STANFORD BROWN

Financial Advisers

Monthly Investment Markets Report

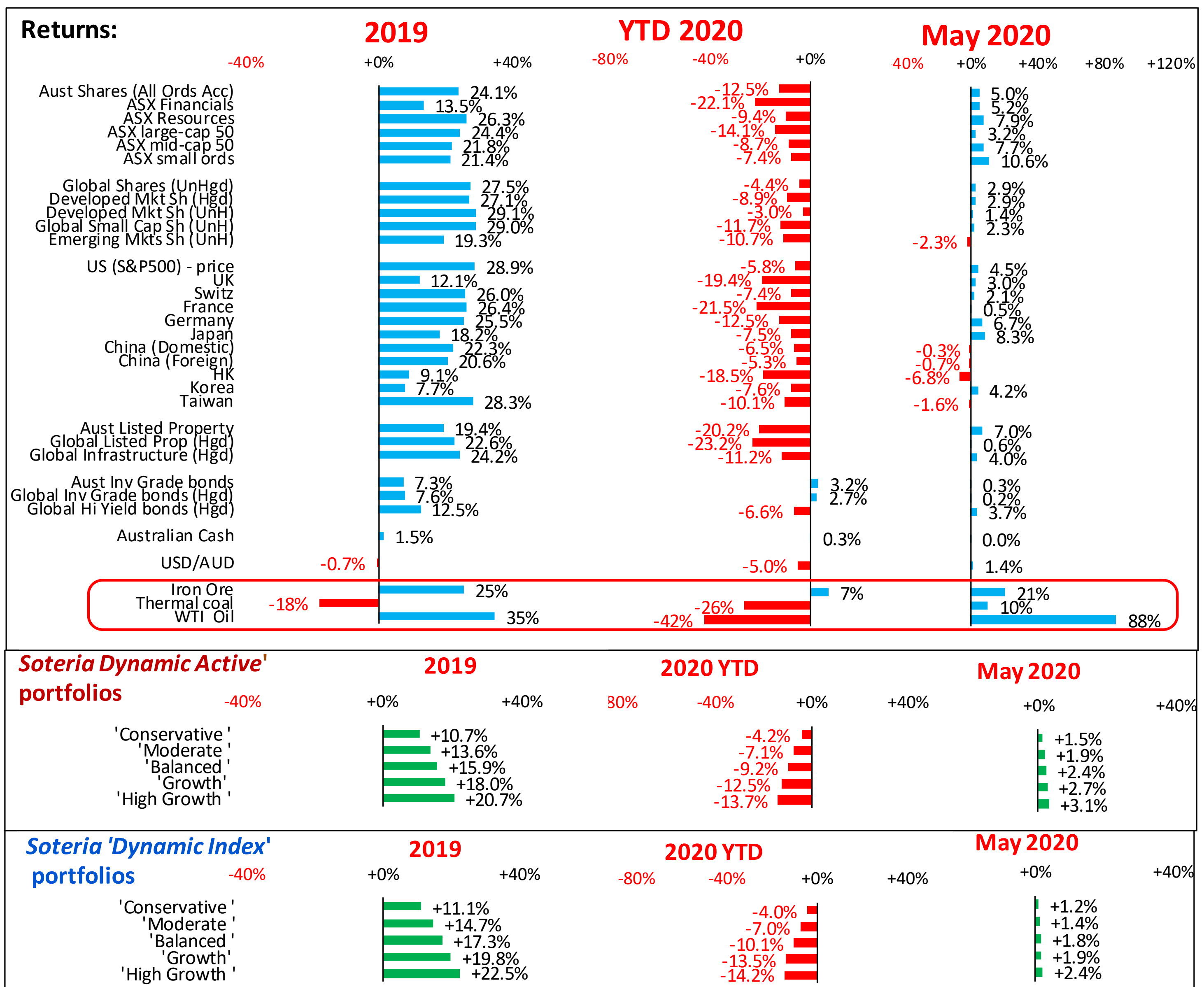
3 June 2020

Investment markets and portfolio returns

Investment markets continue to be dominated by changes in investor perception regarding the likely impacts on company profitability of government restrictions to contain the coronavirus. Rates of infections and fatalities in Australia, Europe and the US peaked in April and are on the way down, and governments are starting re-open parts of their economies gradually. In contrast, many developing nations are still experiencing rapidly rising infections and fatalities. The US leads with more than 100,000 deaths but the rate of increase has been declining since peaking in late April. On the other hand Brazil is about to overtake UK and Italy (2nd and 3rd places) and has yet to peak.

While the rates of infections and deaths have peaked and are now declining in several countries, indicators of economic activity like retail sales, production, income levels and overall economic output in Australia and around the world are only now starting to show deep contractions, and unemployment rates are quickly surging to depression-era levels. However, share prices have risen since late March while economic activity and corporate profitability have fallen sharply. Share markets were flat for most of May but rose a little in the last week in Australia and in most other countries due to gathering optimism that corporate profits will rebound quickly next year once restrictions are lifted. We remain wary that share prices may be running ahead of themselves and that overall levels of corporate profitability may to take longer to recover than is implied by the current rather bullish level of pricing.

