MARCH 2020 INSIGHTS

Rapidly Deteriorating Outlook Has Everyone On Edge

HIGHLIGHTS

- The outlook for the economy has shifted dramatically in March amid further spreading of the Covid-19 Virus and outbreak of an oil price dispute between Russia and OPEC.
- This saw the RBA cut the cash rate to 0.50% in March with a promise of further easing, along with fiscal support from the federal government.
- Market instability was a broad theme throughout the month as Covid-19 and Oil disturbances caused heavy sell-offs and impacted investor confidence.
- With uncertainty about the extent of the virus outbreak, emergency fiscal and monetary policy measures may be required with the only certainly being a continued volatility for the immediate short term.

RATES RECAP

- The RBA lowered the Cash Rate by 25bps in March taking it to a new low of 0.50%
- BBSW fell around 30bps across the curve this month.
- The long end of the curve remains at lows with rates further out remaining lower than a month ago.
- The AUD has been very volatile this month and has drifted lower contributing to an easing in overall monetary conditions over the month.
- Most global yield curves have also ended the month flatter.
- US 10-year yields fell heavily this month with the Fed cutting rates between meetings by 50 basis points.
- Throughout the month both equity markets and bond yields fell heavily as fears around the Covid-19 Virus rattle through the markets.

Key Market Moves

	Latest	1 Month Ago	Change
Cash Rate	0.50	0.75	-0.25
3M BBSW	0.57	0.91	-0.34
6M BBSW	0.63	0.96	-0.33
1 Year Swap	0.51	0.76	-0.26
3 Year Swap	0.55	0.72	-0.17
5 Year Swap	0.69	0.88	-0.19
3 Year Futures	0.42	0.70	-0.28
10 Year Futures	0.66	1.02	-0.36
AUD	0.66	0.67	-0.01
ASX 200	5738	7013	-1275
US 2 year	0.44	1.39	-0.95
US 10 year	0.67	1.57	-0.90
US 30 year	1.11	2.04	-0.93
USD Index	95.54	98.83	-3.30
Dow Jones	23851	29277	-5426

Rapidly Deteriorating Outlook Has Everyone On Edge

A day is a long time in politics, a month can be an eternity in markets impacted by the spread of a pandemic virus – COVID-19.

With equities making all-time highs just last month and traders under reacting to the spread of the virus outside of China, we've seen a lurch in the type of fear and panic moves not seen since the 1987 crash. Adding to the mix are households that are genuinely scared about the impact of the virus on themselves, their health, and that of their families and this has culminated in a funk in markets. This then feeds on further business and household fear, which results in economies in Australia and across the globe moving from stall speed to an increased chance of an outright recession.

Stall Speed

If we wind back just a couple of months, the global and Australian economy were already approaching stall speed. The data for the fourth quarter saw GDP slow or even go backwards in a number of regions. The US and Australian economies grew 0.5% for the quarter. However the contribution of consumers to growth continues to fade.

In other regions growth rates were even weaker. The European economy grew by 0.1% for the second consecutive quarter as their biggest growth engine continues to stall. The German economy, one heavily reliant on value added manufacturing in the global supply chain, hasn't grown in three quarters. Meanwhile the Japanese economy contracted 1.8% over the 4th quarter with the drop exasperated by another consumption tax hike.

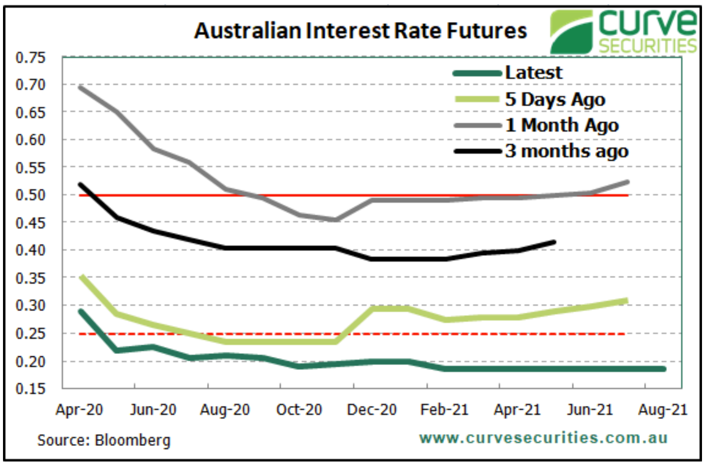
This isn't the strongest backdrop given we have already seen some central banks, such as the RBA and Federal Reserve in the US, easing monetary policy. With little room for central banks to move further, the global economy was always at risk from an 'event', economic or otherwise.

