

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the ongoing economic impact of COVID-19 and how this relates to the stock market.



EXECUTIVE SUMMARY

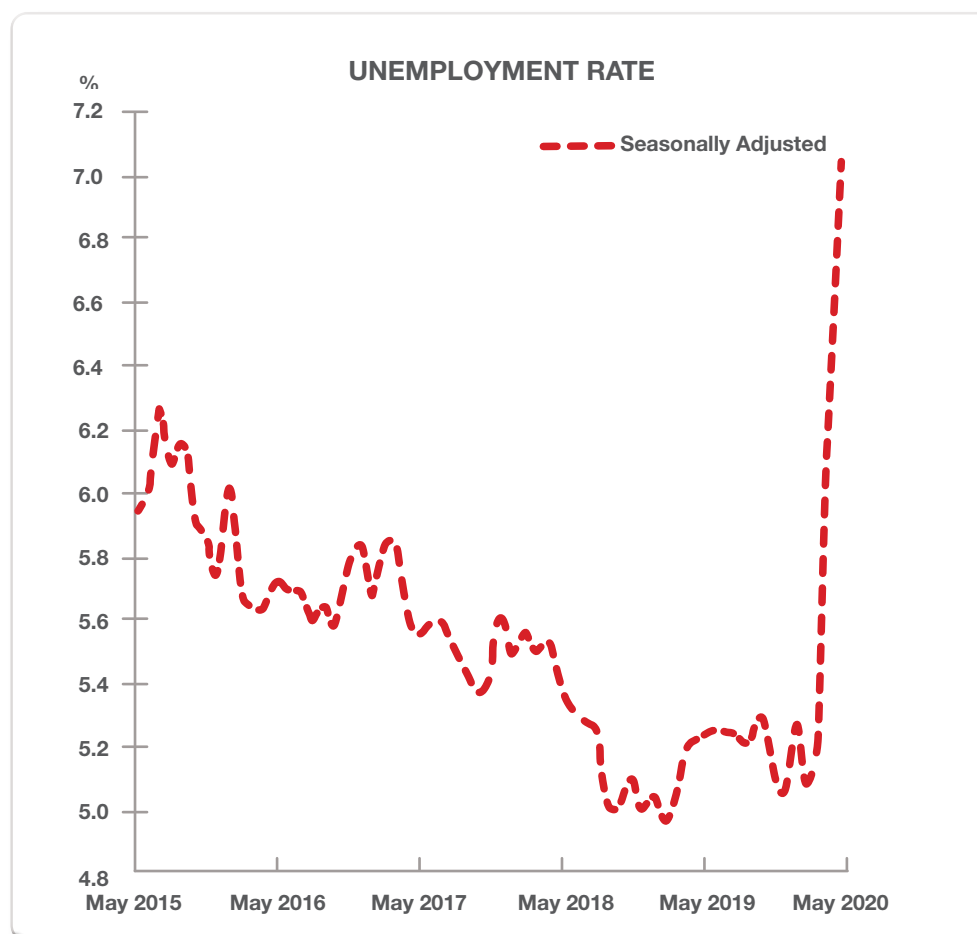
- At face value it appears as though the worst of the economic and health crisis has passed, although uncertainty levels remain high and health risks remain
- Over the past quarter, the stock market recovered strongly, although the benchmark ASX 200 Index is still approximately 18% below the peak reached pre-COVID
- A feature of the response to COVID-19 has been a reduction in interest rates to near 0% levels. We discuss how the impact of this phenomenon is addressed through portfolio construction.

A slow return to normality

After the tumultuous events of the past few months, it has been refreshing to see life slowly return to normal, although the impact of COVID-19 is still very visible in the workplace, social settings, and the economy. In this section we discuss the economic impact of the pandemic, which is becoming more apparent with every passing day.