Portfolio returns for May were positive across the board following the up-tick in share prices in the last week of May.



The Australian share market fared better than most in May thanks to fortuitous price rises for three key commodities – highlighted in red above. While prices of most industrial commodities generally remain weak in the global shutdown, price increases for iron ore, coal and oil drove the local mining sector higher in May. (FMG rose +16%, RIO & BHP up +7% each). Iron ore prices rose another 20%, back up to $100 thanks to mine closures in Brazil following the tailings dam disaster at the Vale mines a year and a half ago, and now also the coronavirus

disruptions. Likewise, coal miners here are benefiting from higher volumes and prices due to virus-related disruptions in South Africa, the largest export competitor. Oil prices nearly doubled in May back up to $35 on talk of supply restrictions in Saudi Arabia and Russia – although oil prices are still down by more than 40% this year.

Most other share markets around the world also rose a little in May. The US led the way, thanks to big tech stocks: Apple +8%, Facebook +10%, Alphabet (Google) +6%, and especially Square +24% (payments used in restaurants and cafes), Uber +20%, and Twitter +8% (despite Trump's attacks on the service). Against this generally positive trend, Hong Kong shares fell as pro-democracy riots resumed and the Communists moved ahead with plans to progressively subsume the former British colony into communist mainland rule. This will probably only increase the exodus of Hongkongers and mainlanders to alternate destinations like Australia.

On the trade war front – Trump and China escalated their war of words, turning their accusations to the alleged source of the virus. ScoMo also jumped on the bandwagon, prompting China to lash back, penalising our beef and barley exports. These were mainly token gestures as Chinese purchases of iron ore and coal are far more important to Australia, and also to China. One of the few aspects of Chinese economic activity that is still growing is steel manufacture (which is heavily reliant on cheap rocks from Australia), and this is one of the important elements of Chinese stimulus programs at home. The reduction in Chinese revenues to Australia from tourism and education is being offset increases in revenues (for miners and federal & state taxes) from mining exports.

While the iron ore and coal restrictions in Brazil and South Africa are doing wonders for miners and tax offices in Australia, China is probably not going to come to the rescue with another huge stimulus boost like it did in the GFC. On 22 May at the postponed National People's Congress the Chinese government announced that it had abandoned its regular growth targets for the first time since 1990. It wants to reduce its reliance on big state-directed infrastructure programs as it is wary of increasing the already mountainous pile of bad debts in the state-directed banking system as a result of previous stimulus programs. It will focus instead on jobs growth more directly via more targeted programs. This is likely to mean less chance of a broad-based rebound in all commodities prices and global demand like 2009-11 or 2016-7 that were driven by big, broad-based stimulus programs in China. It seems the stimulus programs and impacts on commodities prices are going to be more patchy and less comprehensive this time around.

On the currency front - the Australian dollar rose a fraction in late May against a weaker US dollar, Chinese yuan and Japanese Yen, but fell against a stronger Euro. The US dollar drifted a little lower late in the month mainly against the Euro. The recent strength of the Euro is probably due to signs that Germany is slowly being dragged into accepting the notion of mutual debts across the EU - which basically means the frugal 'north' (Germany, Austria, Denmark, Benelux, etc) will have to directly repay the debts of the spendthrift 'south' (Italy, Spain, France, Greece, etc), rather than indirectly through debt restructures and 'haircuts'. The north has fought this tooth and nail since the GFC but the huge new debts to pay for the massive coronavirus stimulus measures may be the final nail in the coffin for German attempts to stave off fiscal integration across the EU. The Merkel-Macron pact announced on 18th May possibly marked the turning point here, and it echoes the Merkel-Sarkozy pact in mid-2012 which freed the ECB to start 'QE' asset buying programs.

On the interest rate front - the RBA kept the 'official' cash rate target at 0.25% but over the past month it has let the actual (unofficial) cash rate fall to about half of the official target rate. In contrast, US short term rates rose a little in May on hopes of economic recovery on the horizon.

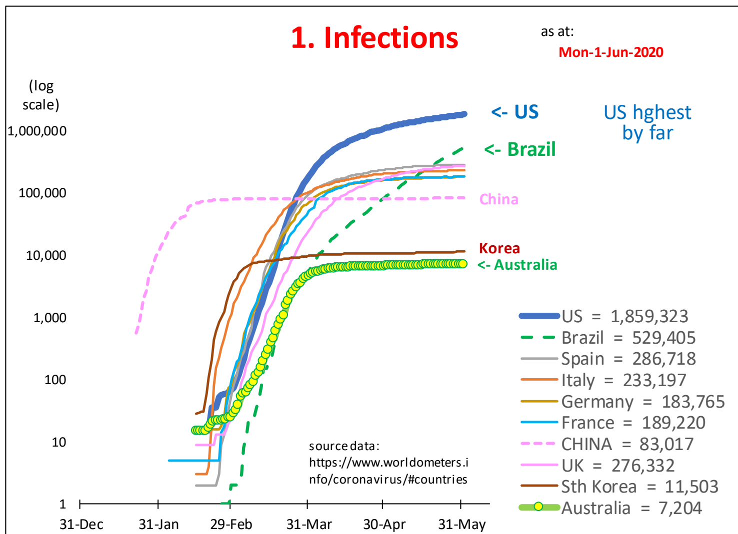
At the long end it was a different story as long-term bond yields remained more or less flat in Australia and in the major global markets during May. Central banks in each of the main markets including Australia are committed to buying up government bonds to keep borrowing costs low so that their governments can flood the market with new bonds at the artificially low rates to finance their huge spending programs. The RBA re-affirmed its rate peg for 3-year bonds at 0.25%. Rates in Europe and Japan remain deeply negative and their aging/declining populations plus their rapidly rising welfare and interest bills will probably prevent them from ever growing or inflating their way out of debt. Permanent monetisation of government debts is probably not far away.

