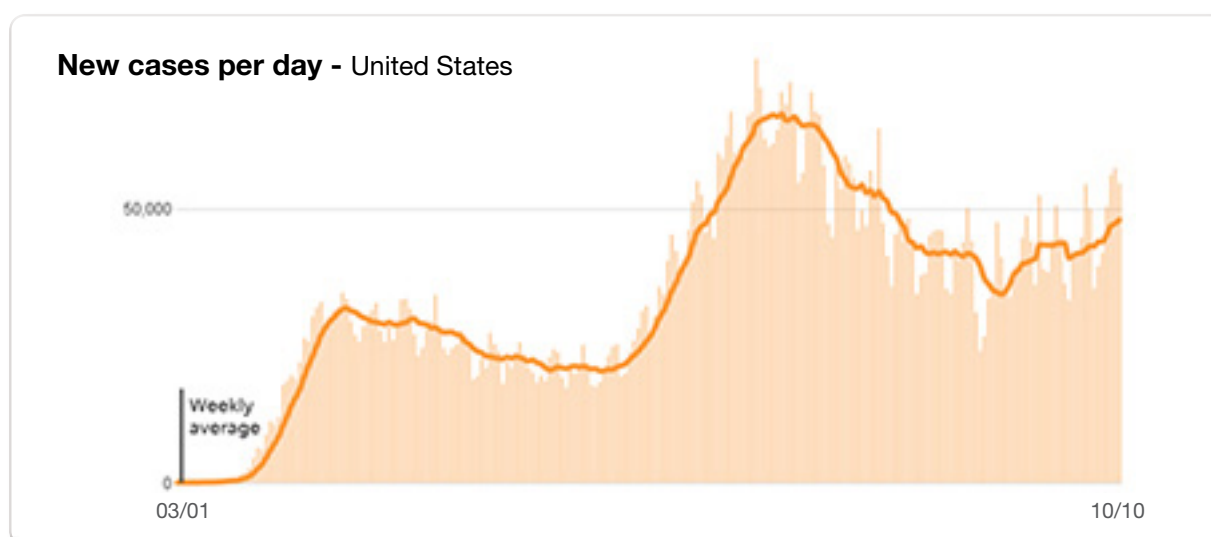
### *An uneven global recovery*

In regard to the economic recovery from the initial impact of the pandemic, it’s fair to say that progress has been mixed. China, where the virus is thought to have originated, has seen the strongest economic recovery, as activity has reached near pre-pandemic levels. To a certain extent this makes sense, given that China has had the most time to deal with the after-effects of the virus. The news is not so promising in Europe and the United States. In Europe rising case numbers pose the risk of renewed lockdowns and restrictions, which can be expected to negatively impact economic activity. In the UK, new measures have been announced to assist the country in getting back on top of the spread of the virus, which had overwhelmed the health system earlier in the year.

The issue of rising UK COVID-19 cases is illustrated in the chart below.



It had been theorised that the spread of the virus may be seasonal, as with the flu, and as the northern hemisphere heads into winter there does appear to be a pickup in new virus cases in many countries. In the United States, where authorities never really gained the upper hand against the virus, rising case numbers represent almost a third wave in less than 12 months, as shown below.

