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Quarter 01 - 2020

ECONOMIC UPDATE

Virus to challenge economies & markets

The sense of cautious optimism that greeted 2020 evaporated within the first two months of the year following the emergence of a new virus. China – the epicentre of the outbreak – is likely to suffer a material economic shock that will reverberate around the world, after the country imposed strict containment measures. Other countries have also been forced to implement economically disruptive policies, further compounding the issue. It is uncontroversial to expect a material economic impact, but there is much uncertainty as to its severity and duration and the response of policy-makers and individuals will be crucial.

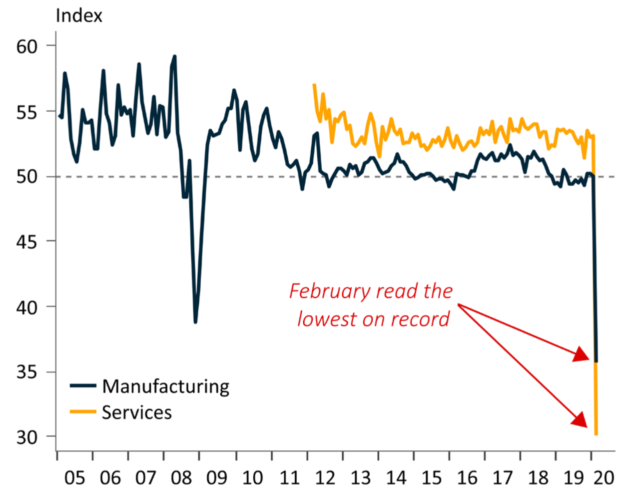
Global: Virus rattles markets & economies

Global markets greeted 2020 with a sense of optimism. In 2019, central banks sought to stabilise economies, abandoning plans to remove stimulus and, in many cases, adding more. Then, early this year came some much awaited progress on US-China trade tensions, with the agreement of an ambitious 'Phase One' deal. This was a key risk to economic growth for 2020 and a major concern for investors which – at least for the moment – has been put aside. Added to this was at least some certainty around Brexit, in terms of date if not in terms of economic impact. Equity markets had been pushing record highs in the US and Australia with 'multiple expansion' a key driver, pricing in better times in advanced economies ahead of the data flow.

But that sense of optimism has now reversed sharply and the better data flow that was priced in is unlikely to come to pass. A new threat to the global economy, which will likely impact more heavily than trade tensions, has

GRAPH 01 CHINA PMIS

Activity in China stops on COVID-19



Sources: IFM Investors, China Federation of Logistics & Purchasing, Macrobond

"Australia is particularly exposed as China is far and away our largest trading partner for both goods and services.

emerged – the spread of the SARS-CoV-2 virus that causes a disease known as COVID-19. This has taken much of the markets' focus through earnings season and, despite some initial resilience, news in early March of the virus spreading globally sparked a material 'risk off' move that saw equities tumble and safe haven assets rally hard.

We have not observed a deterioration in growth indicators in the hard data of advanced economies as yet, however sentiment indicators have begun to fall and anecdotes of interruptions to activity abound. On this alone there is little doubt that there will be a material negative impact at least in the first half of 2020. In the absence of hard data, economists may be tempted to use the SARS (severe acute respiratory syndrome) outbreak from November 2002 to July 2003 as a reference point to gauge the potential economic impact of COVID-19 but, even at this early stage, it is safe to say that this outbreak will likely have a materially larger impact than previous experience would suggest.

The reason for this is that the Chinese economy is significantly more important now than in 2003: it is currently the second largest economy in the world, compared to being the sixth largest in 2003, and is a key global growth driver. China was also the sixth largest exporter in 2003 and is now by far the world's largest. Similarly, China's impact in the services space has had a major impact on the global economy - in 2003 the 'travel balance' in its current account was in a surplus of around 0.3% of GDP and is currently in a deficit of 1.5% of GDP. This largely reflects Chinese tourists, of which there were 170 million in 2019 – far more than any other country.

