Review of 2020 - Outlook for 2021

From pandemic to recovery

BAGGETTA & CO

2020: not what it was supposed to be

2020 didn't exactly turn out the way many expected a year ago. For Australia, the year started badly as severe drought had given way to the worst bushfires on record. But just as the bushfires were receding it gave way to the Coronavirus pandemic.

It caused a massive health crisis claiming at least 1.5 million lives, with many countries seeing at least two waves.

It kept many confined to their homes and shut down big chunks of economies, driving the biggest fall in economic activity since the end of WW2 if not the Great Depression, with major economies seeing peak to trough falls in GDP of 10% to 20% and the Australian economy contracting by 7.3%. This saw unemployment surge and inflation plunge.

Share markets had 35% or so plunges in February/ March, commodity prices collapsed with the oil price going negative at one point, as investors sought out safe havens like bonds. And it, or rather the poor management of it, lost President Trump the US election.

The pandemic also increased tensions with China, and is likely to leave a longer-term mark with a further set back to globalisation, more social tensions, bigger government and public debt, the risk that massive money printing eventually results in higher inflation, faster structural change due to an accelerated embrace of technology, more consumer caution, and a lower population in Australia due to the hit to immigration.

However, while 2020 is a year many of us would prefer to forget, and Coronavirus continues to wreak havoc in much of the world, the end result for economies hasn't been as bad as feared back in March and April. This reflected a combination of:

- An unprecedented and rapid fiscal stimulus that protected businesses, jobs and incomes;
- Debt forbearance schemes that headed off defaults;
- Massive monetary stimulus that saw interest rates plunge;
- Social distancing which helped contain the virus enabling some reopening, albeit better in some countries such as Asia, Australia and New Zealand, than others.

This enabled economic activity to bounce back faster than expected through the second half as restrictions eased. As a result, investment markets also performed far better than feared.

- While share markets plunged in March during the early stages of the pandemic, they rebounded thanks to massive fiscal stimulus and reopening, low interest rates and bond yields that made shares cheap, as well as good news on vaccines that enabled investors to look forward to further recovery in 2021.
- This all drove solid returns in global shares with Asian and US shares outperforming. The more cyclical Japanese and European markets underperformed.

- Australian shares also underperformed due to the greater cyclical exposure of the Australian share market.
- Government bonds had reasonable returns as yields fell in response to central bank rate cuts and bond buying, along with safe haven demand – which drove capital growth.
- Real estate investment trusts had negative returns as a result of a hit to property space demand and rents. It was the same story for unlisted commercial property and infrastructure, although industrial property did well.
- Home prices fell 3% around mid-year but then started to recover as low interest rates, government support measures, and reopening swamped the hit to immigration, weak rental markets and higher unemployment. Houses, outer suburbs and regions benefitted from "escape from the city."
- Cash and bank term deposit returns were poor as the RBA cut the cash rate to just 0.1%.
- After a pandemic driven plunge to $US0.55 in March, the $A rose reflecting higher commodity prices and a falling $US.
- Due to reasonable share returns but weak property and infrastructure returns, balanced super funds have so far seen low but positive returns, but this followed a strong 2019.

2021: Recovery

Just as 2020 was dominated by the pandemic and this determined the relative performance of investment markets and stocks, 2021 is likely to be dominated by the recovery.

This in turn will have a profound effect on investment markets. There are four reasons for optimism.

First, massive fiscal and monetary stimulus is still feeding through economies with very high saving rates indicating pent up demand that can be spent once confidence improves, which will also help offset the wind down of some support measures like JobKeeper in Australia.

Second, the news on vaccines is positive. While uncertainties remain, by end 2021 or early 2022 there is a good chance the world will be approaching a degree of herd immunity.

Third, a new US president in Joe Biden should usher in a period of more stable and expert-based policy making in what is still the world's biggest economy. In particular, it will likely head off a return to trade wars that could have wreaked havoc in 2021. A more diplomatic US approach to resolving differences with China could also help Australia move down a path to resolving its own differences with China.

Finally, Australia along with NZ has navigated 2020 remarkably well, controlling the Coronavirus far better than most comparable countries and seeing its politicians and institutions work well together. It also led to structural reforms that may help future growth (eg property tax reform in NSW and IR reform nationally).

The combination of vaccines, policy stimulus and pent up demand is expected to see a supercharged cyclical rebound in global GDP of around 5.2% and 4.5% in Australia in 2021. This is likely to see strong double-digit rebounds in profit growth.

