Research
Macquarie Wealth Management

Investment Strategy Update #26

A new reality unfolds – Downgrading Australian Equities

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The recent surge in COVID-19 cases and the drastic measures required to contain the outbreak in VIC, creates a highly uncertain near-term economic and equity market outlook even with ongoing Federal and State fiscal support and a committed RBA.

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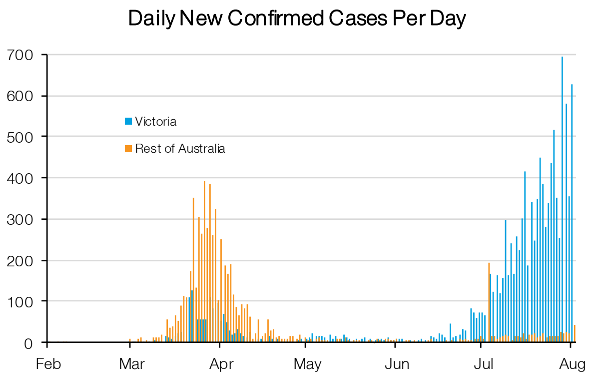
Some spill-over effects from the lock down in VIC can be expected via border controls, business shut-downs and deteriorating confidence. We are confident that economic activity can rebound once social containment policies are removed, but the path forward has become bumpier.

3

Australian equities have rallied strongly since late March. While remaining hostage to the direction of global markets, Australia is more *"old"* world than *"new"* world and a pause in economic momentum alters the near-term risk-reward outlook. After the rally and given limited valuation cushion, we downgrade to neutral.

There were two factors driving Australian's relatively better economic growth outlook versus the rest of the world. First, success at combating the initial COVID-19 outbreak that allowed an early than expected reopening of the economy; and second, a larger amount of policy stimulus vis-à-vis other developed economies – predominantly via direct fiscal supports provided to both consumers and business.

Big increase in COVID cases in Victoria



Source: Worldometer, MWM Research, August 2020

Following the second wave COVID-19 outbreak in Victoria (VIC) and due to the implementation of the most draconian lock down measures the country has seen since the onset of the health crisis, Australia is now at risk of losing one of its key relative growth supports, and with it, a strong domestically-driven tailwind for the equity market.

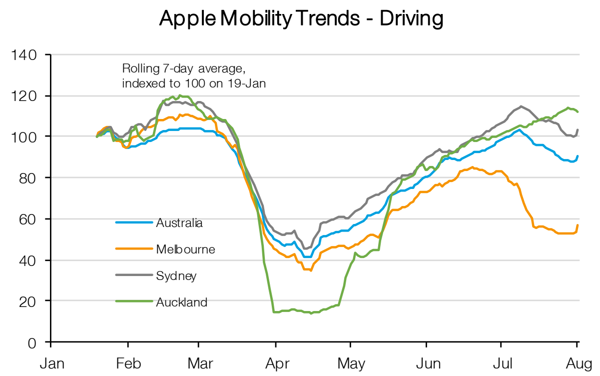
At this stage it remains too early to assess the economic consequences of these latest lock down rules and much will depend on the combination of Federal and State policy support as well as the extent of spill-over effects via new border controls and the potential for weakening consumer and busines confidence as health fears cross over borders.

Central to the view that Australia would recover quickly was the expectation that outbreaks would be dealt with surgically rather than via the imposition of broad (economy-wide) sudden stop policies. Technically this remains true, but the severity of the policy response will now see activity levels fall dramatically below the lows seen during the first wave.

Similarly, while lock down has been announced for a 6-week period, there is nothing to suggest that it could not be extended or that the ramp-up through the other side proves more gradual. We make the following points:

- Victoria accounts for ~1/4 of Australia's economy. More specifically, Melbourne and regional Victoria comprised 19.3% and 4.1% respectively of Australia's GDP in 2018-19. An additional, but ramped up, 3½ weeks of Vic lockdown plus signs of softness in NSW (as seen in mobility indicators) could now see GDP show little growth in Q3. Macquarie think unemployment could now peak noticeably higher than 8% – possibly 10% in Q4 or even Q1 next year.

Auckland mobility collapsed under Level 4 restrictions

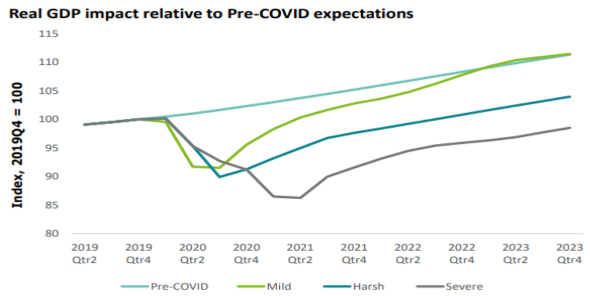


Source: Apple, August 2020

- A rebound and stabilization in business and consumer confidence is a crucial component of any economic rebound. We doubt the impact on confidence will be limited to Victoria. Border closures will affect economic activity (particularly tourist-related) throughout the country and there is also some potential for negative impacts on supply chains (although the Victorian government is providing exemptions for manufacturers of goods so as not to create supply chain gaps).