Such scale suggests that the virus will have a material impact on the global economy as the strict measures employed by the Chinese government will bring Chinese economic activity shuddering to a halt. In order to stem the spread of the virus, Chinese officials locked down most of Hubei (home to Wuhan, the city where SARS-CoV-2 is thought to have originated). Hubei is the 7th largest province in China, accounting for around 4% of GDP, has a population of around 60 million, and is an industrial powerhouse. In addition to this, several other heavily-affected cities have also been put in lockdown, transport has been limited nationwide, and many businesses around the country have been closed for an extended period.

The impact of these measures was seen in China's plummeting PMI data that hit all-time lows in February (see GRAPH 01).

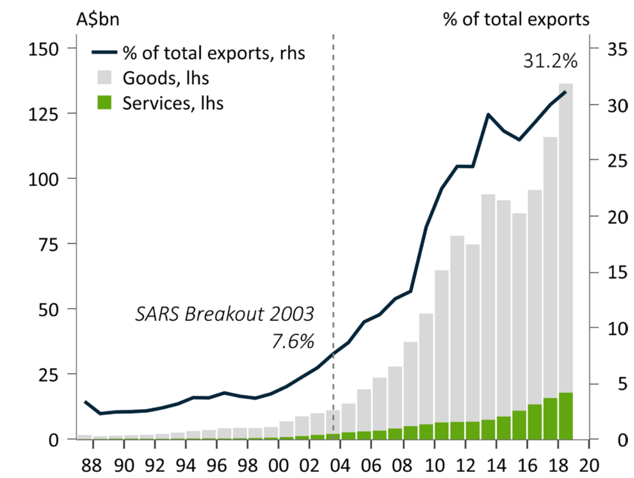
Many economists are now suggesting an almost unprecedentedly weak quarter, with Chinese growth particularly soft. What remains unclear, in terms of the impact of the virus on the global economy, is just how far the virus spreads, for how long it disrupts activity, and the reaction of policy makers around the world. Chinese authorities, for their part, are ramping up stimulus in an effort to support growth. But in developed economies in particular, monetary policy is not well placed, nor well suited, to address the potential impact. However, it is doubtful that governments can formulate an appropriate and timely fiscal response.

Markets will continue to be buffeted by news on progress towards containing the virus, treating those affected, the actual economic impact, and the response of policy-makers. At this stage we look for a more U-shaped recovery for economies, as activity gradually picks up, rather than a V-shaped recovery. It remains to be seen how markets interpret potential recovery scenarios.

Considering the nature of this economic shock, Australia is particularly exposed as China is far and away our largest trading partner for both goods and services. Our resources exposure, via iron ore and coal, is well understood and has been driven by China's urbanisation. When the authorities stimulate the economy via additional infrastructure spending and property stimulus, it is usually positive for Australian resources exports in terms of volume and price. But more recently, it is the services export boom that has been important for Australian growth.

GRAPH 02 **AUSTRALIAN EXPORTS OF GOODS AND SERVICES TO CHINA**

Australia is heavily exposed to China like few others



Sources: IFM Investors, DFAT, Macrobond

Buoyed by rising household incomes in China, a greater freedom and willingness to travel, and riding a tailwind of Australian dollar weakness since 2013 (making US dollar priced education services and tourism packages more than 30% cheaper over that time frame), the sheer number of Chinese travellers that have come has been transformative for our tourism and education sectors. Chinese nationals account for around one in four students enrolled in the

» education sector and one in six tourists. In 2018, the Australian economy had four times as much direct export exposure to China as it did in 2003 when SARS took hold. Over that period, services exports have expanded from A$2bn to A$18bn. It is via this services exports channel that COVID-19 will impact most heavily on the Australian economy.