Inflation is likely to remain weak, reflecting still high levels of spare capacity which in turn means interest rates will remain low.

While this is not good for those relying on bank interest, it benefits the household sector as a whole (with debt exceeding bank deposits) and corporates, eases the servicing of high public debt levels and makes shares cheap.

So, in a way we remain in the 'sweet spot' of the investment cycle with improving growth but low rates. In Australia, the cash rate is expected to end 2021 at 0.1% but there is still a risk of more quantitative easing.

Implications for investors

Shares are at risk of a short-term correction after having ran up so hard recently and 2021 is likely to see a few rough patches along the way (much like we saw in 2010 after the recovery from the GFC). But looking through the inevitable short-term noise, the combination of improving global growth and low interest rates augurs well for growth assets generally in 2021.

In particular, we are likely to see a continuing shift in performance away from investments that benefitted from the pandemic and lockdowns, such as US shares, technology and health care stocks and bonds, to investments that will benefit from recovery, such as resources, industrials, tourism stocks and financials.

Global shares are expected to return around 8%, but expect a rotation away from growth-heavy US shares to more cyclical markets in Europe, Japan and emerging countries.

Australian shares are also likely to be relative outperformers helped by better virus control, enabling a stronger recovery in the near term, stronger stimulus, sectors like resources, industrials and financials benefitting from the rebound in growth and as investors continue to drive a search for year yield benefitting the share market as dividends are increased resulting in a 4.4% grossed up dividend yield. Expect the ASX 200 to end 2021 back around 7200.

Ultra-low yields and a capital loss from a 0.5-0.75% or so rise in yields are likely to result in negative returns from bonds. Unlisted commercial property and infrastructure are ultimately likely to benefit from a resumption of the search for yield but the hit to space demand and hence rents from the virus will continue to weigh on near term returns.

Australian home prices are being boosted by record low mortgage rates, government home-buyer incentives, income support measures and bank payment holidays but high unemployment, a stop to immigration and weak rental markets will likely weigh on inner city areas and units in Melbourne and Sydney.

Outer suburbs, houses, smaller cities and regional areas will see stronger gains in 2021.

Cash and bank deposits are likely to provide very poor returns, given the ultra-low cash rate of just 0.1%.

Although the $A is vulnerable to bouts of uncertainty about Coronavirus and China tensions and RBA bond buying will keep it lower than otherwise, a rising trend is still likely to around $US0.80 over the next 12 months helped by rising commodity prices and a cyclical decline in the US dollar.

What to watch?

The main things to keep an eye on in 2021 are as follows:

Coronavirus and vaccines – problems with vaccines or their deployment could result in ongoing waves of new Coronavirus cases and slower recovery than we are assuming.

US politics – a Democrat victory in Georgia's January 5 US senate elections would risk more of a leftward tilt under Biden, although conservative Democrat senators will limit this. Trump could also try to throw a spanner in the works.

China tensions – we expect a shift to a diplomatic approach here but there is a risk of misjudgement on either side which could start to slow our longer-term economic growth rate.

Inflation – we are assuming it remains weak but if it rebounds faster than expected it will mean faster increases in bond yields and downward pressure on asset valuations.

Further Information

Paul Baggetta
Baggetta & Co

Suite 2, 65 North Lake Road
Myaree WA 6154

Ph: (08) 9317 7300
Mob: 0407 420 078
Fax: (08) 9317 6770

Email: paul@baggetta.com.au
Website: www.baggetta.com.au

Source: Dr Shane Oliver, Head of Investment Strategy and Economics and Chief Economist, AMP Capital, December 2020. Paul Baggetta (T/A Baggetta & Co) is an Authorised Representative (No. 261469) of Capstone Financial Planning Pty Ltd. ABN 24 093 733 969. Australian Financial Services Licence No. 223135. Information contained in this document is of a general nature only. It does not constitute financial or taxation advice. The information does not take into account your objectives, needs and circumstances. We recommend that you obtain investment and taxation advice specific to your investment objectives, financial situation and particular needs before making any investment decision or acting on any of the information contained in this document. Subject to law, Capstone Financial Planning nor their directors, employees or authorised representatives gives any representation or warranty as to the reliability, accuracy or completeness of the information; or accepts any responsibility for any person acting, or refraining from acting, on the basis of the information contained in this document.