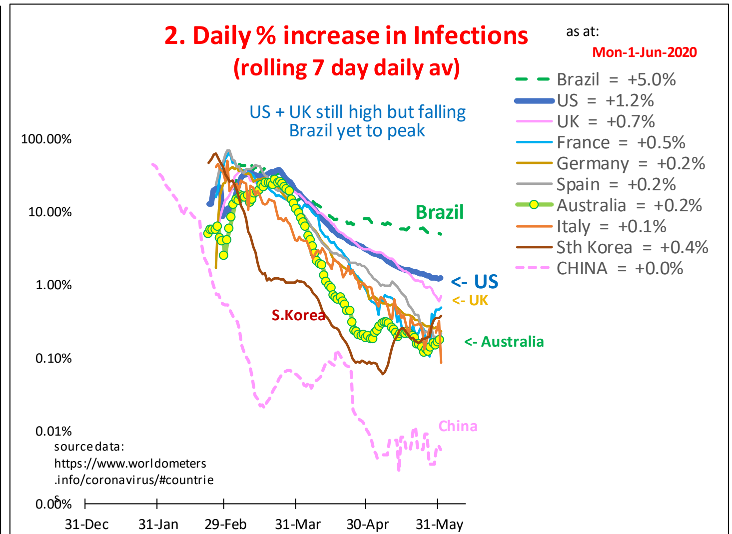
In commercial property markets – values of *unlisted* property trusts fell in May but the values of *listed* property trusts rose (even more than the broad listed share market – the listed property market rose +7% while the broad ASX market rose +5%). This disconnect between unlisted and listed property trusts is not unusual, even though both types of trusts own virtually identical buildings side by side on the same streets in every city around Australia and around the world. The unit prices of unlisted trusts are set by the managers based on the valuations of their properties and it takes months to revalue each property downward to reflect lower rents due the virus-related shutdowns. For this reason unlisted trust prices held up during the share market crash in February-March, but are now being lowered as properties are valued downward. In contrast, listed property trust prices sold off more than shares in the February-March sell-off and are now recovering more quickly from their over-sold levels. Unlisted property trust valuations and unit prices are probably going to fall further in the coming months as more properties are valued downward.

Coronavirus update

Global infections now exceed 6.3 million and the death toll exceeds 377,000. The rates of new infection in aggregate have not yet peaked, and are running at around 125,000 new infection cases per day. The rate of fatalities appears to have peaked in mid-April at 7,600 deaths per day, and is now down to around 3,000 deaths per day. However it may be too early to conclude that death rates across the world have peaked because the focal point has moved from the developed world to less developed countries where health systems are less equipped and reporting is more likely to be slower and less comprehensive. The big European countries (and Australia) peaked in early to mid-April, UK peaked in mid-late April, and the US peaked in late April, but the virus is still accelerating in the developing world.

Here are updates on four key charts we use to track progress. Chart 1 shows the numbers of infections in various countries over time; chart 2 shows the daily growth rates of infections. China was the first to experience mass infections (January), the first to undertake radical and comprehensive shut-downs (February), the first to see the infection curve flatten (left chart) and the growth rate fall to near zero (right). It was also the first to start easing the restrictions, although there have been early signs of second waves and second rounds of restrictions.

