Thursday 2 July 2020

The Alphabet Soup Recovery

- **The economy is beginning to recover as restrictions are lifted and businesses re-open. However, it is a fragile recovery and one characterised by considerable uncertainty.**
- **The shape and nature of the recovery will be determined by consumer confidence. Jobs are also critical to the outlook and the looming financial cliff for many businesses at the end of September is a concern.**
- **The possible shapes that the economic recovery can take is like an alphabet soup. There are the shapes of the letters L, U, V and W. L means we stay in this downturn for a very long time. U means a gradual recovery. V is a quick snap back to business as usual and pre-crisis conditions. W is a double-dip recession.**
- **Our core view is still of a U-shaped recovery. But a shape that we are increasingly liking is the back-to-front or inverted J-shape recovery. This shape incorporates our view that it will be a long time before unemployment falls to 5% again and a long time before economic activity fully recovers.**
- **There are other shapes that also fit this profile – there is the augmented square-root symbol and the Greek mu, µ, written sloppily with a weaker second rise. These shapes all fit in the with the idea that the pandemic will cast a shadow on the economy for some time.**
- **Financial-market participants see a high chance of a W shaped-recovery due to elevated concerns about a second wave of infections and the end of key stimulus measures around the end of September.**
- **A recent business survey revealed around one third of businesses could not survive with cash on hand beyond three months, highlighting the deteriorated operating conditions of many businesses in Australia.**
- **We may have to learn to live with the virus and manage outbreaks with partial or targeted lockdowns and rigorous testing, tracking and quarantining. The pandemic is going to continue to change the way we live, work and learn.**
- **One of these trends is de-globalisation and the reshaping of global-supply chains. Global supply chains are also being reshaped by the US-Chinese trade tensions. These tensions might ramp up further ahead of the US election in November.**
- **One of the norms over the next few years will be low interest rates. The RBA might need to do more heavy lifting over the year ahead.**
- **Rhetoric from the RBA has been strong that it is reluctant to turn to negative interest rates. However, the environment we are in means nothing can ever be ruled out.**
- **The Federal government will undoubtedly need to do more in the year ahead. No crisis should be wasted. In the short term, priority of resources must be given to battling this pandemic and economic crisis, but in time structural reform will also be needed.**

We are in the grips of this pandemic and the world economy is experiencing its deepest downturn since the Great Depression.

World Outlook

The International Monetary Fund (IMF) just last week slashed its outlook for the world economy, projecting a deeper recession and a slower recovery than it anticipated just two months ago. The IMF expect global GDP to fall by nearly 5% this year, revised down from a 3% fall previously. Europe and the US are expected to wear the brunt of the downturn with China expected to grow very modestly this year.

Australian GDP

At home, our success in supressing the virus has meant we have started reopening the economy sooner than anticipated. It means the downturn here is not as big as initially feared.

National accounts data published earlier this month revealed the economy shrank 0.3% in the first quarter of this year. This is the first contraction in nine years and sets Australia up to record its first recession in 29 years.

The largest fall in GDP in this downturn will have occurred in the June quarter and this contraction is expected to be around 7% in size.

The good news is this recession may be short and limited to just the first half of this year. Growth this calendar year will still be sharply weaker; we anticipate 4% weaker, before 3% growth next year.

The not-so-good news is that the Australian economy is likely to be driving in the slow lane for some time.

What Shape is the Recovery?

With the economy reopening and restrictions gradually lifting – the economy is beginning to recover. However, it is a fragile recovery and one characterised by considerable uncertainty.

The shape of the recovery will be first and foremost determined by consumer confidence. That is, confidence that the pandemic is being well contained and confidence that the economic outlook is improving.

Consumer confidence recovered in May and June, after collapsing in March and April. But consumers still feel pessimistic about the outlook, as do businesses. Both consumer and business confidence remain below the critical level of 100 and 0, respectively, which divides the optimists from the pessimists.