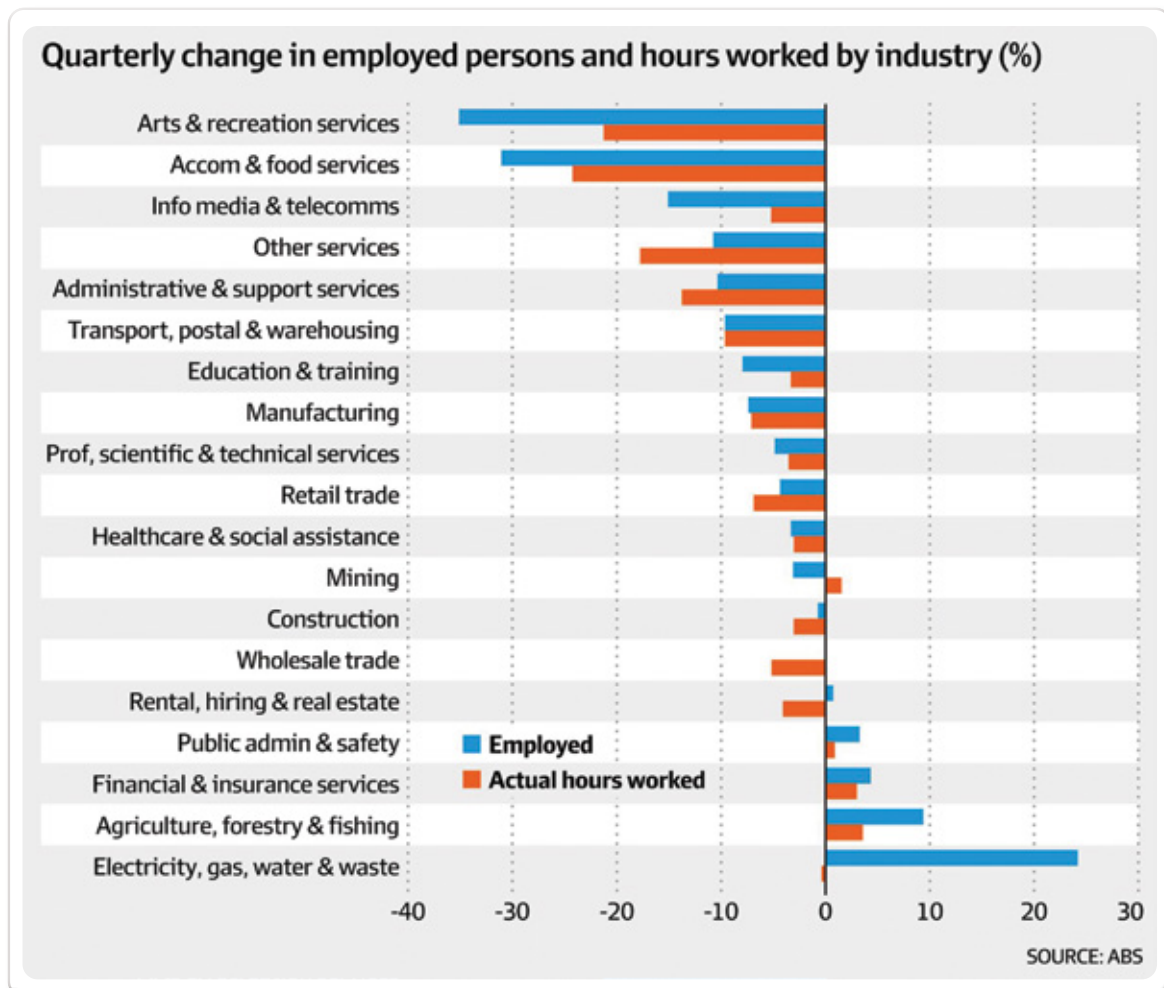
While the situation remains fluid (witness the spike in infections in Victoria), it is fair to say that the impact of the pandemic within Australia, both from a public health and an economic perspective, has not been as bad as was initially feared. While this is no consolation to those who lost their jobs or even their lives, there is little doubt that the steps taken to slow the spread of the virus, and the economic assistance provided by both the government and the Reserve Bank, proved successful in sparing Australia from the worst of the pandemic.

While many of the restrictions on gatherings and movement which were in place earlier in the year have gradually been lifted, only now is data being released which illustrates the economic damage wrought by the pandemic. The most obvious indication of the economic impact of the economic shutdown has been in unemployment, with the unemployment rate reaching a 19-year high in May of 7.1%. By the end of May, nearly a million jobs had been lost in Australia as a result of the pandemic.