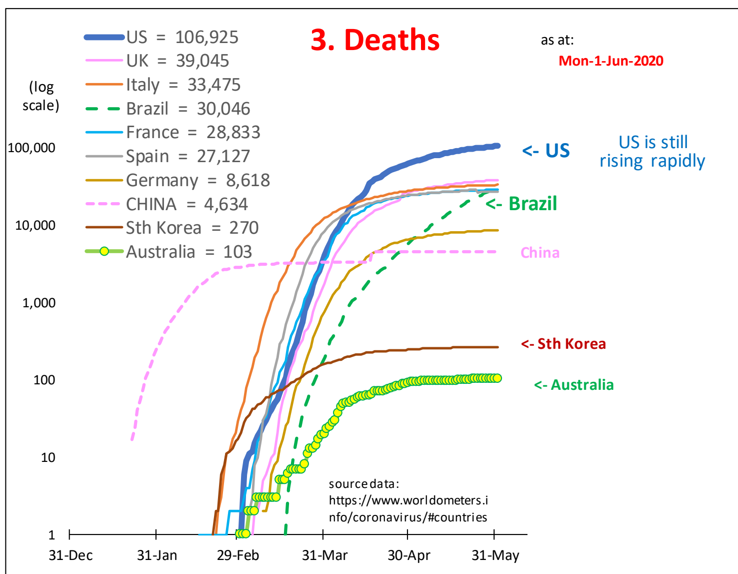


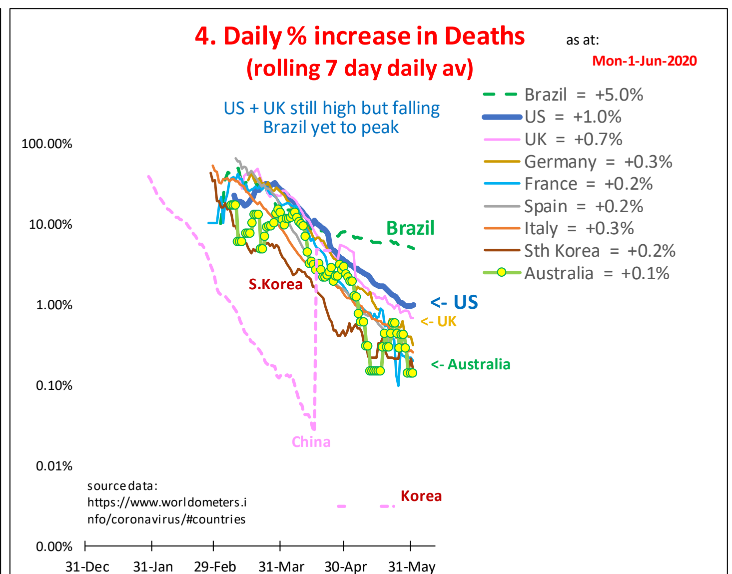


The flattened curves for China are echoed in South Korea, Hong Kong, Taiwan and Singapore – all of which took early hard-line containment action and also early easings. Each has also seen recent up-ticks in infections and re-tightening of restrictions.

The above charts show how the US was the late mover in recognizing the problem and then in taking radical shut-down action. As a result it rapidly shot to the highest numbers of infections (left chart) and still has a relatively high growth rate in infections (right). The US market is the key for investors as it is the largest single economy and it dominates global investment markets. What happens in US investment markets sets the trend in other global markets including Australia.

Charts 3 and 4 show the same statistics for deaths. The US took the lead in mid-April but Brazil is fast catching up.





In Australia the rate of new infections peaked on 29 March and the death rate peaked on 6 April (similar timing to Germany and France).

Although there is always a threat of second and third waves, it appears that the early dire predictions of millions of deaths may not be realised – at least not in 'developed' countries. However the virus is only just starting to take hold in more densely populated, less developed countries with less extensive health care systems – like Brazil, Russia, India, Peru, India, Chile, Mexico, Pakistan, and many others. Reported numbers in these countries probably understate the true extent of the problem emerging there.

