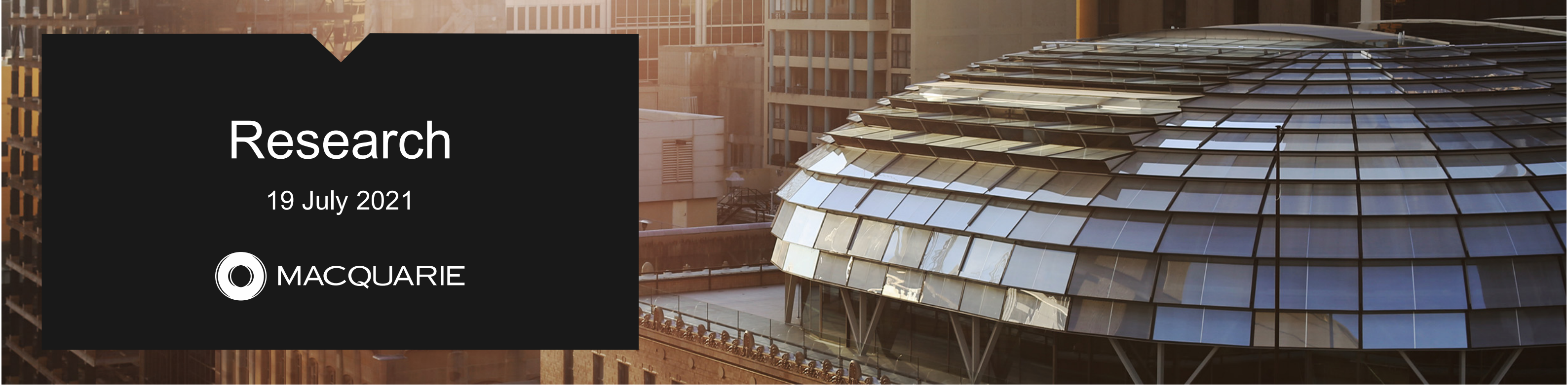


Research

19 July 2021

MACQUARIE

Investment Strategy Update #63

Taking something good from something bad

- Like policy makers who are being guided by the science, we felt a "fact" rather than "opinion" based analysis was necessary as we unwrap the impacts from the latest COVID-19 outbreak for the equity market. While the pandemic and lockdowns have had a tragic human toll and cause widespread economic destruction, the impact on the economy has proven to be temporary – a statement rooted in fact via V-shaped recoveries – with the equity market powering through every COVID-19 outbreak and subsequent lockdown.

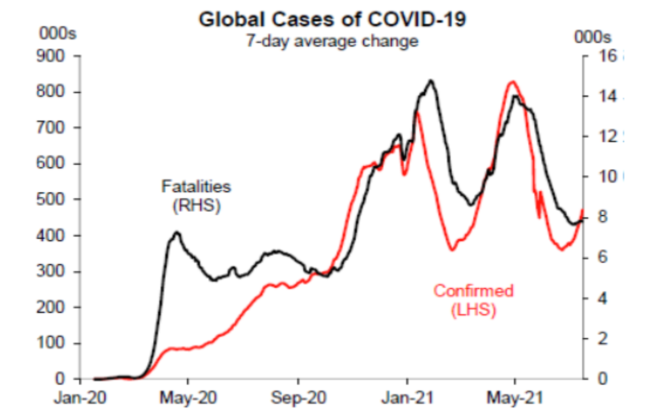
- To take something good from something bad, the pandemic, due to a number of highly unique circumstances, has been positive for equity markets. While it has created a widening dispersion in wealth – the rich getting richer and the poor getting poorer, it has also driven flows into risk assets. Similarly, it has driven a wedge between strong and weak corporates and as a result (opportunistic) consolidation. Government programs have boosted savings and consumption (positive for goods facing consumer firms), while zero rates have boosted house prices, helped drive a steeper yield curve (good for financials) and boosted valuations for many.

- This is not to say that all areas of the equity market have benefited as Utilities, Energy, Real Estate, Healthcare and Industrials are all still below 2020 pre COVID-19 highs. But on balance, these have been offset by areas which have gained strongly including IT, Materials and Consumer Discretionary. How the market deals with smaller fiscal supports, or longer lock-downs, or rising inflation risks or expensive valuations this time around is another matter. But for now, the facts are that the equity market is a forward discounter of news and temporary lock downs have had little lasting impact.

COVID-19 continues to ravage Australia with the latest delta strain driving a fresh set of rolling lockdowns across the country. Anyone watching TV, reading a newspaper or has spent time on their social media accounts over the weekend has been inundated with commentary around the virus and the economic impacts of policies designed to control its spread. To top it off, and to raise the "worry" factor even further, market commentators have added the latest COVID-19 woes to ongoing inflation fears, a softening in growth expectations that were occurring prior to latest outbreaks and a deterioration in consumer sentiment which is usually a precursor to a slowdown in spending.

Like policy makers who are being guided by the science, we felt a "fact" rather than "opinion" based analysis was necessary as we unwrap the impacts from the latest outbreak for the equity market. Nearly 18 months after the coronavirus drove the fastest bear market in history, it's is safe to say that we now have some precedent for evaluating the market outlook. We know fiscal and monetary policy support can provide a substantial cushion to offset the economic effects of lockdowns and border closures; that activity bounces back quickly once lockdowns and social restrictions are removed; and that consumers quickly release pent-up demand and businesses resume hiring once restrictions are removed (i.e., that lockdowns have had little permanent impact on spending hiring or investment). We don't know if multiple lockdowns drive non-linear impacts for consumers or businesses given more restrictive fiscal support this time around, or just from the pain of going through the same scenario multiple times and never being given the time to fully recover.