While uncertainty around the impact of the virus will continue until we get hard data, it is uncontroversial to expect the Australian economy to record a negative quarter of growth in Q1 2020 and two consecutive quarters, a technical recession, can't be ruled out. This comes primarily via services exports declining materially, along with some impact from weaker resources exports. It could also be exacerbated by a run down in inventories, as supply chains from China are disrupted, although at the margin, consumer spending will also soften due to fewer students and tourists. This may be partially offset by the reduction in services imports as fewer Australians travel offshore. There is also likely to be a huge disruption to the normal behaviours of businesses and consumers as uncertainty rises - this will have a material impact but is difficult to quantify.

So what should be done?

The slowdown in growth will impact the economy and consequently the budget balance, likely deferring any surplus for a year at least. But it is entirely proper for both the Federal and State governments to be lending further assistance. After all, one argument for a balanced budget is to be able to assist the economy when it is in need. A fiscal approach is clearly more appropriate than one from monetary policy-makers. As we strongly suspected, central banks have acted first, evidenced by the Reserve Bank of Australia (RBA) cutting 25bp, the US Federal Reserve (the Fed) implementing a 50bp cut at an 'emergency' meeting and the Bank of Canada doing the same at a scheduled one – clearly a coordinated global response. We are of the view that these moves will likely serve more to placate markets than to assist the real economies facing the virus in the near term. Fiscal policy stimulus, including direct injections of cash and tax and investment incentives that support business confidence and employment, are still, in our view, the best response. At the time of writing, we await the Federal Government's response.

Australia: Q1 challenge to come

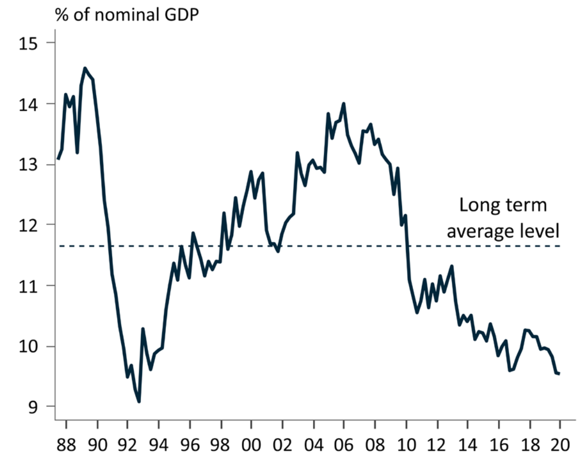
Fourth quarter GDP surprised marginally to the upside, with 0.5%qoq growth bringing the through-the-year rate to 2.2% (with the assistance of an upward revision to Q3 growth by 0.2pp to 0.6%qoq). Key growth drivers were a better outcome on household consumption (supported by the boost to incomes from tax offsets), inventories, and net exports. Government consumption continues to be supportive of growth. Investment – private and public – were softer in Q4 and weighed on growth, as did dwelling investment. Private capital expenditure unexpectedly fell in Q4 (2.8%qoq, the largest fall since Q3 2016), indicating a continued cautious outlook from the business sector.

Of most concern was a 3.6%qoq decline in non-mining business investment, which has so far not been responding to easier monetary policy: it currently wallows at just 9.5% of GDP, a low not observed since the early 1990s recession. It has become increasingly clear that easier monetary policy is not a complete solution to this investment drought. Interestingly, while we downplay the impact of the 'wealth effect' on consumption, the strong rebound in property market turnover had a material impact on Q4 growth. Ownership transfer costs rose 12.3% in the quarter, adding 0.16pp to growth. This is largely stamp duty, real estate, and conveyancing costs – not high quality growth (with stamp duty in particular being a widely criticised and inefficient tax) but impactful nonetheless.

Overall, the narrative of this GDP data was a solid public sector but a stagnating private sector. Public spending as a proportion of GDP rose to 17.7% – a historic high. By stark contrast, small business income (gross mixed income in the national accounts) has recorded six consecutive negative quarters of economic growth and seems vulnerable to the challenges the March quarter will bring.