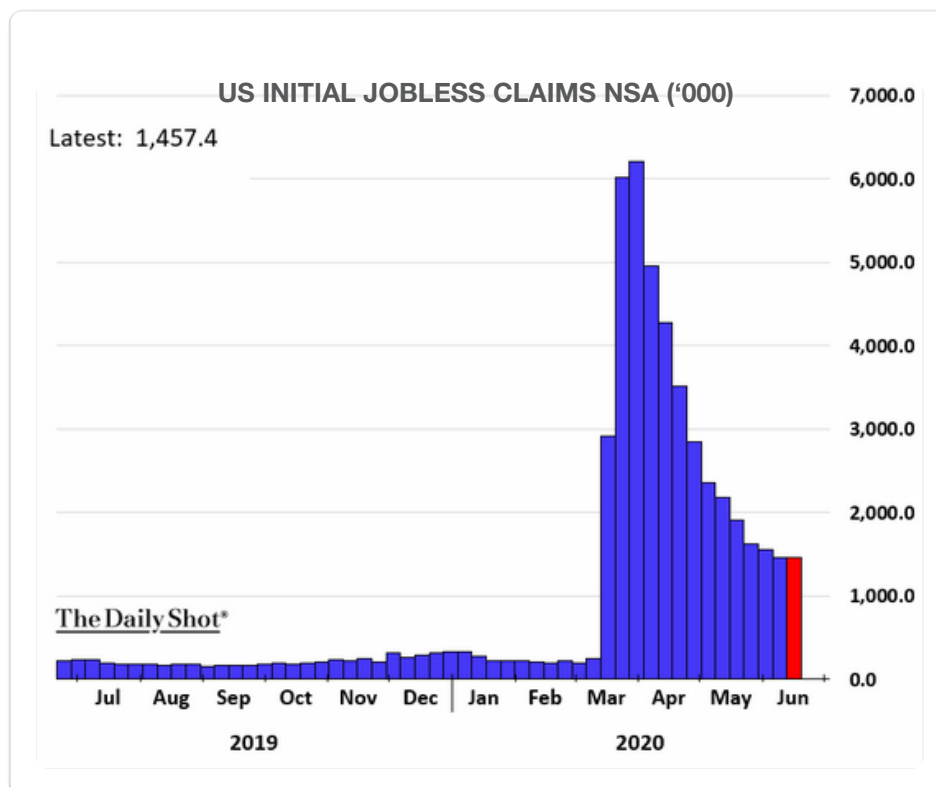


In fact, were it not for the fact that hundreds of thousands of people had given up searching for work, the unemployment rate would have been even higher, at around 11%.

As expected, job losses have been highest in those occupations and sectors hardest hit by the government-mandated lockdown. Arts & recreation and the food and accommodation sectors fared the worst, as shown below.



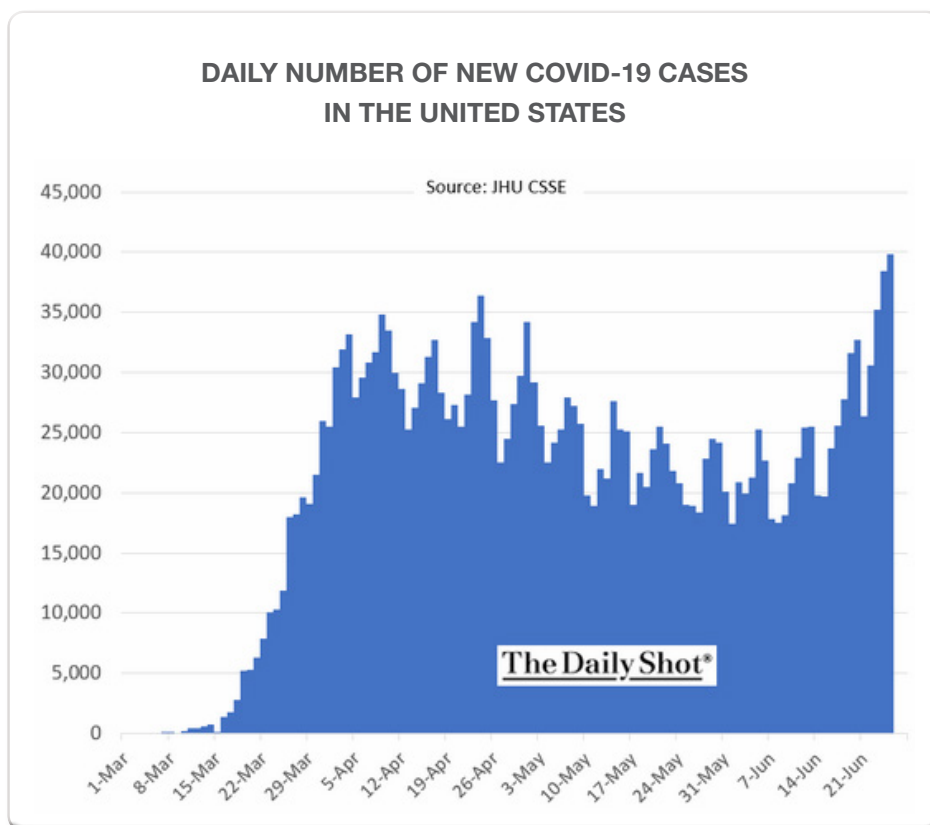
That said, as bad as the situation in Australia appears, the country appears to have weathered both the economic impact and the medical side of the pandemic better than many other countries. In the United States for example, the unemployment rate is considerably higher at 13.3%, although the rate of job losses has at least declined somewhat, as shown in the following chart.