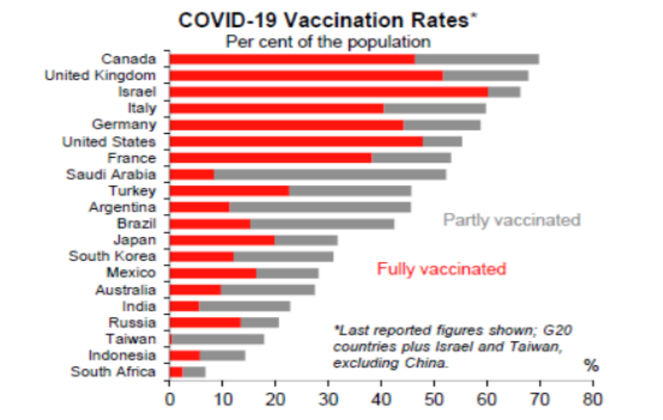
Delta variant is driving another spike in global cases ...



Source: GISAID, Worldometer, Macquarie, July-21

But, while Australia reverts to lockdowns, more successful vaccination programs in many other developed nations (UK and US) appear to have broken the link between cases, hospitalisations and deaths which suggest broad lockdowns may not be necessary in some parts of the world suffering another COVID-19 spike, therefore reducing the global drag on Australia.

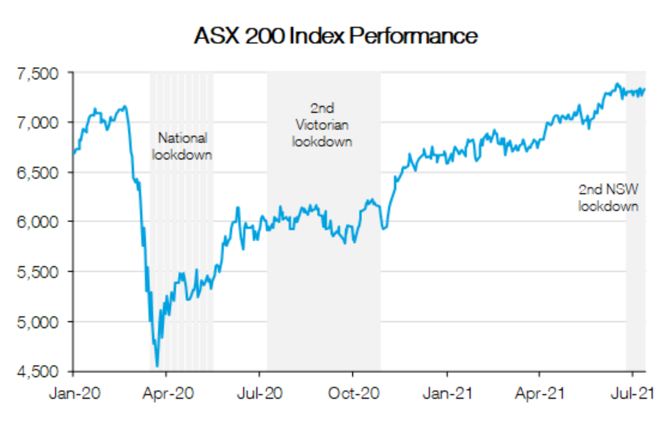
... but improving vaccination rates may limit lock downs



Source: Our World in Data, Macrobond, Macquarie, July-21

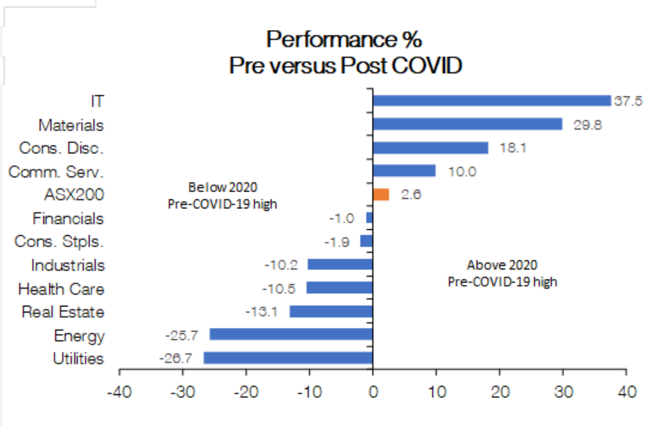
Thus, while the pandemic and lockdowns have a tragic human toll and cause widespread economic destruction, the impacts on the economy have proven to be temporary – a statement rooted in fact via V-shaped recoveries – with the equity market powering through every COVID-19 outbreak and subsequent lockdown. The pandemic, due to a number of highly unique circumstances, has actually been positive for equities and we'd expect that this remains the case until we start to see a normalisation in pandemic driven policy supports, household savings levels, valuations and confidence – which is still some time away.

Equities have looked through lockdowns …



Source: Factset, MWM Research, July 2021

… but not all sectors are back to pre-COVID-19 highs



Source: Factset, MWM Research, July 2021

We think pandemic policy responses and outcomes continue to outweigh the economic pain and uncertainty in dealing with the health crisis for a number of reasons:

- The pandemic has disproportionately impacted those on low incomes (versus high income earners) while increasing valuations has benefited existing asset owners. This in turn has increased income and wealth dispersion versus high income earners and asset owners. The unfortunate outcome is that the rich have gotten richer and the poor, poorer. So far, the result is that the rich have continued to plough funds into stocks (…commodities, housing and many other risk assets).
- Economically strong corporates have survived and cemented positions versus the economically weak. This is now driving a wave of M&A fuelled by cheap liquidity and large valuation dispersions. High bid premiums and the prospect of consolidation is supporting areas of the equity market.
- The commitment of central banks to underwrite the recovery has put a floor in risk assets which is generating a strong “buy the rally” mentality and supporting large allocations to risk assets (equities and commodities in particular).
- Emergency policy settings have pushed valuations for rate sensitive assets sky high and when the prospect of a cyclical rebound has emerged, rotation into value stocks has given markets another kicker.

When the dust settles, asset owners and high-income earners will find themselves better off while lower wage earners and those not fortunate enough to own assets will be further left behind in the absence of structural reforms and/or policy responses. For the equity market, which is already above its pre COVID-19 high, the policy responses from the pandemic are unquestionably positive and the combination of factors driving the market higher - corporate consolidation, funds inflow, easy policy and high savings – will be seen as the positives that have emerged from a very negative event. How the market deals with increasing wealth dispersion, inflation, the prospect of rising rates and expensive valuations is something entirely different but something we are separating from the current lockdowns.

Macquarie WM Investment Strategy Team

The report was finalised on 19 July 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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