GRAPH 03 NON-MINING BUSINESS INVESTMENT

Investment is soft and unresponsive to monetary easing



Sources: IFM Investors, ABS, Macrobond

Despite soft private sector activity, employment growth in the three months to January was reasonable with an average of 26,400 jobs added to the economy per month. Although relatively softer job growth in January – combined with the participation rate lifting to 66.1% – saw the unemployment rate lift to 5.3%.

With this continued spare capacity, fourth quarter wages data remained soft – as expected – with the wage price index tracking sideways from Q3 at 0.5%qoq and 2.2%yoy. No improvement in wages growth and tepid domestic demand means any inflationary pulse remains weak. And while fourth quarter inflation marginally beat expectations, with the headline measure rising 1.8%yoy (1.7%yoy expected), it remains below the RBA's target. This was evident in the trimmed mean measure of inflation (preferred by the RBA) that tracked sideways at 0.4%qoq and 1.6%yoy (marginally » above market expectations but in line with RBA forecasts).

Despite speculation late in 2019 of an imminent easing, the RBA left rates unchanged at 0.75% in February citing the already low level of rates and the long and variable lags of monetary policy transmission as key factors in its decision. Concern about upside risks to household debt and financial stability posed by the strong property market recovery were also provided as justification. There were also no red flags in the data flow leading up to the meeting, hence this was not an overly surprising outcome.

The RBA's February Statement on Monetary Policy signalled that a "material" lift in the unemployment rate and no progress towards the inflation target are both hurdles for further easing. In an important shift in tone, the bank noted that at these low rates, a balance needs to be found between the benefits of further easing and the costs (borrowing to purchase houses in a rising market with already elevated debt levels). Monetary easing in 2019 and mortgage serviceability requirement changes appear to be supporting the housing rebound. As of February, prices rose 1.2%mom (the eighth consecutive month of growth), bringing the year-on-year change to 7.3%. Lending activity also picked up materially in December, with unexpectedly strong growth in owner occupier and investor loan value (5.5%mom and 2.8%mom, respectively) causing overall home-loan value to jump 4.4%mom (the fastest growth in over 3-years) following a robust November print. On the consumption front, the RBA noted that it was too soon to see if household spending is responding to previous rate cuts.

The takeaways from the RBA's assertions and forecasts in February have now become largely redundant given the deterioration in the COVID-19 situation. Australia's significant exposure to China (as highlighted on Page 2) and the emerging downside risks to the economy superseded any concerns about the negative consequences of low rates. In response, the RBA ease rates in March by 0.25pp to a new record low of 0.5%. The decision was taken solely to "support the economy as it responds to the global coronavirus outbreak" and, by implication, concerns we will see a "material" increase in the unemployment rate. Both the Treasury and the RBA have now communicated that the March quarter negative impact of the virus will be "at least" 0.5pp and this is likely too conservative already as it takes into account only the direct impact on services exports and not that on the broader economy via supply chains, consumption and changed consumer behaviours.

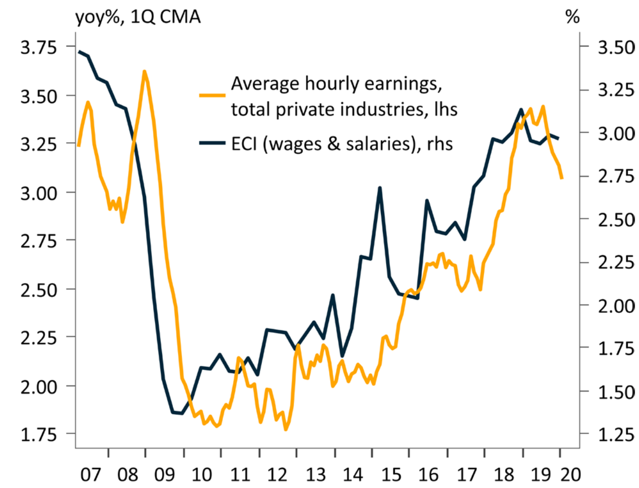
Prime Minister Scott Morison signalled that the government would also be supporting the economy with tourism, education and trade exposed industries the most likely to receive support and a focus on jobs. Policy should be aimed at limiting upside risk to the unemployment rate and facilitate the business sector in retaining staff and providing job security. A material rise in the unemployment rate via broader economic dislocation would be most concerning given Australia's other vulnerability, namely very high levels of household debt. We expect governments will rightly take action to prevent this, despite it delaying progress to a much desired budget surplus. At the time of writing, we await the Federal Government's response. We hope the coming package will be material enough in terms of magnitude to offset what it is increasingly lacking in timeliness.

