Macquarie Infrastructure and Real Assets **(MIRA)**

Macquarie Asset Management

The impact of COVID-19: A brave new world or more of the same?

April 2020

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Agenda

Key focus

- **Current global macroeconomic dynamic and its impact on asset markets**
- **COVID-19: The economic and policy impact on inflation, risk and emerging markets**
- **Thematics and structural changes emerging from the crisis**
- **Implications and outlook for key asset classes**
- **Key points**

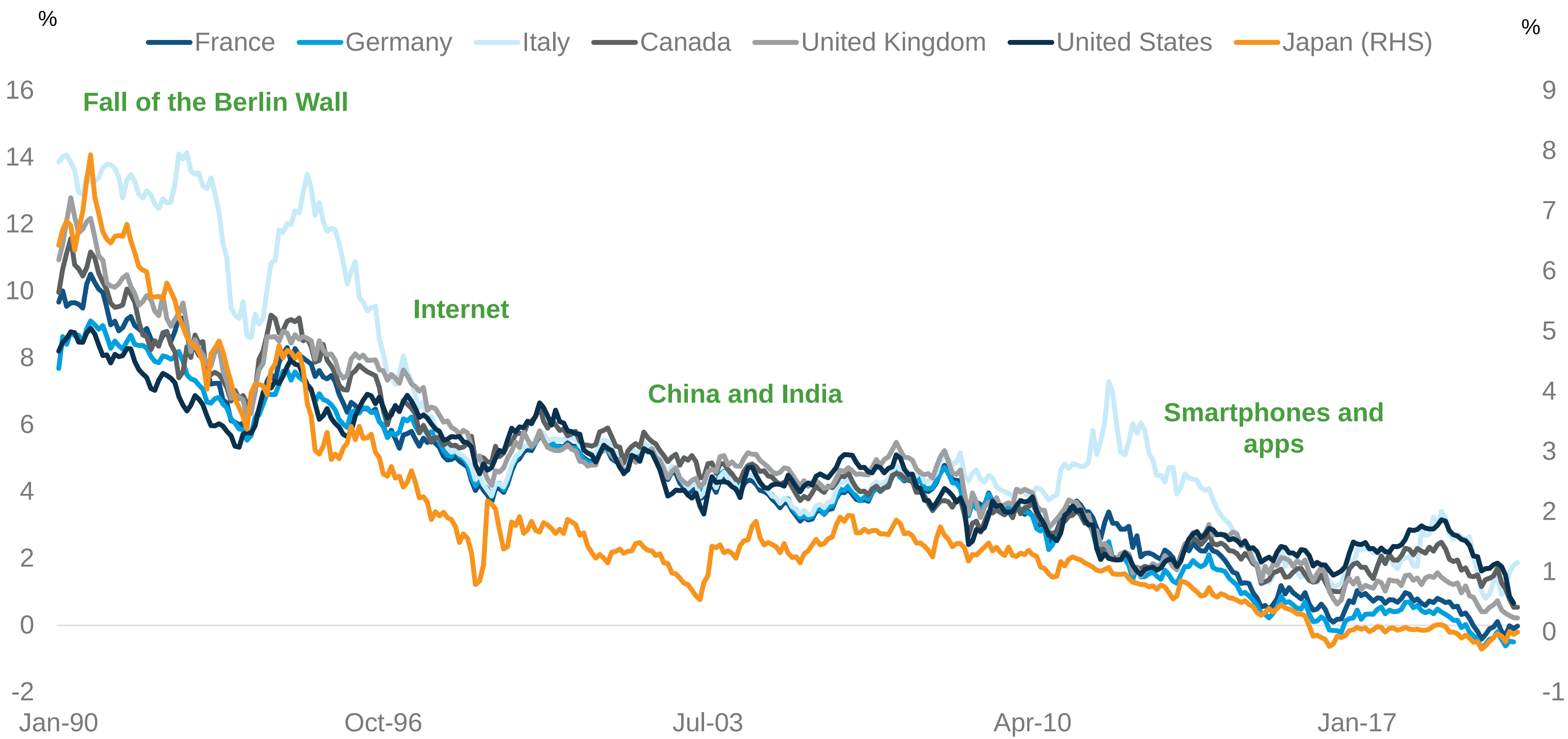
A 30-year downtrend in *the* key anchor to global markets and the global economy