Debt levels – no lessons from the GFC

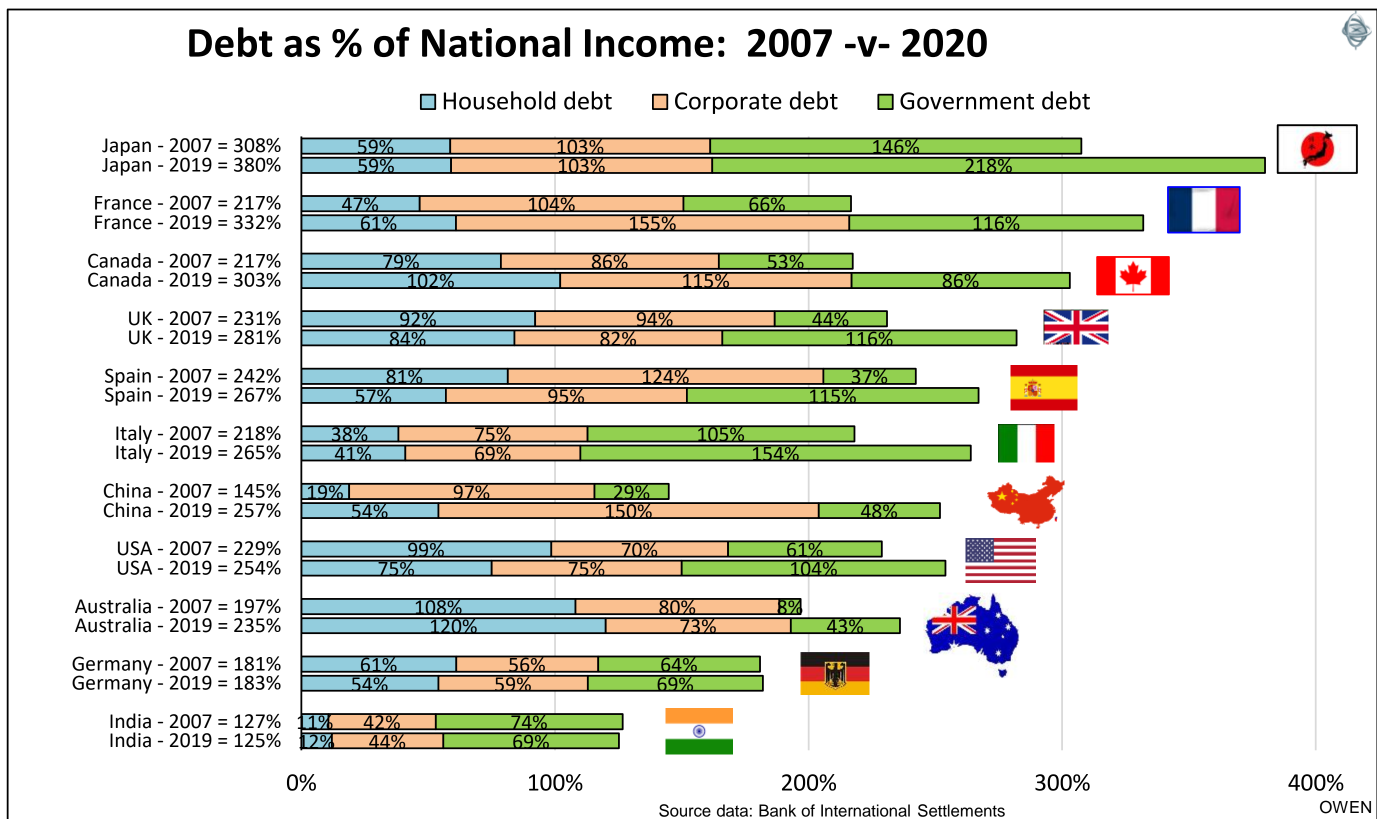
One of the main reasons for our caution about the sustainability of the recent share market partial rebound is that it is based on the assumption that consumers and businesses will quickly go back to their big spending ways once coronavirus restrictions are lifted. The problem is debt.

Households, corporates and governments in virtually every country are carrying much more debt now (relative to output and incomes) than they were leading into the GFC. If the problem revealed in the GFC was that the world had too much debt, the lesson from the GFC was to load up on even more debt! And it seems as if the solution to the economic damage caused by the coronavirus shutdowns is for governments everywhere to load up even more debt on top of their already high debt levels. Additionally, central banks globally have cut rates further in order to encourage households and business to take on more debt.

The problem is that high debt levels are sustainable only if everything is going right in the world. As soon as a ripple comes along – whatever the cause (it happened to be the coronavirus shutdowns this time around) – bankruptcies quickly start to come out of the woodwork. In Australia the main problem is household debt – not just home mortgage debt but also investment property debt, personal debts and credit cards. The spending boom over the past 30 years was financed not by rising productivity and real incomes but by simply taking on more debt.

In the US and Europe it is mainly corporate debt levels where companies across all industries will be hit hard by the dramatic reductions in incomes. We are starting to see waves of corporate profit reductions, losses and bankruptcies across a wide range of industries.

The following chart shows significant build-up of debt levels in a range of countries since the GFC. Each country has a pair of bars – the upper bar shows debt levels at the end of 2007 just before the GFC, and the lower bar shows at the end of 2019 before the coronavirus shutdowns. Debts are divided into the three main types of debtors - households, companies and governments. Japan retains the wooden spoon, endlessly increasing debt levels in a death spiral due to its ever-increasing welfare bills for its declining & aging population.



Far from de-leveraging after the shock of the GFC, almost every country has loaded up on cheap debt over the past 11 years, with total debt loads relative to national income rising virtually across the board. The only exceptions have been Germany and India which have remained flat. They were the two lowest debt countries to start with and they are still the lowest today. Both have been criticised heavily for not borrowing and investing enough to fund critical productivity-boosting infrastructure to fuel future growth.

China has gone from having low debt levels before the GFC, to middle-ranking debt levels today. It has nearly caught up with Italy and France and is now on a par with the US. For China it is not the level of debt that is the problem, it is the rate of growth of debt. China has had the largest increase in total debt loads in the world (apart from Hong Kong, and Singapore is not far behind).

One of the first rules of lending is that rapid lending growth rates are always at the expense of credit quality. Lending growth rates in China have been extraordinarily high in all three sectors: households, companies (mostly state-owned), and government. The build-up of debts in the corporate and government sectors is the result of three waves of frenzied state-directed lending to state-directed projects to prop up

growth numbers and jobs following a series of slowdowns - the 2008-9 GFC, the 2012 slowdown, and then the 2015 slowdown. Each time the government announced grand plans to reduce debts and close down inefficient loss-making state-run operations, but each time it chose instead to refinance existing bad debts into the never-never, and announce yet another raft of new debt-funded stimulus projects. During May, China abandoned formal growth targets and appears to be less likely to use big state-directed stimulus projects to hit growth targets. This new approach will probably result in lower national growth rates, a weaker boost to global commodities prices, but hopefully also a slowdown in the build-up of more bad debts.