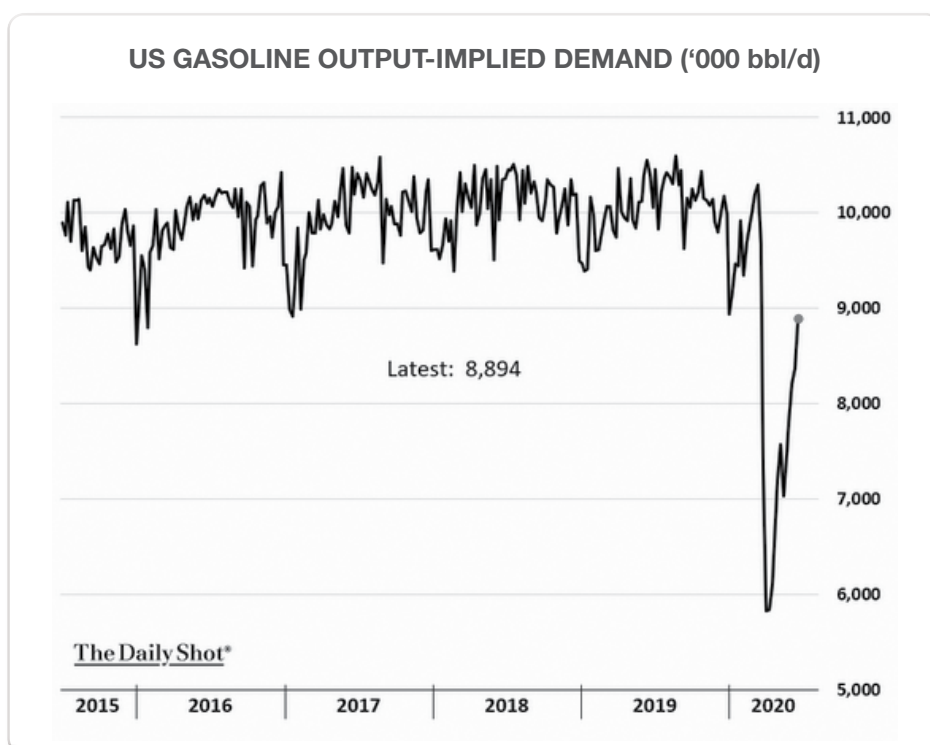
The most recent week saw only(!) around 1.4 million American workers file for unemployment benefits, as compared to over 12 million over a two-week period at the end of March. Clearly the worst of the economic crisis has passed, although in the US there are currently just over 30 million unemployed workers, which is almost 15% of the entire US working-age population.

Worryingly, the number of new daily COVID-19 cases in the US has reached record levels, which suggests that the pandemic has not been controlled in the US as effectively as other countries. To a certain extent this may reflect the significant ramp up in testing rates, however there is little doubt that the US was perhaps too quick to re-open its economy and wind back the strict lockdowns which had proven to be highly effective in other countries.