US interest rates – short term and long-term

Source: Bloomberg Finance LP

It's a global phenomenon: Globalisation and technology

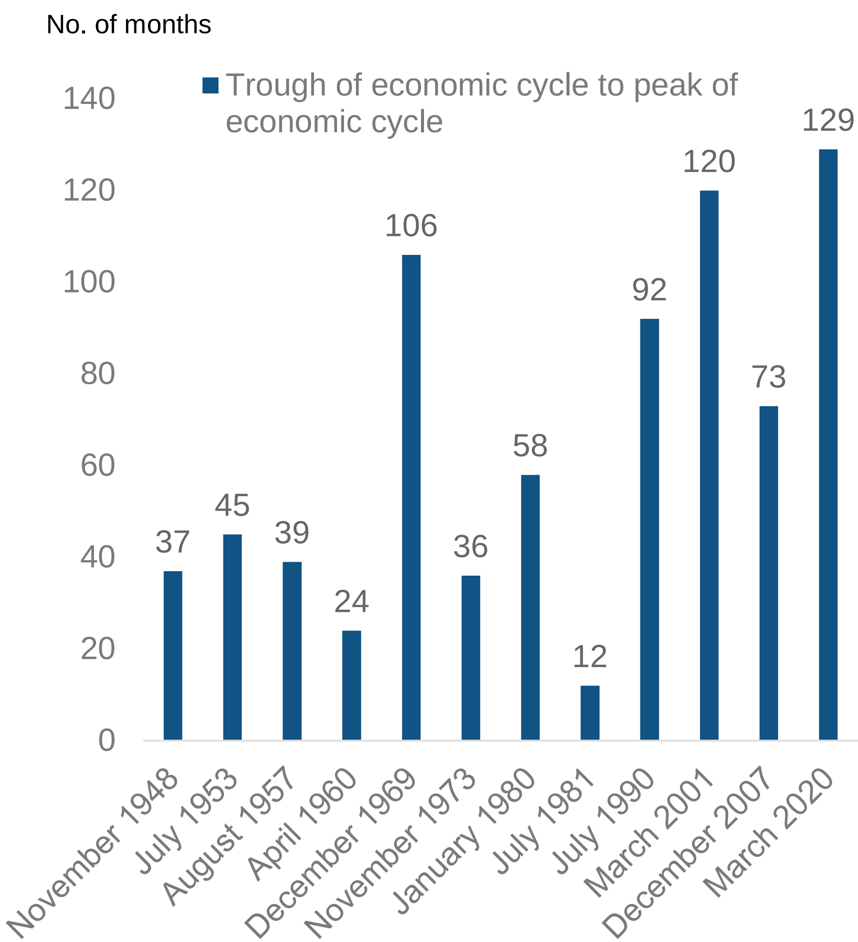
G7 10-year bond yields since 1990