US: Solid, but virus impact sees Fed act

The US and China signed a 'Phase One' trade agreement in mid-January. The US agreed to withdraw scheduled tariff increases and wind back existing tariffs and China agreed to materially increase its imports of certain US goods, improve IP protection in China, lower barriers to trade and stop forced technology transfers. This was welcomed by both markets and economists. Yet almost before the ink had dried on the agreement, a new challenge – COVID-19 – emerged to impact the Chinese economy. US data were solid going into this crisis but downside risks have materially increased.

GRAPH 04 **US EARNINGS AND EMPLOYMENT COST**

Earnings growth has slowed; a further fall would be worrying



Sources: IFM Investors, U.S. BLS, Macrobond

Fourth quarter GDP was slightly above expectations, tracking sideways from Q3 at 2.1%saar, to bring 2019 growth to a respectable 2.3%. Despite the reasonable headline figure, the details were on the softer side. A sharp drop in imports – likely due to tariffs – was a key positive contributor. But household consumption disappointed modestly (1.7%saar, mkt: 2.0%saar) and business investment did so materially, declining 1.5%saar (its third consecutive fall).

Higher frequency consumption measures also disappointed, with personal spending and retail sales soft in January. Survey data, however, sent more positive signals in the past few months. Consumer confidence firmed over the three months to February; the Conference Board leading index had its biggest jump in over two years in January; and the manufacturing and non-manufacturing Purchasing Managers Indices (PMIs) both firmed in the three months to January.

Labour market data in the three months to February were also largely positive. Employment growth was strong, with an average of 233,000 jobs added to the economy each month that saw the unemployment rate track sideways to 3.5% in February with an unexpected uptick in the participation rate to 63.4% - a positive development for the economy. Average hourly earnings continued to grow at a reasonable pace in the period, averaging 3.1%yoy. Although the pace of growth continues to decelerate from early to mid-2019.

Headline and core CPI measures sent conflicting signals in the three months to January, with the former firming over the period to 2.5%yoy, and the latter broadly tracking sideways at 2.3%. Personal Consumption Expenditure (PCE) inflation measures firmed over the period, with the headline measure up 1.7%yoy and the core measure up 1.6% in January. Although this is still materially below the Fed's target.

Minutes from the January Federal Open Market Committee (FOMC) meeting highlighted less prominent downside risks from trade disputes and foreign growth as a positive, but flagged COVID-19 as a key uncertainty. Then in an unusual statement in late February, Federal Reserve chair Jerome Powell added that the Fed was "closely monitoring [COVID-19] developments and their implications" for the economy and would "use our tools and act as appropriate to support the economy." Markets increasingly priced in easing, as the outlook for the COVID-19 situation deteriorated in late-February/early-March, but the Fed surprised nonetheless by unexpectedly (in terms of timing as it was an inter-meeting move) cutting rates by 50bps on 3 March to 1.00-1.25% in response to "evolving risks to economic activity" posed by COVID-19. The FOMC emphasised that "the fundamentals of the US economy remain strong" but markets sold off in response to the first inter-meeting cut since the Lehman Brothers' collapse in 2008.

A fiscal response may also be forthcoming, but for the time being politics is taking centre stage, with Super Tuesday voting causing the Democratic candidate field to narrow markedly, with Vermont Senator Bernie Sanders and former Vice President Joe Biden emerging as front runners, with Biden performing particularly well.