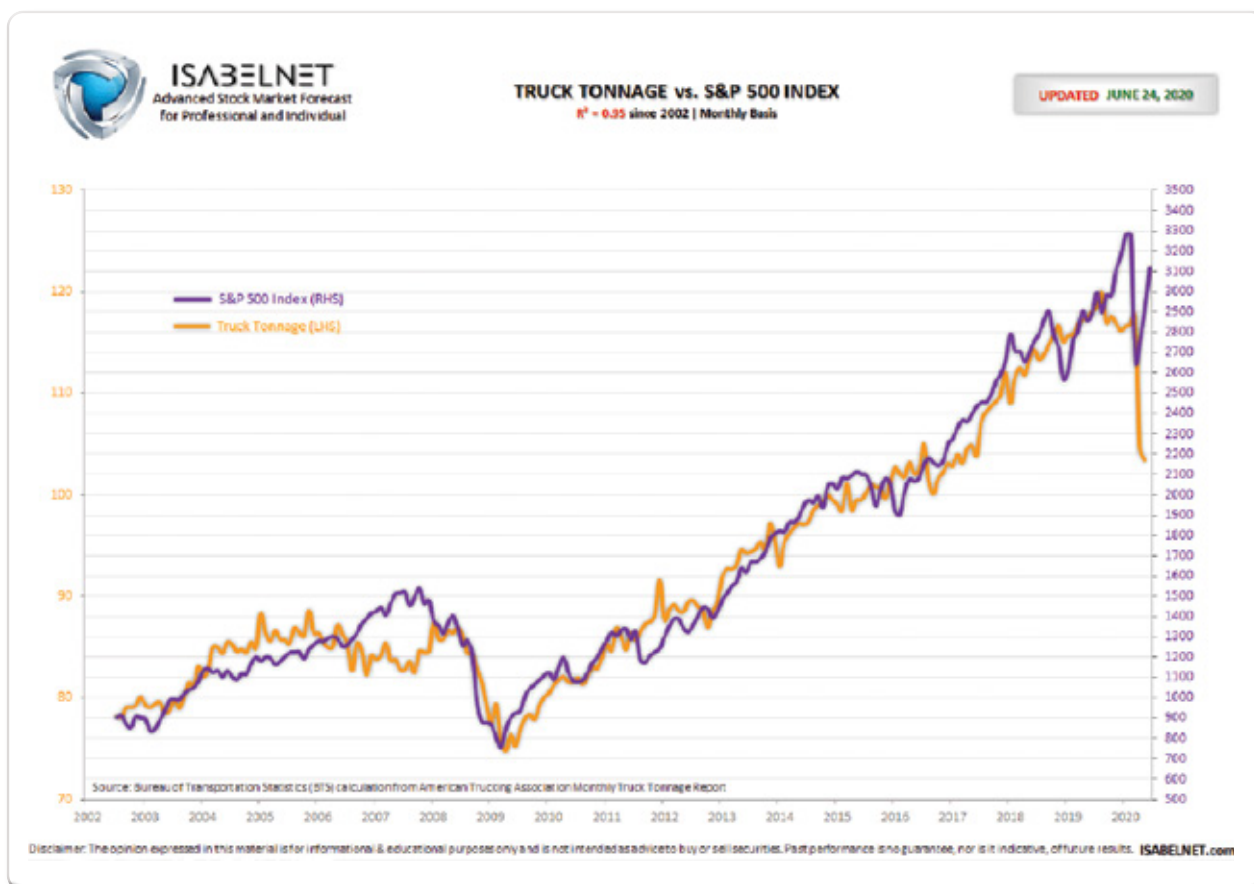


One of the charts we showed in our March quarterly newsletter highlighted the sudden fall in gasoline demand in the United States, as stay-at-home orders were implemented throughout the country. With the gradual reopening of the US economy, gasoline demand has improved somewhat, although it remains well below normal levels.



A return to regular commuting to and from work is of interest to us as one of the companies on our watchlist is Transurban, who own and operate the majority of tollroads within Australia, in addition to a number of overseas tollroads. The evidence suggests that while 'work from home' has had an impact on the number of vehicles using tollroads on a daily basis, people are understandably keen to avoid using public transport if they can. As a result, daily travel on tollroads has recovered better than expected, which is just another small way in how the pandemic is having an impact on many facets of life.

Related to transport is the chart below, which shows the relationship between the performance of the main US shares index, the S&P 500 Index, and an index of truck tonnage (a measure of the level of trucking activity on US roads). As can be seen, there is a fairly close relationship between the two measures, which seems reasonable as one would expect there to be a correlation between the amount of trucks on the roads and the stock market (more trucks equates to a stronger economy, which should lead to a stronger stock market). However, if you look at the chart carefully you can see that this relationship has broken down in the past few months, with the stock market rising while the truck tonnage index has fallen sharply. At a superficial level, this may imply that the recovery of the US stock market in the past few months is not justified, when considering the impact on the economy.