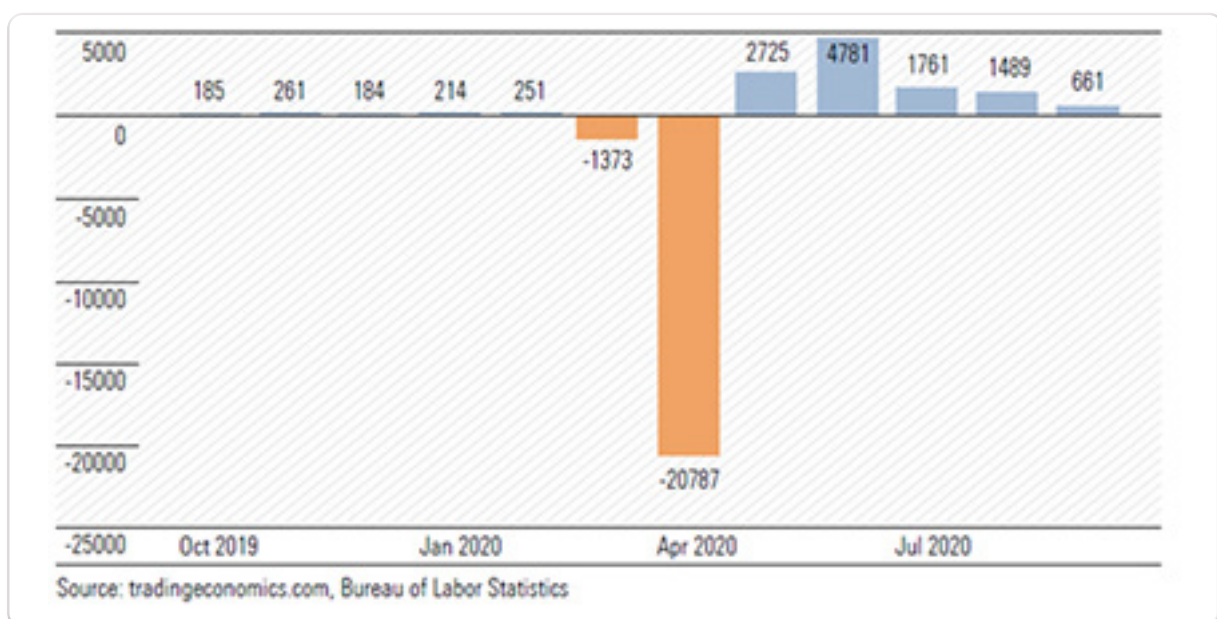


The dire COVID-19 situation comes as the US nears the Presidential election, set down for Tuesday the 3rd of November. Unfortunately, in the US the approach to managing the virus has become highly politicised, as both sides of US politics seek to leverage the current situation to their gain. Even relatively benign activities, such as wearing a mask or avoiding large crowds, have become politicised, with the conservative side of US politics (led by President Trump) pushing against restrictions designed to limit the spread of the virus. Unfortunately, this partisan fighting has crippled the US response to the virus, reflected in the country's inability to slow the spread of the virus. Compare this approach to the relatively bi-partisan manner in which both sides of politics in Australia have approached the problem, albeit that this is not the sole reason for Australia's relative success in managing the virus.

Proximity to the US Presidential election has also impacted the fiscal response to the pandemic induced recession. After rebounding from the initial effects of the lockdowns in March and April, US economic growth has once again begun to slow. There is general consensus that the US economy requires an additional round of fiscal stimulus (government spending), however the process has been bogged down in negotiations between Republicans and Democrats. More recently, President Trump announced that he was walking away from negotiations until after he won the Presidential election, a move which was not viewed favourably by markets. This is despite US Fed chief Jerome Powell calling for more government stimulus, stating that "too little support would lead to a weak recovery, creating unnecessary hardship for households and businesses."