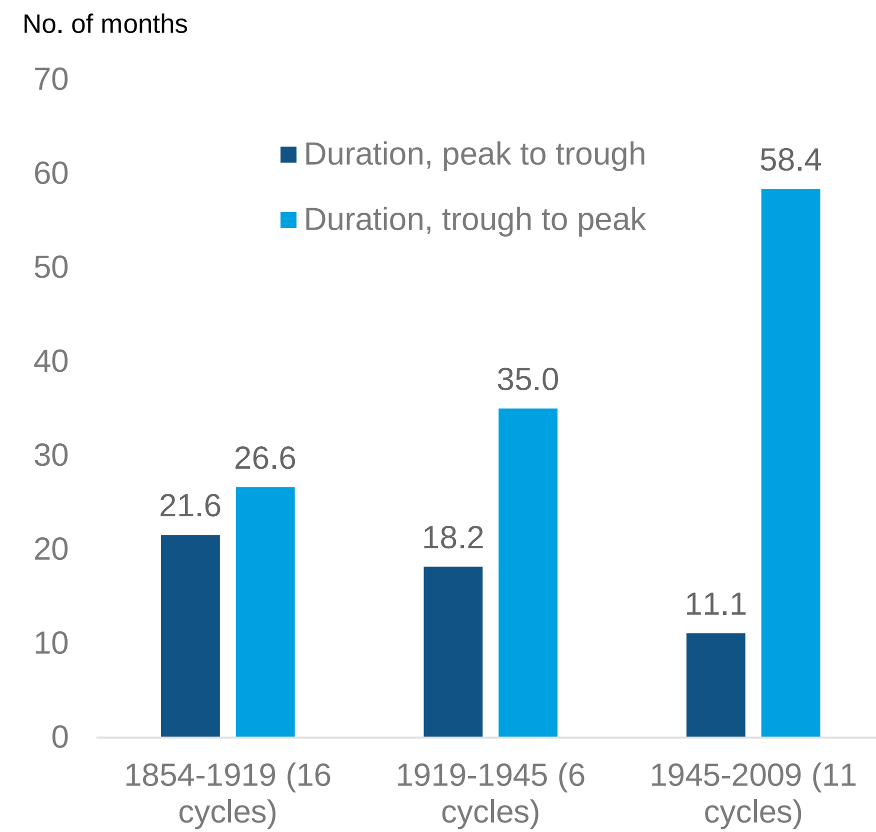
Source: Bloomberg Finance LP

A growing sense that we are 'conquering' the economic cycle

US economic upswings post WWII



US upswings and downswings – long-run



Source: https://www.nber.org/cycles.html