So, what is confidence revealing about the shape of the recovery? The possible shapes that the economic recovery can take is like an alphabet soup. There are the letters L, U, V and W. L means we stay in this downturn for a very long time. U means a gradual recovery. V is a quick snap back to business as usual and pre-crisis conditions. W is a double-dip recession.

Our core view is still of a U-shaped recovery.

Last week I was invited to be on a panel on Bloomberg's Inside Track. Bloomberg conducted a live poll and asked registrants to vote on which letter they thought the recovery would take. U was the winner, but U and W were almost neck and neck.

Why are so many participants thinking W is a strong possibility and what could bring about a W shaped recovery?

The W

There are 2 factors that could most likely cause a W.

Firstly, a second wave of infections could mean we re-enter lockdown, causing economic activity

to collapse again. However, the hurdle to return to full lockdown is now higher due to lockdown fatigue and concerns from governments around the economic cost of lockdowns. There is also greater awareness of the virus among the public and better testing abilities than previously.

The high probability placed on a W recovery is likely being driven by the recent high number of daily infections in Victoria, the second wave in some US states and the recent cluster of infections in Beijing and South Korea.

Secondly, there is the looming financial cliff for many businesses at the end of September when JobKeeper is due to end. Around that same time, the coronavirus supplement paid to those on unemployment benefits and other social welfare programs also ends. So too do the mortgage holidays provided by the banking industry.

If JobKeeper ends fully and abruptly, job losses will re-accelerate and the nascent recovery will be threatened. Higher unemployment means less household income and less job security for those who are employed, causing consumers to be more cautious and pullback spending, especially discretionary spending.

JobKeeper is currently under review and the outcome of that review will be announced in late July. We expect JobKeeper will be extended, given the challenging conditions, but the Federal government might diminish the size of the scheme or change it to be more targeted.

The Jobs Market

So far around 835,000 jobs have been lost over April and May. The biggest loss of jobs likely occurred in April, with job losses in the months ahead unlikely to be as big as April's record-sized drop of 607,000.

The unemployment rate has risen from 5.1% before the crisis to 7.1% - its highest level in 18½ years. Without JobKeeper, unemployment would already be in the teens. The unemployment rate has further to rise. We see the peak in the unemployment rate as around 9% later this year.

But we should not restrict our focus to the headline unemployment rate because it is not telling us the full story.

The participation rate has fallen sharply, from 66.1% in January to a near 20-year low of 62.9% in May. It demonstrates that many people have dropped out of the labour force, limiting the rise in the unemployment rate. In fact, if the participation rate held steady these last two months, the unemployment rate would be at 11.4%. You have to go back more than 40 years (beyond the data available) to get an unemployment rate that high.

Hours worked gives us a more comprehensive picture of the jobs market. Hours worked fell by 10.1% over April and May. The fall in hours worked means household incomes are under pressure.

The Back-to-Front J Recovery and Other Possible Shapes

There is a less conventional shape of recovery which increasingly appeals to us over a U shape. It is the inverted or back-to-front J recovery. After an initial recovery after hitting bottom, the economy settles into an extended period of, bumpy, sub-par growth. It incorporates the view that it will be a long time before we see unemployment at 5% again and a long time before we see the economy fully recover and grow at (or above) trend (of around 2.6% per annum).

There are other shapes that could also fit this profile – there is the augmented square-root symbol first coined by George Soros in 2009. There is the Greek mu, μ, written sloppily with a weaker second rise. These shapes fit in the with the idea that the pandemic will cast a shadow on the economy for some time.

Consumer Spending

Rising unemployment and the hit to household incomes means retailing will be soggy over the

year ahead. Discretionary spending will remain particularly fragile.

We have seen wild swings in retailing but expect these swings to moderate. There was a record-sized spike in March, as consumers stocked up on essential items; a record-sized fall in April, as consumers went into lockdown; and a fresh record pace in May was recorded when consumers hit the malls as the economy reopened.