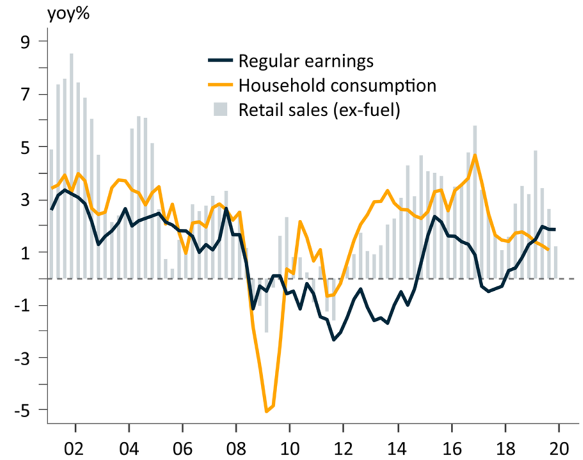
UK: Brexit uncertainty not over yet

The UK held a general election in mid-December in which the Conservative Party won a significant majority and got a clear mandate to "Get Brexit Done". The UK officially left the EU on 31 January and entered a transition period until (at this stage) the end of 2020. During the transition period, the UK will still keep the same trading relationship with the EU but a new trade agreement will need to be negotiated in the 11-month period – an ambitious undertaking if history is any guide. Should negotiations not be completed in time, there is still a risk of a disorderly Brexit and this uncertainty will likely continue to weigh on the UK economy.

Uncertainty continues to weigh on the economy, with UK economic growth stagnating in the fourth quarter in line with expectations. Real GDP growth slowed from 0.4%qoq to 0.0%qoq seeing the year-on-year change track sideways

GRAPH 05 UK EARNINGS AND CONSUMPTION

Consumption softens despite reasonable earnings growth



Sources: IFM Investors, ONS, Macrobond

from Q3 at 1.1% (above the 0.8%yoy expected). Robust government spending growth of 2.1%qoq (highest in nearly eight years) was supportive over the quarter, with caution surrounding Brexit and the general election on 12 December likely contributing to falling business investment (-1.0%mom) and a decline overall investment (-1.6%qoq), which dragged on the economy. Private consumption was also soft, as expected, rising just 0.1%qoq with real earnings growth in Q3 outperforming household consumption for the first time in over a decade. Retail sales data were mostly soft over the three months to January, with unexpectedly strong January consumption somewhat offsetting a weak November and December.

"The UK officially left the EU on 31 January and entered a transition period until (at this stage) the end of 2020.

As has been the hallmark of the UK economy, economic weakness seemed to have little impact on employment growth, which surprised to the upside with 180,000 new jobs added in the three months to December. The unemployment rate tracked sideways as expected, at 3.8% over this period, with a rising participation rate exerting some upward pressure. Despite the continued strength of the labour market, earnings growth continued to slow in December with average weekly earnings growing 2.9%3m/yoy and the ex-bonus measure growing 3.2%3m/yoy. This is the slowest rate of growth since September 2018 for both measures.

The Bank of England (BoE), at its December meeting, reiterated its readiness to adjust policy if global activity remains subdued or if "Brexit uncertainties remain entrenched". The BoE left rates unchanged at 0.75% at both its January and December meetings – against increasing market expectations of a January cut – and struck a 'wait and see' tone in its January meeting, noting the recent recovery in sentiment indicators but saying that "The Committee will monitor closely the extent to which these early indications of an improved outlook are sustained and follow through to the hard data on domestic activity in coming months". A recovery in the hard data, if forthcoming, will likely be disrupted by COVID-19 impacts, with BoE Governor Mark Carney signalling in early March that the BoE was committed to "take all necessary steps to support the UK economy and financial system".