Aside from China's bad debt crisis, the other big problem is in Europe (ex-Germany). Italy, France and Spain are locked into the Euro, low productivity growth and aging populations. Like Japan, they can't grow fast enough to pay off their mounting piles of government debt. The only solution is large scale immigration of young workers but that is politically unlikely in the current era of xenophobic nationalism, which will probably only worsen as unemployment numbers rise across Europe.

In Australia - the Commonwealth government entered the GFC with virtually no debt but it soon became addicted to big spending sprees and big budget deficits financed by a build-up of debt. It almost returned to surplus in 2019 thanks to windfall spikes in commodities prices, not frugal budgeting. Another $300b of debt to finance the welfare handouts this year would add another 20% of GDP to the total pile – putting Australia on a par with the pre-coronavirus levels in the US, China, Italy and Spain (but those countries are also rapidly increasing their debt piles now).

Corporate debt levels in Australia have shrunk as the big banks (which are now just bloated building societies that exist mainly to line the pockets of executives and armies of over-paid consultants) prefer mortgage lending to business lending because it requires less capital and no brains.

The main problem is our level of household debt. It was the highest in the world before the GFC and has increased its lead even further over the past 10 years (exceeded only by Switzerland). Some countries have reduced their household debt loads – notably USA and UK - via painful price corrections and mass foreclosures. Germany and Japan also reduced their household debt levels – but they are afflicted by stagnant / declining populations, which is very different from Australia's relatively high population growth rate.

In 2008 it was the US sub-prime crisis that triggered cascading debt crises around the world. If the main underlying problem with the world going into the GFC was excessive levels of debt, the main outcome from the GFC was that every sector in nearly every country loaded up even more debt! Since debt levels are now higher almost everywhere in the world, the coronavirus crisis might be the trigger for the next global bad debt crisis.

The intention here is not to say that debt *per se* is good or bad, only to point out that the post-GFC expansion of debts across the board relative to incomes and output make every sector in almost every country much more vulnerable now to hiccups in income. The rise in share prices around the world since late March has been based on the assumption that corporate profitability will rebound in 2021 as households and businesses everywhere quickly revert to their big borrowing and big spending ways as soon as the coronavirus restrictions are lifted. We remain sceptical that this is realistic.

Recessions – mostly good for share prices!

Today (3rd June) it was announced that the Australian economy contracted by -0.3% in the March quarter. Since the June quarter will almost certainly see a much larger contraction, Australia is in now in its first economic 'recession' since Paul Keating's 'recession we had to have' in 1990-1. Share prices rose on the news of recession because economic recessions have generally been good for share prices in Australia (we will return to this in a moment).

Most other countries have also reported economic contractions in the March quarter, including -4.8% in the US, -3.8% in the Eurozone, -2% in the UK, -9.8% in China, and -0.9% in Japan. Economists have already shifted their discussions from 'recessions' to 'depressions' and they are already predicting contractions in economic output in the order of -5% or more for 2020 in the main countries, and for the world in aggregate. (A 'recession' is generally defined as two or more consecutive quarters of negative real growth in total output; a 'depression' is generally defined as a deeper and/or longer economic contraction accompanied by high unemployment of say 20% or more). There is widespread acceptance that the government-ordered shutdowns of activities created instant recessions and almost instant unemployment for tens of millions of workers. The debate is now about how deep and how long the recessions and/or depressions will be.

Looking at the last two economic 'depressions':

- in the 1930s depression (caused by collapses in commodities prices, incomes and credit, excessive levels of debt, rising protectionism, and bursting of speculative bubbles) – the Australian economy contracted by -19% and lasted two years, and the US economy contracted by -33% and lasted 3 years.
- in the 1890s depression (also caused by collapses in commodities prices, incomes and credit, excessive levels of debt, rising protectionism, and bursting of speculative bubbles) – the Australian economy contracted by -13% and lasted 4 years, and US economy contracted by -8%. and lasted 2 years.

By comparison the 2008-9 GFC was very mild. The US economy contracted by -4% and lasted 6 quarters, while Australia's economy contracted by just -0.5% - hardly a blip - and lasted for just one quarter, but share markets still fell by more than 50%.

The next most recent 'big recession' was in 1990-1, which was also very mild by comparison. The US economy contracted by just -1.4% and lasted 2 quarters, and the Australian economy contracted by just -1.4% and lasted 4 quarters (Keating's 'recession we had to have').

It is notable that the current recession/depression may have been triggered by an unforeseeable set of events (government shutdowns to contain a virus spread) but it is also accompanied by similar underlying pre-conditions as previous deep depressions, and as well as several mere 'recessions'. The common culprits are familiar: collapses in commodities prices and incomes, contractions in credit, excessive levels of debt, rising protectionism, and potentially the bursting of the QE-inspired asset price bubbles.

This time is different from previous depressions of course. The 1890s depression was prolonged by the absence of central banks to prevent bank closures and business bankruptcies, and by the tiny size of central governments that were unable to increase welfare or infrastructure spending.