The wild swings are making it tough for retailers, especially small retailers, to also order stock and manage inventory levels. These are on top of the raft of other challenges facing retailers.

Impacts on Businesses

The waves of stimulus deployed by all forms of government and the Reserve Bank have been focussed on helping otherwise viable businesses survive and building a bridge to the recovery phase. Businesses are the backbone of the economy, especially small business.

The Australian Bureau of Statistics (ABS) ran a business survey from 10 to 17 June. One of the key findings was that 66% of businesses reported a decline in revenues compared with a year ago. Only 8% of businesses reported an increase in revenues on a year ago. It suggests businesses continue to face challenging conditions, despite some reopening of the economy.

Of the businesses reporting lower revenue, 14% reported a huge drop of more than 75% and another 17% reported a large fall of 50% or more.

The hospitality industry had the highest share of businesses reporting a revenue hit of over 50%. It reflects the hospitality industry being one of the hardest hit industries due to lockdown, restrictions, consumer caution over contagion and the closure of international borders.

Other survey responses also suggested the operating position of businesses have deteriorated. Indeed, 8% of businesses said their operations could not be supported by current available cash on hand for more than a month and another 21% of businesses said operations could only be supported by cash on hand for 1-3 months. That tells us that the financial cliff looming at the end of September is very real for many businesses.

Nearly 75% of businesses surveyed said they had modified their operations in response to the pandemic. Many businesses have had to innovate, especially accommodation & food services, as they moved their offering online.

Longer-term New Trends

The World Health Organisation's special envoy, Dr David Navaroo, recently warned the world is 2½ years away from having a commercial vaccine available globally. Navaroo added that even if a vaccine candidate is found before the end of this year, testing for safety and efficacy takes time.

We may have to learn to live with the virus and manage outbreaks with partial or targeted lockdowns and rigorous testing, tracking and quarantining.

Therefore, the pandemic is going to continue to change the way we live, work and learn.

What are some of the new longer-term trends that the pandemic might leave as a legacy?

One of these trends is de-globalisation and the reshaping of global-supply chains. It will involve countries bringing some production back home and diversifying supply chains. Expect some manufacturing to be brought back home, especially for vital supplies. This will benefit our manufacturing States of South Australia and Victoria.

Global supply chains are also being reshaped by global trade tensions, especially between the US and China. Trump might ramp up these tensions further ahead of the US election in November, especially if he continues to fall behind in the polls.

A second trend is the rising use of technology and innovation, especially as masses of the population have been propelled to work and shop from home. Meetings and presentations are

now done over Zoom and similar platforms.

Business travel will take a long time to recover and demand for international events and conferences is likely to never be the same again.

A third trend is we should expect the share of people working from home to be much higher post the pandemic than before it because the acceptance of working from home has spread. It certainly is cheaper for companies and makes for a more flexible work force. Regional areas with affordable housing will benefit, as where you live will depend less on where potential employers are based.

The long-term demand for office space in the CBD will no doubt decline, although some of that will be offset by a reduction in hotdesking (to contain the spread of the virus). In the short term, office demand is also weakening, as unemployment rises.

Other sectors are also relying increasingly on remote communication technologies. For example, more entertainment and cultural experiences are being delivered digitally. Telemedicine is taking off.

Another trend is that the take up and reach of online spending has spread.

Expect all these new trends (plus more) to become a permanent fixture of the next normal.

Interest Rates and New Norms

One of the new norms over the next few years will be low interest rates.

The Reserve Bank (RBA) cut the cash rate to 0.25% on March 19, which the RBA has said is the effective lower bound. It launched term funding facilities for banks. And for the first time ever it deployed a quantitative easing (QE) program. QE in Australia has taken the form of yield-curve control where the RBA buys and sells bonds to target a 3-year government bond yield of around 0.25%.

The RBA has stated it will not raise the cash rate before lifting QE and it will not lift QE before progress is made towards its employment and inflation goals.