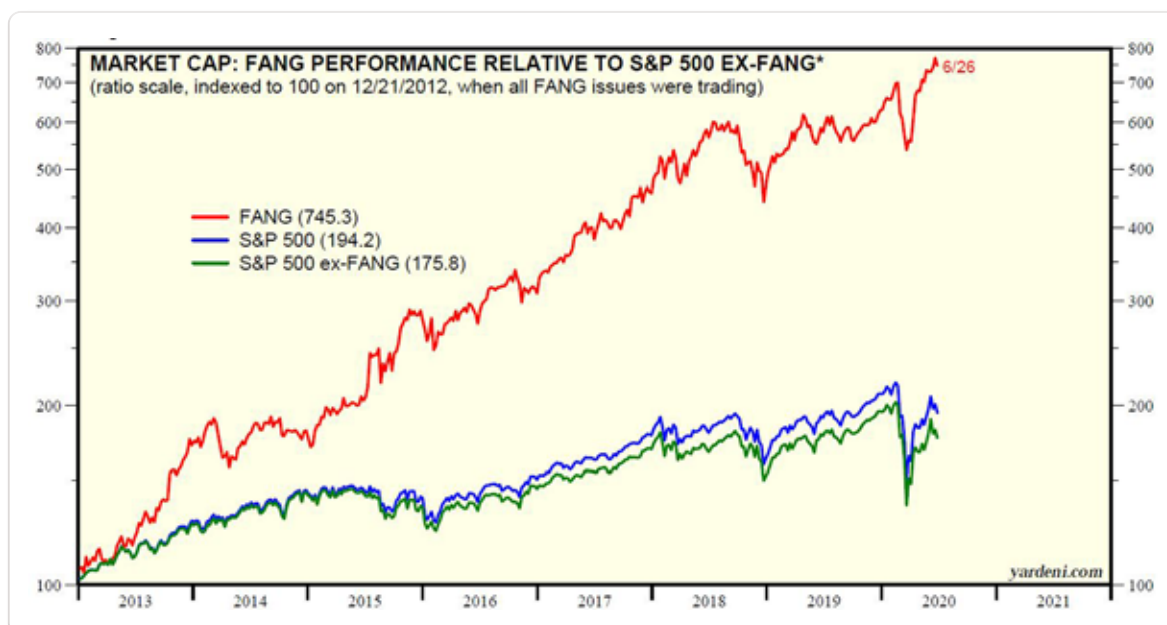
While on the performance of the US stock market, an interesting development over the past few months has been the far stronger performance by US shares as compared to the rest of the world. Although the United States has both the highest number of COVID-19 cases and deaths in the world, and the economy has been as equally impacted as others by lockdowns and shutdowns, the US stock market has performed far better than most other countries.

The chart below shows the outperformance of US shares compared to the rest of the world. When the black line is falling, US shares are underperforming relative to the rest of the world, while a rising black line indicates that US shares are performing better than shares in the rest of the world. As shown on the chart, the last few years have seen US shares perform far better than other share markets.