Eurozone: Tentative recovery unlikely

There have been some tentative signs of a recovery in the Eurozone over the past few months. In December, the European Central Bank (ECB) acknowledged some initial signs of stabilisation, with the minutes from the ECB's January meeting suggesting that, although growth risks were still tilted to the downside, they had become less pronounced. The soft data released in the three months to March seem to support this interpretation. The German Ifo index edged up 0.1pts to 96.1 in February, with particularly strong gains in manufacturing; the manufacturing PMI for the Eurozone as a whole unexpectedly rose in February to 49.1 – the highest level since this time last year; the services PMI unexpectedly edged up to 52.8; although the ZEW survey of economic growth expectations slumped 15.2pts in February, it still sits at a reasonable level after making strong gains since a trough in August 2019; economic confidence rose more than expected to 103.5 (fourth consecutive rise); and consumer confidence rose to -6.6.

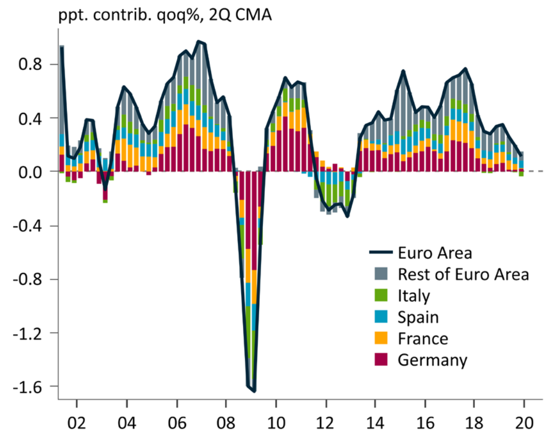
However, these data largely do not reflect the rapidly evolving COVID-19 outbreak. Downside risks have become more pronounced in recent times and are likely to dominate any improvement in the economic situation in the near-term. Indeed, details in the PMI release show a material virus impact with sharp declines in export orders, a sudden lengthening of delivery times, and a modest impact on sentiment.

Italy is particularly at risk following a large virus outbreak in the country's north in late February. The Italian economy already performed poorly in Q4, shrinking by 0.3%qoq and the economic disruption caused by the virus might push the ailing economy into a technical recession. Beyond Italy, the rest of the bloc also looks delicate: fourth quarter Euro Area GDP disappointed (0.1%qoq/0.9%yoy) clocking the slowest growth since 2013 with sluggish German (0.0%qoq), French (-0.1%qoq) and Italian growth key drags. Beyond any domestic disruptions, the bloc is also sensitive to external conditions which will almost certainly deteriorate in the coming months, further weighing on the outlook. Indeed, the ECB in early March joined the chorus of central banks committed to supporting the economy. The ECB is "ready to take appropriate and targeted measures" and has highlighted that the outbreak "creates risk for the economic outlook and functioning of financial markets".

> **The ECB in early-March joined the chorus of central banks committed to supporting the global economy.**

GRAPH 06 EUROZONE GROWTH BY COUNTRY

Sluggish growth as the big Eurozone economies slow



Sources: IFM Investors, Eurostat, Macrobond

Moving back to the economic data, the labour market continues to look relatively healthy. Employment growth for Q4 accelerated from the previous quarter by 0.2ppts to 0.3%qoq and is around the average rate for the past five years. The Eurozone unemployment rate unexpectedly ticked down by 0.1ppt to 7.4% in December (the lowest rate since March 2008) and tracked sideways in January. Inflationary pressures remain subdued, despite the reasonable labour market performance, with headline HICP[1] inflation slowing to 1.2%yoy in February and the core measure ticking up to 1.1%yoy. Eurozone retail sales for November beat expectations but this unexpected strength was likely due to increasingly prominent 'Black Friday' sales across the Eurozone. Indeed, retail sales for December were softer than expected, falling 1.6%mom and more than undoing the November rise. Additionally, consumer confidence for January was softer than expected, tracking sideways at 8.1, its lowest level since February 2017.