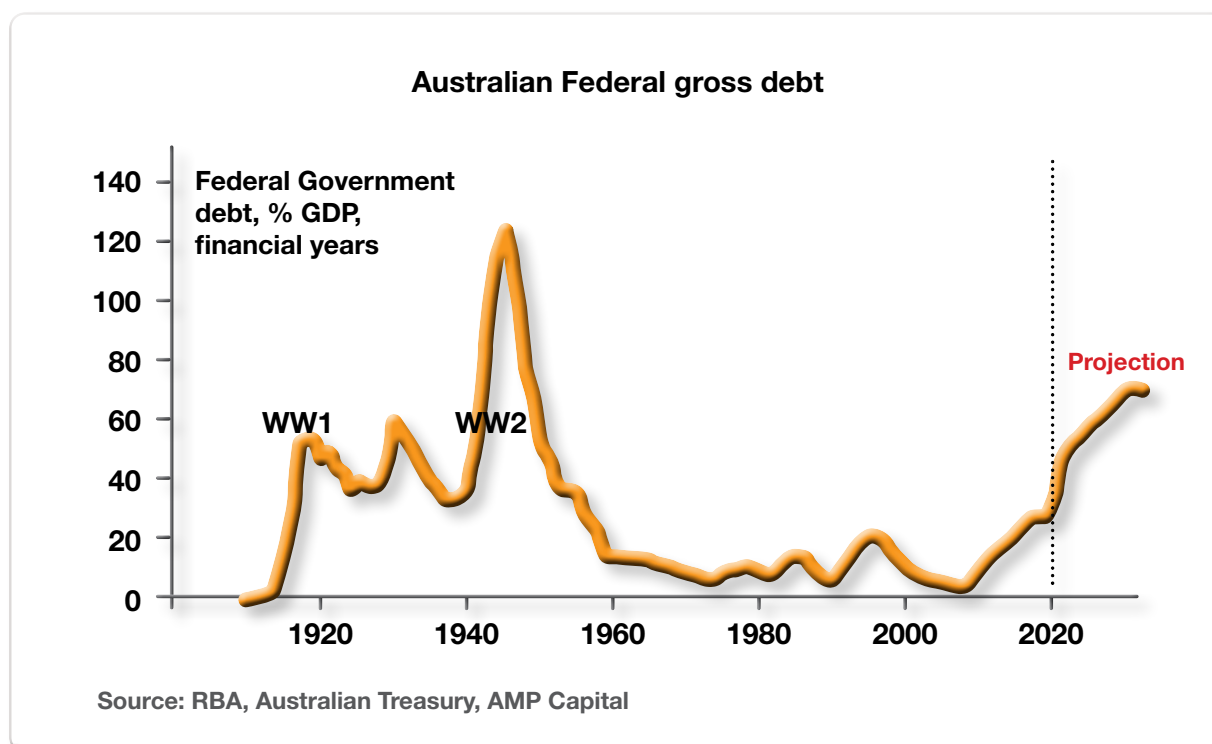
The headwinds facing the US economy were evident in the September nonfarm payrolls figure, which showed that the economy added only 661,000 jobs in that month, significantly below expectations of around 800,000. With 22.2 million jobs lost in March and April, there is still a long way to go in making a significant dent in the unemployment rate.

**US Nonfarm Payrolls – Jobs added per month**



### Australian Federal Budget

Usually released on the second Tuesday in May, the federal budget was delayed by COVID-19 and was instead released on the 6th of October. As was expected, job creation was the centrepiece of the budget, with a number of measures aimed at encouraging business to hire more workers. A JobMaker scheme was unveiled, where businesses would receive financial credits for hiring younger workers. An instant asset write-off scheme was expanded to include nearly all businesses, with the government hoping to boost company investment, which has been below average for many years. Infrastructure spending also received considerable attention, although it was rightly pointed out that some of the spending measures had in fact been put forward in previous budgets and could hardly qualify as additional spending. Personal income tax cuts were also a feature of the budget, with the government hoping to underpin household consumption, which is the most important component of the economy. The various measures came at considerable cost however – the ratio of government debt to GDP is expected to peak at 44% in 2024, when total government debt is expected to reach \$966 billion, a level not seen since the end of World War 2.