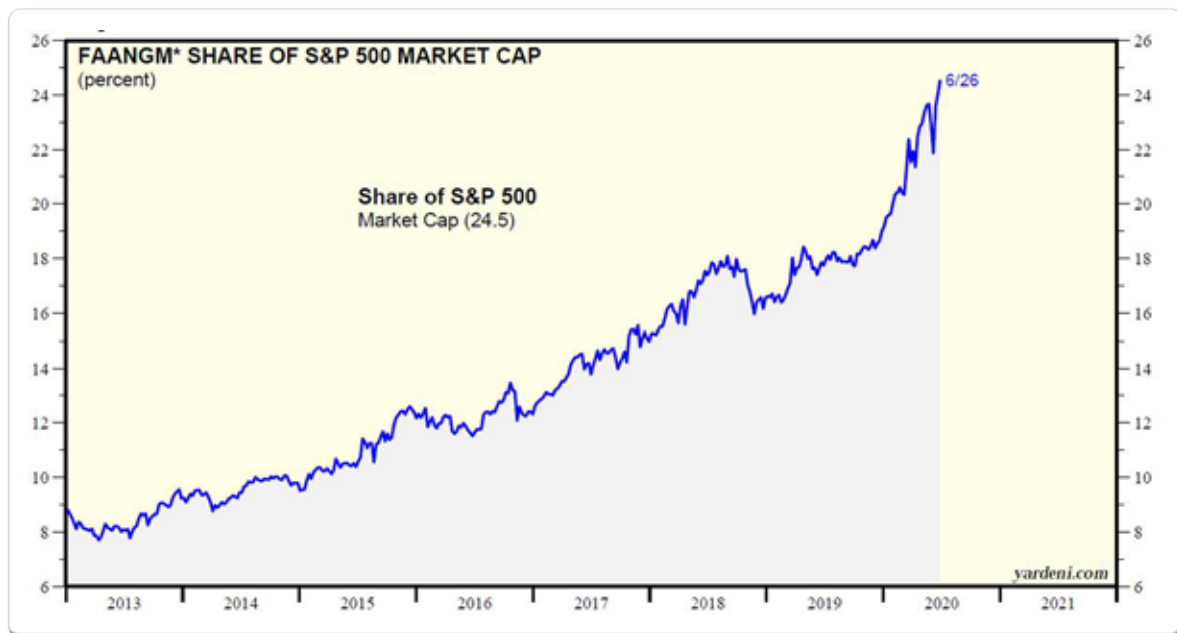


The obvious question is why? On what basis have US shares outperformed their global counterparts to such an extent over recent years? Is the US economy growing that much faster than other countries, or is the outlook for the US in general that much better than other countries? Short answer – no. In fact, the real reason behind the outperformance of US shares is largely down to one reason – FANG. Not a swear word, FANG refers to the gang of large tech companies in the US: Facebook, Amazon, Netflix and Google. These four companies have experienced such significant growth that they have been responsible for much of the outperformance of US shares when compared to the rest of the world.

The chart below shows the relative performance of the FANGs compared to the S&P 500 since the start of 2013. The FANGs are nearly 800% higher in value, while the S&P 500 increased by 200% over the same period.



Some investors choose to also include Apple and Microsoft in the tech group, which gives rise to the FAANGM acronym. Due to the increase in market valuations of those six companies, they now comprise nearly a quarter of the entire US stock market, as per below.



Effectively, any investor who invests in the S&P 500 Index is putting a quarter of their money into those six companies. This is a similar situation to the Australian stock market, which for many years was dominated by the four large banks – CBA, Westpac, NAB and ANZ. This can pose a problem with regard to diversification, as underperformance by just one or two of these large companies can impact the entire index.

In regard to the Australian market, the past quarter has seen a significant recovery from the falls experienced in the first quarter, although the market is still around 18% below the high reached in mid-February.



The chart quite clearly shows the panic which set in in the last few weeks of March, as the market reacted negatively to the initial spread of COVID-19. In fact, the falls during March constituted the fastest bear market in history – never before had the share market lost as much value in such a short period of time. Not quite as fast, but equally significant, has been the partial recovery of the market since the low on 23 March. At this stage the market appears to have split investors and observers into two camps: those who believe the worst is behind us and the global economy will bounce back relatively quickly; and those who believe that the stock market has recovered too far too quickly and a retracement back to the low in March is possible.

In our view, this divergence of opinion is grounded in the fact that the current level of uncertainty is extremely high. Given that neither the global economy, nor stock markets, have been through a similar situation in our lifetimes, any subjective opinions as to the course of events in coming months is simply guesswork. Current prices either represent a case of hope over reality or are a once-in-a-decade buying opportunity. Unfortunately, the truth of the matter is only going to be known in hindsight. At this time our approach is to invest where appropriate, but otherwise maintain healthy allocations to cash. We recognise that the return on cash is very low, however having cash on hand does assist in terms of capital stability, in addition to allowing selective investments as the opportunity arises.