The 1930s depression was prolonged by slowness of governments and central banks to react – and in the case of Australia by the inability for the government to deficit spend because bond markets refused to lend it money, and the commercial banks (including even the government's own Commonwealth Bank) also refused to lend it money. The US depression was prolonged by the timing of the electoral cycle - Roosevelt came to office only in March 1933 after the November 1932 election. By the time Roosevelt started his reforms, Australia was already nine months into its recovery, having defaulted and restructured its debts and depressed its currency.

The GFC taught governments how to deficit spend and it taught central banks how to create artificial money to buy bonds from governments, companies, mortgage borrowers, car borrowers, and even credit card borrowers. These ultra-loose monetary and fiscal policies are now embraced by left and right governments almost everywhere – even in Germany.

The problem is that, even after the very hasty unleashing of trillions of dollars in government and central bank stimulus and support measures this time (which were not available to cushion previous depressions), economists are still talking about economic contractions in the order of 5-10% - ie several times worse than the GFC and the other mild contractions – and unemployment levels are still heading for 20% or more. It seems we are still heading for contractions in overall economic activity and unemployment levels in the in the same league as the big depressions of the 1930s and 1890s. What the stimulus might do this time is shorten the contractions, but they are unlikely to lessen or shorten the unemployment pain.

All this talk of economic 'recessions' and 'depressions' can be depressing! But that is where the good news starts for investors.

The issue for investors is that previous economic depressions and also most of the mere recessions were associated with deep share market crashes. The fear is that, since the economic contractions are only just starting now and may last for several quarters, then perhaps the February-March share market fall may not be the end of the overall share sell-off.

The good news is that while shares market crashes and economic recessions and depressions are in most cases related, share prices generally fall before economic contractions start and then start rebounding while economies are still contracting.

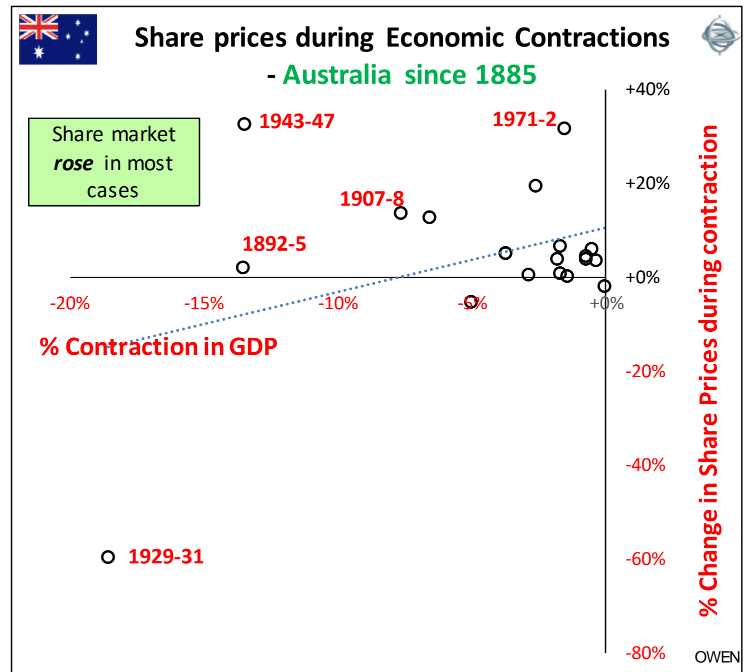
Australian share prices in recessions and depressions

Because share price falls generally precede economic recessions, share prices in Australia have actually risen during the vast majority of economic recessions. Here are the facts.

Australia has experienced 20 economic 'recessions' (including two 'depressions') since the 1880s. These are summarised below. The table sets out the dates and length of each economic contraction, and what share prices did in during each period of economic contraction. The chart on the right shows the inverse (negative) relationship between economic growth and share prices.

Recessions (contractions 2q or longer)
Australia since 1885

	Start		End		Qtrs / yrs		Real GDP fall	Share prices
1	Dec 1891		Dec 1895		4	yr	-13.5%	+2.2%
2	Jun-1900		Jun-1901		1	yr	-1.7%	+1.0%
3	Jun-1902		Jun-1903		1	yr	-6.5%	+12.9%
4	Jun-1904		Jun-1905		1	yr	-1.7%	+7.0%
5	Jun-1907		Jun-1908		1	yr	-7.6%	+13.9%
6	Jun-1911		Jun-1912		1	yr	-2.9%	+0.9%
7	Jun-1914		Jun-1915		1	yr	-5.0%	-5.1%
8	Jun-1916		Jun-1918		2	yr	-3.7%	+5.3%
9	Jun-1927		Jun-1928		1	yr	-0.5%	+6.2%
10	Jun-1929		Jun-1931		2	yr	-18.6%	-59.6%
11	Jun-1938		Jun-1939		1	yr	-0.0%	-1.8%
12	Jun-1943		Jun-1947		4	yr	-13.5%	+32.8%
13	Jun-1952		Jun-1953		1	yr	-0.7%	+4.7%
14	Jun-1961	qtr	Sep-1961	qtr	2	qtrs	-1.8%	+4.0%
15	Sep-1965	qtr	Mar-1966	qtr	3	qtrs	-0.3%	+3.8%
16	Dec-1971	qtr	Mar-1972	qtr	2	qtrs	-1.5%	+31.9%
17	Sep-1975	qtr	Dec-1975	qtr	2	qtrs	-2.6%	+19.7%
18	Sep-1977	qtr	Dec-1977	qtr	2	qtrs	-0.7%	+4.1%
19	Dec-1981	qtr	Jun-1983	qtr	7	qtrs	-3.7%	+5.2%
20	Sep-1990	qtr	Jun-1991	qtr	4	qtrs	-1.4%	+0.4%
						count:	20	20
						median	-2.2%	+4.4%
						% Positive for shares:		85%