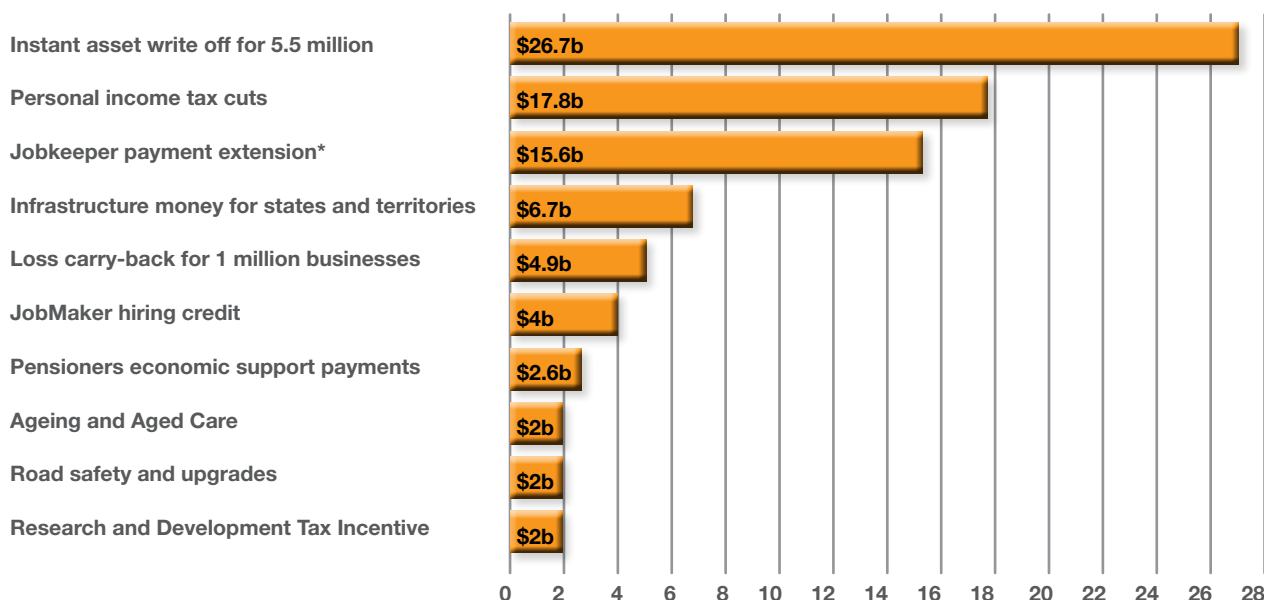


Critically however, all the budget forecasts regarding job creation and future economic growth depend on one key assumption: all Australians will be effectively vaccinated against COVID-19 by the end of next year. Given the current progress in discovering a vaccine and the logistical issues faced in rolling out a vaccine to every Australian, such an assumption appears somewhat optimistic.

Perhaps the biggest criticism of the budget is that it failed to take advantage of the fact that the economy is in an unprecedented position and here, more than ever, was an opportunity to make bold decisions in regard to economic reform. It is fair to say that for many years no Australian government has been willing to attempt truly innovative economic reform, lulled into a false sense of economic security by continued Chinese demand for our raw materials. The current crisis may have presented the government with an opportunity to make some of the more difficult decisions which previous governments have put into the too-hard basket. Failing that, even ambitious nation-building projects could have been attempted (high speed rail, new highways, renewables...). Instead the government trod a well-worn path in unveiling a relatively uninspiring mix of tax cuts, asset write-offs and increased spending in key areas. Winston Churchill is credited with the saying 'Never let a good crisis go to waste', and it may be that we look back in future years and consider that the current government did exactly that.