Supportive backdrop for debt and corporate profitability

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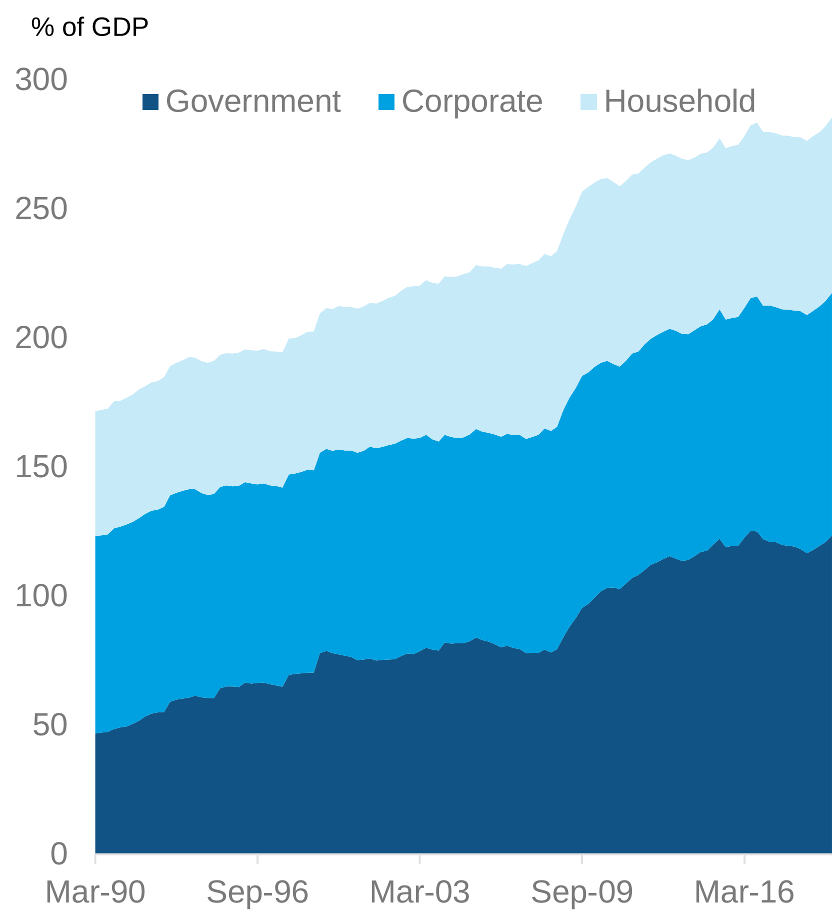
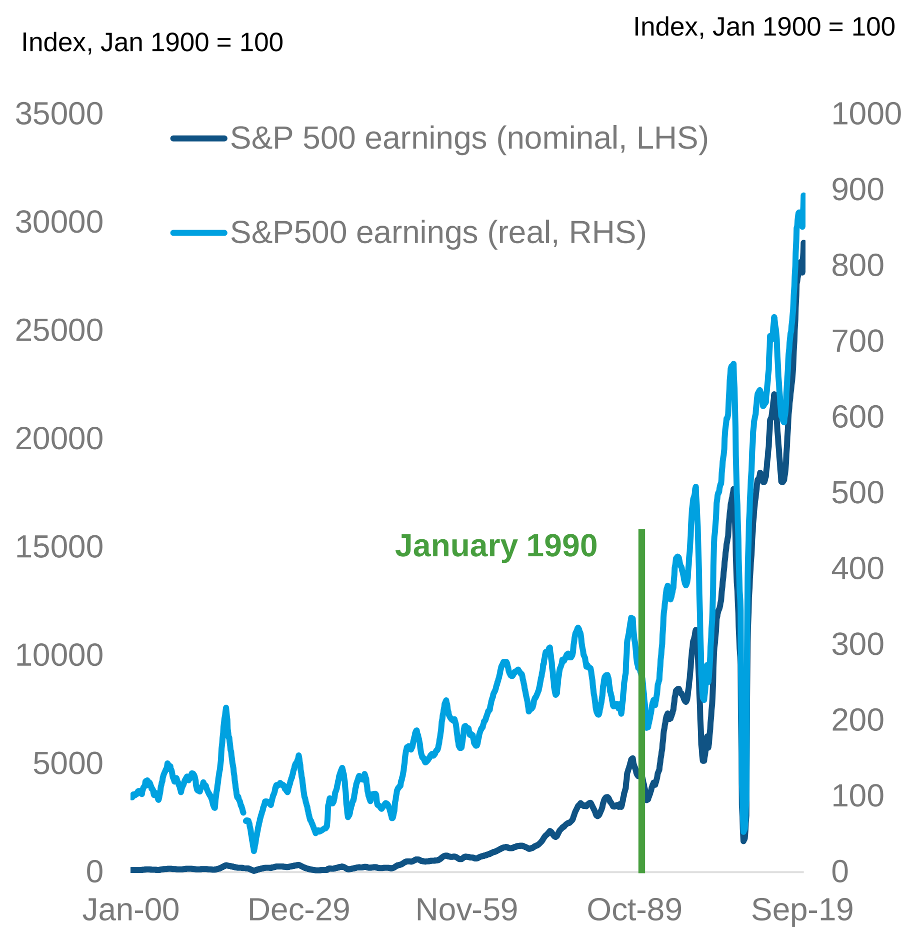
G7 debt