Unexpected Event(s)

Before Coronavirus was even on the radar, Australia was already battling an event of its own that would have significant ramifications. A severe bushfire season raged across much of Australia causing a significant impact on local regions as well as the national economy.

As news spread around the world, tourism operators were already seeing a fall in demand as holiday makers cancelled trips and shunned Australia for other destinations. That cost was on top of the direct impact that the fires had on those who lost property and local areas that were isolated and cut off from the rest of the Australian economy.

We then saw the emergence of the Coronavirus. What started as an isolated health crisis in China has morphed into a global issue as the virus has spread. It is hard to grasp the enormity of the situation and where it could be headed, as concrete data encompassing testing, case numbers, deaths and recoveries is hard to come by. It is that uncertainty causing the issue and fueling the behavioural response that we are seeing at all levels; Government/Central Bank/Regulators, Corporations and consumers.



Economic Implications

Beyond the unpredictability of the Coronavirus is even more uncertainty over the economic implications it will have. The reaction to the virus and its spread so far is going to cause a number of issues.

Efforts to contain the spread through quarantine measures is and will continue to have an impact on supply chains. This is most acute in China. However Italy has now locked down one quarter of the population in its highest effected areas. These areas account for roughly 20% of their economy.

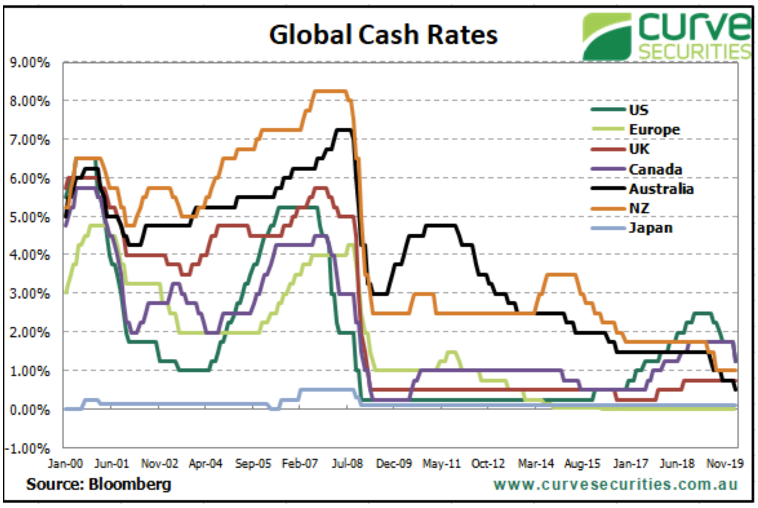
Then there is the obvious demand side impacts. Along with lockdowns, governments are also increasing crackdowns on travel from those most affected areas. Every inbound passenger entering Australia is being scrutinised on entry. Other governments are forcing the cancellation of mass gathering events in an attempt to slow the spread. Many companies are also following suit. Large multinationals such as Nestle are grounding their entire workforce of around 270,000 people. In the US, Banking giant Wells Fargo has suspended all domestic travel for its 300,000 workers. Apple has encouraged workers at its global offices to work remotely where possible. Other companies will follow suit not wanting to be left responsible for compromising their workforces safety.