## TOP 10 MAJOR SPENDING

Includes tax cut and spending measures; cost over four year budget horizon

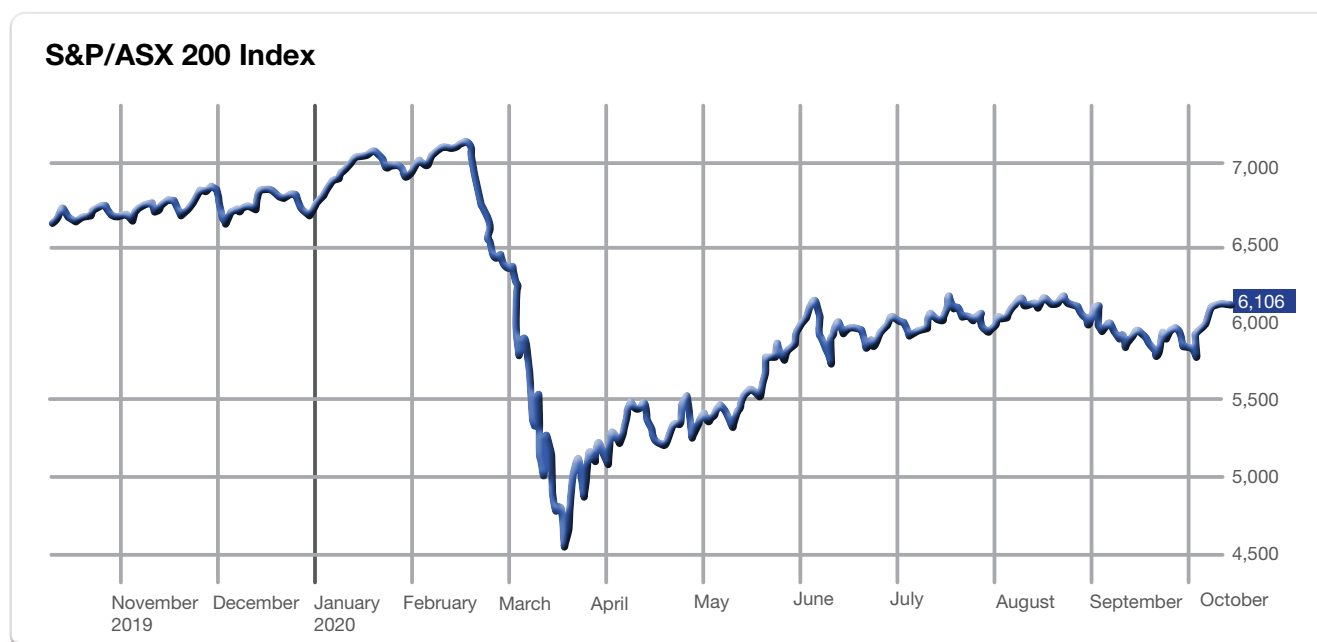




## The stock market over the past quarter

After a strong rally in the second quarter of 2020, the reality of a synchronised global recession appeared to halt the market's recovery from the March low. The benchmark S&P/ASX 200 Index ended the quarter at 5,815 points, which was 82 points below the 30 June level of 5,897, a fall of 1.39%.