The RBA Governor conceded it would be at least three years before the cash rate would be lifted.

Financial market participants are wondering what more the RBA can do, given the RBA might need to do more heavy lifting in the year ahead.

The RBA could move to extend targeting to the 10-year part of the curve, it could alter QE to buy a specified volume of bonds or it could include more instruments such as corporate bonds.

But some market participants are also increasingly wondering if negative interest rates are next.

Rhetoric from the RBA has been strong that it is reluctant to turn to negative interest rates. However, the environment we are in means nothing can ever be ruled out. We suspect negative rates remain in the RBA's toolkit even if they are at the bottom of the toolbox.

The reluctance to move to negative interest rates partly has to do with psychology. When rates turn negative, it can fuel fear among consumers and businesses that something must be deeply and permanently wrong with the economy, hurting confidence. Negative-interest-rate policies can have the perverse effect of causing people to borrow less.

Negative rates can also impair the banking system.

US central bank policymakers have also expressed reluctance to adopt negative interest rate policy. But if the US central bank goes down the path of negative interest rates, Australia may need to do more if it is to prevent the Australian dollar appreciating sharply. This 'more' could involve adopting negative rates.

Australian Dollar

Already, the Australian dollar has risen from its 17-year low of 55.10 US cents on March 19 to an

11-month high of 70.6 US cents on June 10. It is now consolidating below this level and has been consolidating within a range of 0.6775-0.6985 for the past three weeks.

In 12 months' time the AUD/USD exchange rate could be in the high 70s, underpinned by a stronger Australian growth outlook compared with most other major economies, a recovering Chinese economy and resilient iron ore prices with Brazilian production disrupted.

But one thing is certain, volatility in currency markets and other asset markets will continue, as uncertainty remains heightened. Concerns about second waves and geopolitical risks will continue to rattle investors.

Share Markets

That includes investors in the share market. Share markets had run away from underlying economic fundamentals.

Many Australian companies have cut or suspended dividends underscoring the fragile business environment companies are operating in. In fact, 18 of Australia's top 50 listed firms have cut or suspended dividends, adversely impacting the incomes of many households.

As at the June 30 close, the ASX 200 share market index was up 29.7% from its low on March 23 but 17.7% below from its peak struck on February 20.

Our analysis of past downturns reveals that it takes some years to get back to the share market peak that prevailed prior to the downturn or crisis. For example, it took nearly 12 years to get back to the pre GFC peak and it took 6 years after the 1987 crash.

It means there is also a wealth effect playing out in the economy. Another key wealth effect comes from the housing market.

Housing

Some press reports have suggested large declines of 20-30% in dwelling prices this year. We are not so pessimistic, although forecasting is tough at the best of times.

Yesterday's data from CoreLogic shows dwelling prices fell for the second consecutive month in June amid low transaction volumes and deteriorated confidence in the economy. COVID-19 has halted momentum in the housing market, which had been on a broad uptrend in the months leading into the pandemic. The 8-capital cities index fell 0.8% in June following a 0.5% fall in May. It was the largest fall since February 2019. The annual pace of growth slowed to 8.9%.

We anticipate dwelling prices will fall 5-10% this year. Rents are falling, vacancy rates are rising, Airbnb properties are joining the long-term rental market and lending is softening. Immigration has also stalled.

However, rates are low, auction clearance rates are recovering and in downturns the volume of housing stock for sale drops, as people wait for a better time to sell if they can. The key is obviously what happens to jobs. This brings us back full circle.

Long Term Reform

The shape and nature of recovery will be determined critically by confidence and the employment outlook. The timing of the withdrawal of stimulus will feed into this story. The Federal government will undoubtedly need to do more in the year ahead.

No crisis should be wasted. The Federal government needs to prioritise the Australian economy getting through this crisis and what further stimulus might be needed. But in time it will also need to consider what sort of longer-term structural reform we need for the economy, including tax, competition and productivity reforms.

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The Detail

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