There are obvious impacts that stem directly from these actions. The tourism industry will be acutely affected including airlines, hotels and tourism operators. It quickly waterfalls from there with ground transport operators, restaurants and suppliers then seeing a fall in activity.You can quickly then imagine the impact on city and town centers with cafes and retailers then being impacted as foot traffic declines with more people working from home. The list goes on.

Market Amplification

Then there is the role that markets play. Markets hate uncertainty and unpredictability and when they react it is usually swift and severe. Central banks launched a week ago what seemed to be co-ordinated action. We saw rate cuts from the RBA, US Federal Reserve and Bank of Canada with assurances from the BoJ and ECB that they too are ready to act.

Actions and reassurances from central banks has done little to calm markets.



Equities are unwinding massive gains driven by loose monetary policy while the moves to safer assets such as fixed income has seen yield curves collapse.

Further complicating the financial market backdrop was a fallout at the OPEC meeting at the weekend. The extended group, that included Russia, failed to agree on production cuts that were designed to support the price of oil that has been falling on concerns over demand. Ironically, the failure to come to an agreement has seen the Saudi's launch in effect a price war which saw the price of oil fall 24% at the open on Monday.

Moves of this magnitude that we are seeing across multiple markets and asset classes causes issues in and of their own. As we saw during the GFC over a decade ago, while the Sub-Prime bubble bursting saw an initial economic impact, it quickly was dwarfed by the financial market impact both in the US and around the globe. The present danger is that the financial and economic impacts we are seeing morph into something far more significant as second and third round implication come into play.

Depth and Breadth Unknown

One of the big reasons that we have seen the reactions we have from Governments, Corporations, Consumers and Markets is that there are so many unknowns. Going into this current situation, the global backdrop was very different to what would be considered normal. Policy rates were around record lows, many markets were around all time highs and a number of economies were already under pressure.

It is too early to know how this may play out. A lot will come down to how long it takes for the Coronavirus situation to work through. It could be that what we are seeing at the moment will continue until the fear around it subsides. The longer it continues, the more that will be known about it. The more that is known about it, the better the actions that can be taken to manage it. The longer it goes, presumably, the closer we will be to a vaccine to help deal with it.

For now though, we can only speculate about how deep the impact from the current events will be and how long they will last.

Support is Coming

The RBA has already taken some action in order to support the economy as it deals with the economic fallout from the current events it is dealing with it. They have said they stand ready to ease policy further and the markets expects them to.

In addition to monetary support, fiscal support is expected to follow. The government has said they are working on a stimulus package to help the economy through this difficult period. It is expected to focus its efforts on keeping people in work rather than handing out cash to households. As opposed to the GFC, this isn't just a demand problem. There is no guarantee that it would be spent. If anything, recent behaviour of households suggest that it would be saved.

Job losses are the biggest risk that the Australian economy faces right now. If the current downturn that is upon us drives up unemployment at a time that consumption is already weak, it will have serious ramifications for the Australian economy.

The Outlook

While people are worried about their health, more money in their pocket won't necessarily be enough incentive for them to spend. Fears stemming from the virus means that 'survival instinct' driven behaviour will offset any support measures in the short term.

As such, monetary and fiscal support is unlikely to have as much impact at it usually would. What we need to remember is that the storm will pass eventually. Given the monetary and fiscal settings that will be in place, it should sow the seeds for a robust recovery once it does come.

For now it is a case of waiting, watching, acting rationally and positioning your business or personal situation as best to weather the current storm.