In summary:

- Share prices *rose* during 17 (85%) of the 20 economic recessions in Australia in the past 150 years.
- Share prices *rose* during each of the Australia's last 9 recessions.
- The last time a recession was accompanied by *falling* share prices was the 1938-9 recession (share prices fell by only -1.8%).
- Share prices *rose* in each of the recent well-known recent recessions – including: Keating's 1990-1 'recession we had to have', the long 1981-3 recession, the 1975 post-Whitlam dismissal recession, and the 1971-2 oil crisis recession.
- Aside from a couple of minor share price falls during the 1938-9 recession and the 1914-5 WW1 recession, the only recession or depression in Australia that was accompanied by significant share price *falls* was the 1929-31 depression, when shares fell by 60%.

Although shares prices often fell heavily at around the same time as the economic crises, in almost all cases the share market fell *before* the economic contractions and then started to rebound *during* the contractions. As a result, most our big share market crashes were not actually during economic 'recessions' – not the 55% share crash in the GFC, the 50% crash in 1987, the 60% crash in 1973-4, the 39% mining crash in 1970-1, the 40% fall in 1981-2, nor most of the other big falls.

Conversely, some of the best years for Australian shares have been when the economy was contracting or still weak (albeit after big share falls earlier). For example: 1983, which was the best year ever for Australian shares (up +60%), during the 1981-3 recession.

The hard part for investors is having the courage to buy shares when the economy is still contracting and the media headlines are full of doom and gloom about a cascade of corporate collapses, bankruptcies, and rising unemployment.

What lies ahead?

Investing in this type of fast-moving landscape is difficult, but there are a few major factors that have shifted over the past couple of months.

The first is that many of the early predictions coming out of credible scientific bodies warning of deaths in the millions or even tens of millions – are now probably not going to eventuate – at least not in the 'developed' world, and at least not in the first wave. Although previous pandemics (like the 1918-20 'Spanish Flu') saw most of the deaths occur in second and third waves after the first wave appeared to be contained, this time health care systems and methods are much more advanced, and there may be a vaccine within a year.

A second shift has been the unprecedented extent and speed of government support to businesses and households – both on the fiscal front (government hand-outs, gifts, bailouts, tax breaks) and on the monetary front (central bank interest rate cuts, asset buying and lending programs). It has been incredible to witness the extent to which governments have been willing to burden future generations of taxpayers who will have to pay off war-time-like debts, without any business case, and with the odd $60b error here and there.

While these two shifts might have helped in the short term – a third theme is that the real extent of the problem has probably just been shifted down the road by a few months, during which time the extent of the problems and possible complexities of solutions may be compounded further.

In other countries, jobless numbers are escalating rapidly toward depression era levels, and these are likely to take many years to bring down. In Australia, most of the problem is being hidden in the temporary 'Job Keeper' scheme and the true damage will only be revealed when it ends. Likewise the true numbers on mortgage arrears are being hidden by APRA's magic trick of allowing banks to pretend arrears from the six-month repayment deferral scheme are magically not counted in the 'arrears' numbers. Similarly, the unknown hundreds of thousands of tenants in arrears under the six-month rent holiday and ban on evictions, are magically not counted as arrears and so landlords have no recourse in the courts. Likewise for the six-month extension of the waiting period to pursue corporate debts by winding up action, and the temporary lifting of the normal directors' duties on insolvent trading. The true picture on jobless, arrears/defaults on mortgages and rents, and corporate insolvency will only emerge in October when this magical world ends. There will, of course, be enormous pressure on the government to prolong this magical world (at even greater cost to future taxpayers) when the true picture is revealed.

The early rebound in share prices over the past few weeks has been based on optimism that, although 2020 will be written off as a bad year for corporate revenues, profits and dividends, they will all bounce back from the start of 2021 and pick up where they left off in 2019. This will require households and businesses everywhere (not just in Australia) to revert to their debt-fuelled big spending ways from 2021 onward.

Our investment portfolios are defensively positioned as we believe the current level of optimism does not fully price in the downside risk that this magical return to boom time conditions may not occur as quickly and/or as easily as hoped. Our portfolios remain on track to achieve their long-term goals for investors, and they are beating their peer multi-sector funds. We remain vigilant and ready to make further changes as conditions evolve, and we will keep you informed of developments and changes.

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