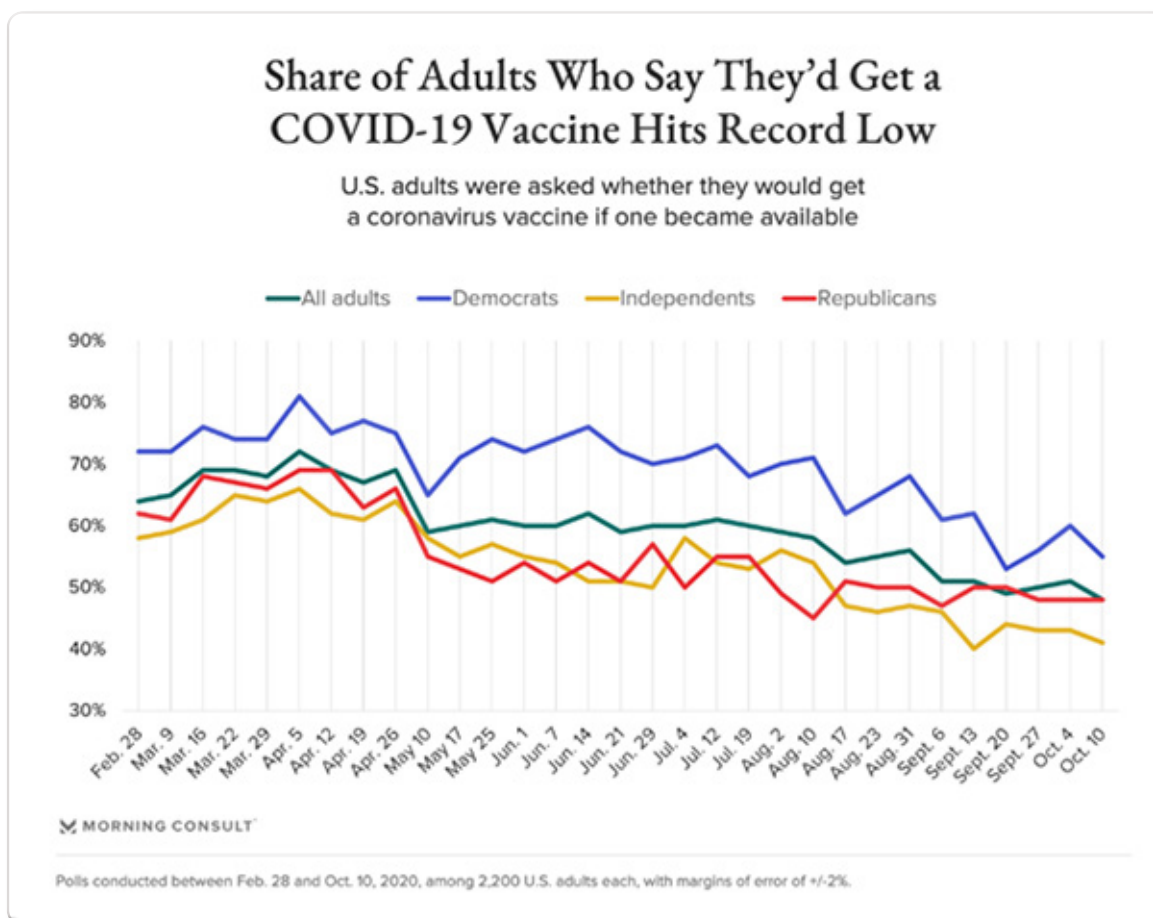
The sideways movement of the market over the past few months is evident in the chart below:



Following the collapse in February and March, the market recovered over the next three months, reaching a new high in mid-June. Since that date, the market has moved within a relatively narrow range and it remains around 16% below the pre-virus peak. In our view this likely reflects the market's general indecision over the direction of the economic recovery over the next six to twelve months. Now that the initial panic in regard to the health impact of COVID-19 has subsided to a large degree (recall early predictions that over 180,000 Australians were going to die from the virus), the focus has rightly turned to the economic impact of the pandemic and the measures that will be required to reinvigorate global economic growth.

The recent federal budget, as discussed earlier, provides an important piece in the puzzle as to how this will be achieved, at least insofar as Australia is concerned. A clear resolution of the upcoming US Presidential election will also remove one factor which is responsible for heightened uncertainty levels. That said, our expectations for the market over coming months hinge largely on the continued search for a vaccine, as we outlined at the start of this newsletter. A sustained increase in the market should not be expected unless there is concrete evidence of progress in this regard. That is not to say that individual companies or sectors may not perform strongly, however a broad market recovery does appear vaccine dependent.

We conclude this edition of our newsletter with a worrying chart, with the sobering news that according to polls, less than 60% (and falling) of Americans would actually get a COVID-19 vaccine if one was available.





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PRIVATE WEALTH



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We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We trust that you and your families remain safe and healthy in these uncertain times.

With kind regards,

*Justin, Ray & Michelle*

## FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	2.2% (Mar)	-2.5%
Australian unemployment rate	7.1% (May)	-0.2%
RBA Cash rate	0.25% (Mar meeting)	-0.50%
ASX 200 Index	5,897	-82 points
Australian \$ vs. US \$	\$0.6863	+0.0317
Australian \$ vs. UK £	\$0.5586	-0.0048c
Australian \$ vs. Euro €	\$0.6111	-0.0053c

*This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.*



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