Interest rates and portfolio construction

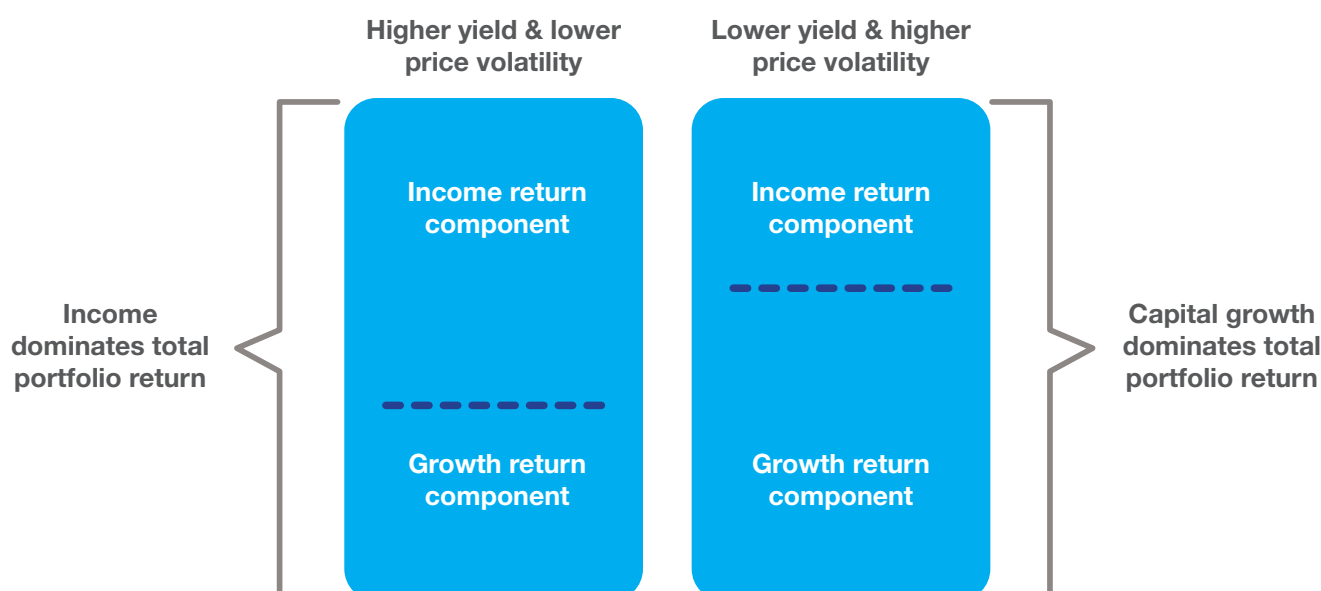
One of the unfortunate consequences of actions by the authorities to soften the economic impact of COVID-19, has been a reduction in official interest rates to near zero. The Reserve Bank's official policy is to target a cash rate of 0.25%, which is a 50% reduction from the rate that was in place prior to COVID-19. While reducing interest rates is of obvious benefit to businesses (who usually carry some amount of debt) and mortgage-holders, savers, investors and self-funded retirees are collateral damage.

As the cash rate is the effective benchmark rate of return for all investments, the decision by the Reserve Bank has led to a fall in the income generated by nearly all fixed interest investments, be they term deposits or corporate bonds. In the past, a balanced portfolio comprised of a mix of shares, fixed-interest investments and other asset classes, could be expected to reliably generate an income return of around 7%. For most investors, such an outcome usually allowed one to live off the earnings while keeping their capital intact (or even increase over time). The same mix of investments today, however, might only be expected to generate an income return of between 3% to 4%. This poses a challenge in regard to portfolio construction.

The difficulty for investors is how to manage this shortfall in income. Some have opted to invest in riskier higher-yielding investments, such as emerging market government bonds or corporate junk bonds. The issue with such an approach is that it entails a significantly higher level of risk and for very little extra reward. You could invest in Nigerian government bonds for example, which offer a rate of around 9%, which seems far too low considering the risk of a potential default on the debt. Junk bonds, which are issued by companies with very poor financial prospects, also offer too low a return given the associated risks of the investments.

In our view, dealing with the fall in yield from income-generating investments means adopting a total return approach to portfolio management. That is, in the past the portfolio return might be comprised of a 5% income return and 3% capital growth, for an overall return of 8%. With interest rates at record low levels, the same approach might generate a 3% income return and 3% capital growth, for an overall return of 6%. In order to maintain the overall return at 8%, one approach is to try and increase the capital growth of the portfolio, by marginally increasing the portfolio's allocation to growth assets. In practice, for example, this might entail selling shares in a company like Woolworths (which is solid and dependable, but low growth) and investing the proceeds in a company such as Xero (the online accounting provider, which is growing faster than Woolworths, but is also more risky). The challenge is to manage this process in such a way that the desired higher long-term capital growth is achieved without increasing the risks beyond an appropriate level.

This change in emphasis is outlined in the graphic below, showing the same return but different proportions of each component.



This approach also requires accepting that occasionally assets may need to be sold in order to provide the cash required to fund living or retirement expenses. In theory, if the total return remains the same as a portfolio which has higher cash earnings, there is no difference in the impact on the investor's total wealth. Achieving this fine balance between risk and return is our primary focus when it comes to making recommendations for our client's portfolios.



BAIOCCHI GRIFFIN
PRIVATE WEALTH



Justin Baiocchi



Ray Griffin



Michelle Higgerson

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)	+0.4%
Australian unemployment rate	7.1% (May)	+0.6%
RBA Cash rate	0.25% (Mar meeting)	-0.50%
ASX 200 Index	5,897	+821 points
Australian \$ vs. US \$	\$0.6863	+6.88c
Australian \$ vs. UK £	\$0.5586	+5.80c
Australian \$ vs. Euro €	\$0.6111	+5.06c

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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