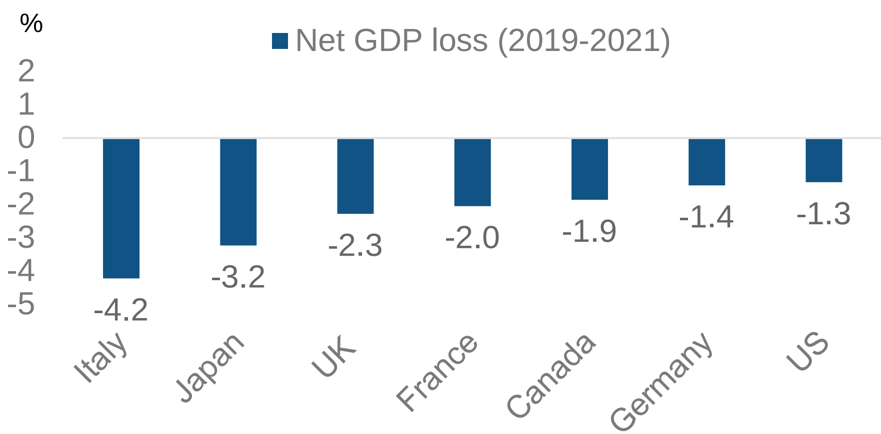
Corporate earnings



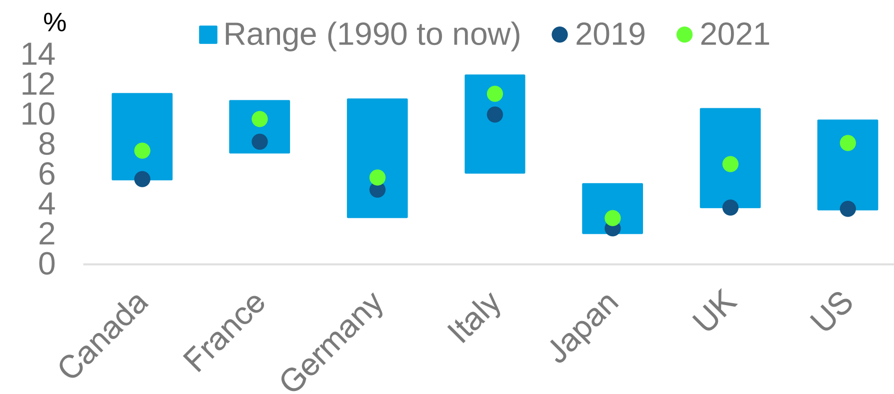
Source: Bank for International Settlements (BIS), International Monetary Fund (IMF), http://www.econ.yale.edu/~shiller/

Impact of COVID-19: Economies weakened, debt levels higher, and more spare capacity

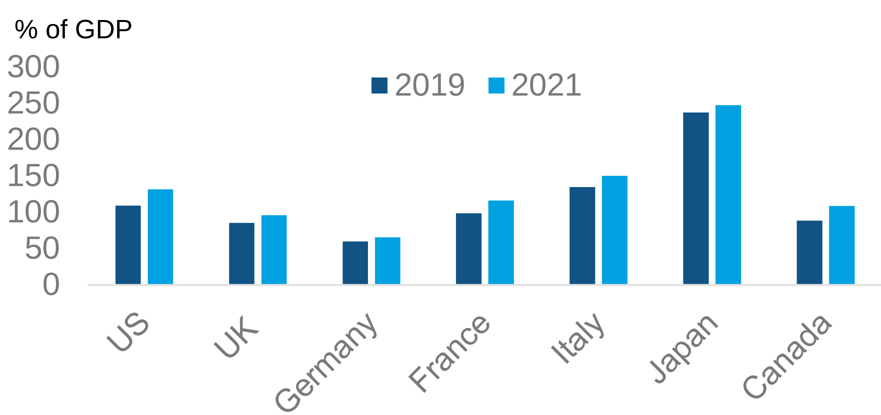
Permanent (?) loss of GDP



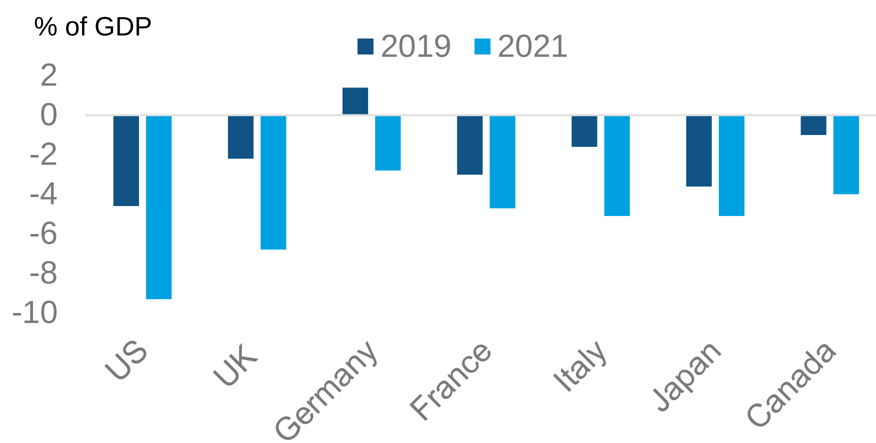
Unemployment rates



Government debt (2019-2021)