- The Federal government has not ruled out providing additional assistance to support jobs and businesses in Victoria. However, it also signalled that the additional cost of any extra support will have to be shared with the Victorian government. The Federal government is also considering softening the eligibility criteria for the recently revamped JobKeeper scheme given Victoria's impact on the national economy.

Australian GDP under various lockdown scenarios



		2020	2021	2022	2023
GDP growth year average, percent	Pre-COVID	2.1	2.7	2.9	2.9
	Mild	-4.7	6.5	4.8	4.6
	Harsh	-5.0	1.6	4.2	3.2
	Severe	-4.4	-6.6	6.9	2.8

Source: Deloitte, May 2020

Downgrading Australian equities

We are downgrading Australian equities from overweight back to neutral. While **there are several positive factors that are likely to prevent the market from entering a deep or sustained correction**, we think the near-term risk-reward is unappealing versus earlier in the second quarter and this has already been seen via its laggard performance versus the tech heavy (structural growth driven) US equity market.

Since bottoming in late March, the Australian equity market has closely tracked global equity markets which have successfully looked through concerns such weak economic data, 2nd wave outbreaks and rising political tensions. However, the V-shaped recovery in economic activity has already past and with markets pricing in an optimistic economic and earnings trajectory, we think the market is likely to consolidate further which would see it continue to lag markets with more structural growth heavy allocations. Factors likely to slow recent performance include:

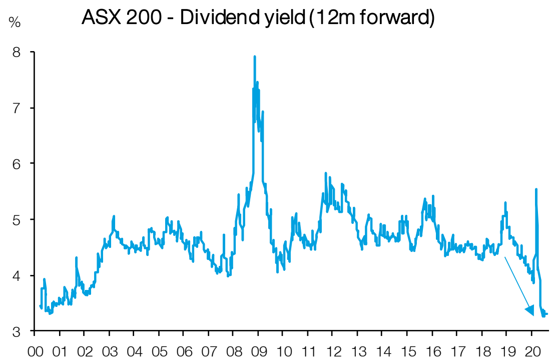
- The domestic economic recovery has been dealt a significant blow as Victoria lockdown. Markets have been closely correlated with growth momentum and this is now at risk of rolling over.

- Business and consumer confidence will be under pressure as most Victorian businesses close doors and other states introduce pre-emptive restrictions including border controls. Confidence will be susceptible to negative "headlines" in coming weeks/months and it will put further pressure on the willingness of businesses and consumer to spend, investment and employ.

- Equity valuations have been supported by falling interest rates, but in many cases, they are expensive based off anything other than expectations out 2-3 years. **We do not think a broad valuation de-rating is necessary,** but a weaker economic outlook will slow upgrade momentum, and this reduces the likelihood that recent P/E expansion can continue unabated.

- Corporates will horde cash as uncertainty rises. Dividends will be modest (if paid at all) and some firms will be forced into highly dilutive capital raisings. In addition, we are yet to see the Australian economy unsupported by fiscal policy.

Dividend yield is at a 20-year low

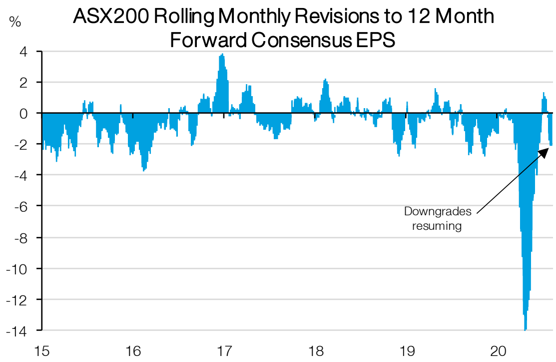


Source: Factset, August 2020

Our overweight position was, in part, based on Australia's success in containing COVID-19 and the unprecedented levels of policy support. The recent surge in cases, and drastic measures required to contain the outbreak, creates a highly uncertain near-term outlook which has the potential to dent the recovery trajectory. In addition, we have long thought that the impacts from COVID-19 lockdown were not linear – the longer they remained in place the harder it became for a business to survive. Against this backdrop, and given the rally seen in the equity market from its recent lows, we think it is prudent to downgrade to neutral and to raise our cash levels.

We do not know how long the VIC lockdown will last, if it will be successful, or if other states will be forced into the same drastic response. The fiscal response isalso not yet known although we think the federal government will remain supportive of Victoria even if it requires the state to bear more of the financial burden.

Earnings revisions had already begun to turn negative



Source: Factset, August 2020

Against a backdrop of more elevated growth uncertainty, we think 'value' sectors will continue to underperform as the recovery is pushed further into the future. Banks may weigh most heavily on the index given their geographic exposure, but retail landlords, builders, casinos and retailers will also be affected to varying degrees.

Valuations are at all-time highs

Source: Macquarie, August 2020

Over the medium-term we continue to think the outlook for equities is better than fixed income. Key drivers such as government stimulus, excess liquidity and conservative positioning (i.e. overweight cash) will also continue supporting risk assets once we are through a period of growth uncertianty.

Jason & the Investment Strategy Team

The report was finalised on 4 August 2020

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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