Outlook for interest rates

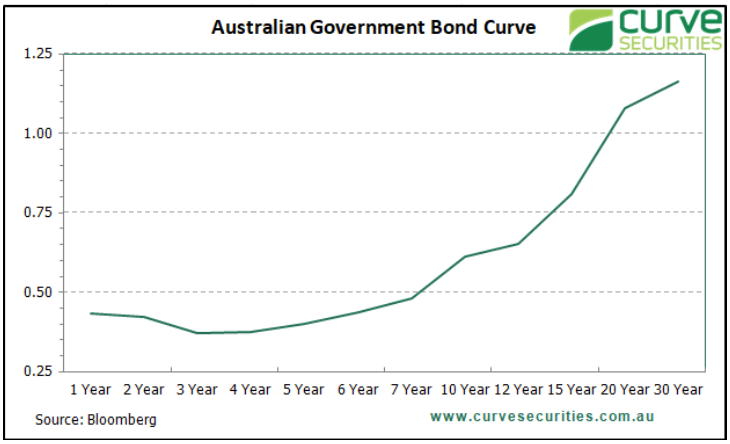
The events of the past month have materially changed the outlook for the economy and interest rates. After pointing to a 'gentle turning point' in their Quarterly Statement on Monetary Policy a month earlier, the RBA cut the cash rate a further 25bp to 0.5% at their March Board meeting.

Risks to the outlook were already skewed to the downside, even before the spread of the Covid-19 aggressively to the rest of the globe. Markets expect there is more to come. Current market pricing almost has a cut fully priced for the RBA's April Board meeting. If not then, it will certainly follow when the RBA meets in May.

First the bush fire and now the impact of the global spread of the virus is expected to hit the Australian economy hard. A negative quarter of growth in Q1 is now expected with the chance of Australia's first recession since 1991 now highly likely.

As a result, it is now expected we will see the cash rate at 0.25% for the foreseeable future. It also means that the RBA could be set to look at unconventional policy measures to further easy policy should the situation warrant it.

At this point it will be questionable as to whether or not yield curve control, as the RBA put it, will have a material impact on the economy. Government bond yields, which would be the target of further action, by the RBA, have already fallen to extremely low levels.



The Commonwealth government bond curve is currently sitting below 0.5% all the way out to 7 years already.

Yield curve control is designed to bring down the risk free rate in order to pull other rates down. This is supposed to in turn lower the funding costs of the banks, which is then supposed to be passed on as lower borrowing rates to mortgage holders.

Given the dislocation we are seeing in markets at present as fear of uncertainty reigns, the impact of yield curve control could be largely moot in this environment. So for now we are likely to see the RBA cut the cash rate again at their next meeting and then wait to assess if unconventional measures are warranted.

Australian Economic Highlights

- Growth ticked up slightly in Q4 for 2020 printing at 0.5% for the quarter bringing the annualised rate to 2.2%. Despite an indication that growth may be at a gentle turning point recent event could see large changes when Q1 data arrives.
- Inflation pressures rose slightly in Q4, with both headline and core inflation printing in line with expectations. The headline index was up 0.7% which saw the annual rate edge up to 1.8%, while the trimmed mean was up 0.4%, leaving the annual rate unchanged at 1.6%. Both were in line with the RBA's forecasts.
- Employment data for January saw a gain of 13,000 jobs over the month. The unemployment rate edged higher to 5.2% with the participation rate a steady 66.0%.
- ANZ Job ads gained back some of the lost February ground in March, up 0.7%. Despite the volatility the series trend still appears to be in decline.
- Business confidence fell heavily in February, losing 3 points to post at -4 for the month. Business conditions also fell at 0 points for the month. The crucial Employment index gained 1 point to post at 2 points for the month.
- Consumer confidence fell in February and continued it's recent run of soft prints. The index posted a 93.4 reading, which was a 2.3% fall over the January reading.
- Retail sales had a weak start to 2020 with a negative print for January. Of the sectors that grew in January, food retailing 0.2% was the strongest.
- After a mixed run of data, housing finance was slightly up in December. The value of new credit to owner occupier's continue to rise but by a reduced rate, printing at 2% for the month. Growth in outstanding credit continues to slow as mortgage holders continue to repay their loans quicker thanks to interest rate cuts.
- Australia continues to post robust trade surpluses, chalking up another $5bn in January, down slightly on December. The decline was the result of reduction in exports outpacing the reduction in imports.
- Building approvals saw improvement in January up 0.5%, after the strong recent downtrend the market looked favourably upon the recent uplift.