Japan: A possible recession in train

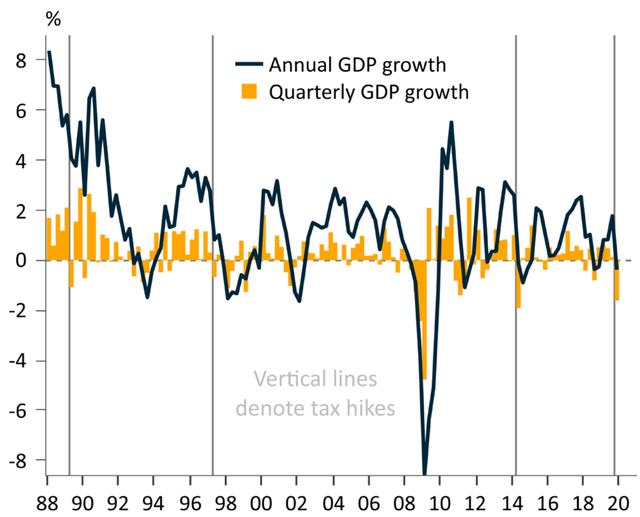
The Japanese economy had a soft fourth quarter, with GDP growth surprising materially to the downside (-1.6%qoq) and a downward revision to Q3 growth (0.3ppts to 0.1%qoq) with private consumption falling 2.9%qoq and business spending

[1] The Harmonised Index of Consumer Prices (HICP) is a composite measure of inflation for the entire Eurozone.

falling by 3.7%qoq. This soft performance was driven at least somewhat by a VAT hike from 8% to 10% on 1 October that prompted consumption frontloading in Q3, and an unusually strong typhoon (Typhoon Hagibis) disrupting activity in early October. Household spending contracted in each month of the final quarter of 2019, with nationwide department store sales falling through November to January, inclusive.

GRAPH 07 **JAPANESE TAX HIKES AND GDP GROWTH**

The Japanese economy is sensitive to changes in tax



Sources: IFM Investors, CaO, Macrobond

The combination of this economic contraction and the recent COVID-19 outbreak puts the Japanese economy at risk of falling into a technical recession, given that the economy is exposed to tourism and external demand (especially from China), both of which will almost certainly contract materially in Q1 2020. Indeed, in February the manufacturing PMI fell to 47.6 (with the report noting that supply chains had been hit by the virus outbreak) and the services PMI fell to 46.8 (with evidence that virus impacts were hitting tourism). Both PMI measures are at their lowest levels since early 2014. This also comes with external trade having been soft recently, with imports and exports falling for 9 and 10 consecutive months, respectively, in January. This has resulted in a fall of 5.1% in imports and 5.2% in exports in the 12-months to January 2020 compared to the same period one year ago. The coincident index for December fell 0.6pts to 94.1, continuing to plumb lows last seen in early 2013, and the leading index ticked up to 91.6 (lifting the measure off the lows last seen in the GFC).

Another potential issue on the horizon for Japan is the impact that the virus outbreak may have on the 2020 Olympic Games, due (at this stage) to start on 24 July. It is difficult to envisage how the situation will develop moving closer to the scheduled start date, but there is at least some risk of a postponement or cancellation of the event which would likely drag on the economy.

The labour market situation deteriorated in January, with the unemployment rate unexpectedly rising to 2.4% and the job-to-applicant ratio unexpectedly slumping to 1.49 (the biggest monthly fall in 30 years to the lowest level since May 2017). Added to this is a softening in labour cash earnings of -0.1% in the three months to December compared to the same period last year. Real cash earnings were similarly soft, falling 0.8%3m/yoy. Inflationary pressures continue to be subdued, on balance. Core and core core (ex-fresh food and energy) inflation have trended up over the past few months but in January, headline and core core measures softened, bringing core and core core inflation to 0.8%yoy and headline inflation to 0.7%yoy – still well below target.

In monetary policy, the Bank of Japan (BoJ) decided to leave policy settings unchanged in December and January, as expected. Governor Kuroda Haruhiko's comments on inflation and growth remained relatively cautious, although these comments came before the COVID-19 outbreak picked up momentum. In early-March, Kuroda issued an emergency statement to calm markets and pledged to "provide ample liquidity" and stabilise financial markets through "appropriate market operations and asset purchases".

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