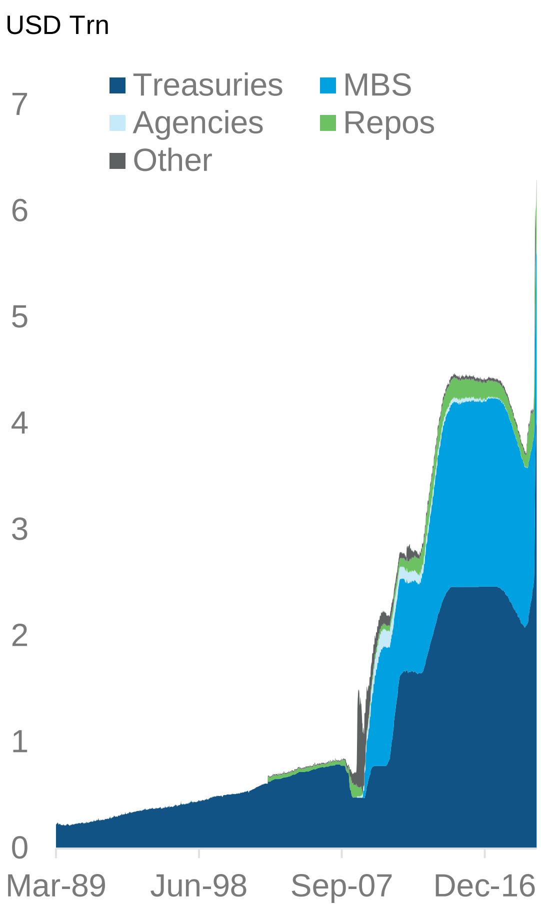
Government deficits (2019-2021)



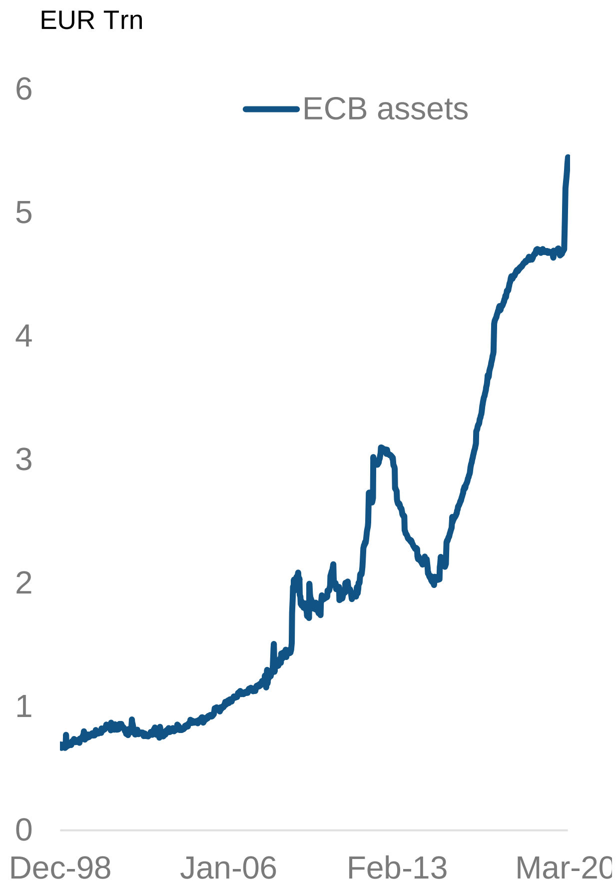
Source: CEIC, IMF

Impact of COVID-19: The policy response has been enormous

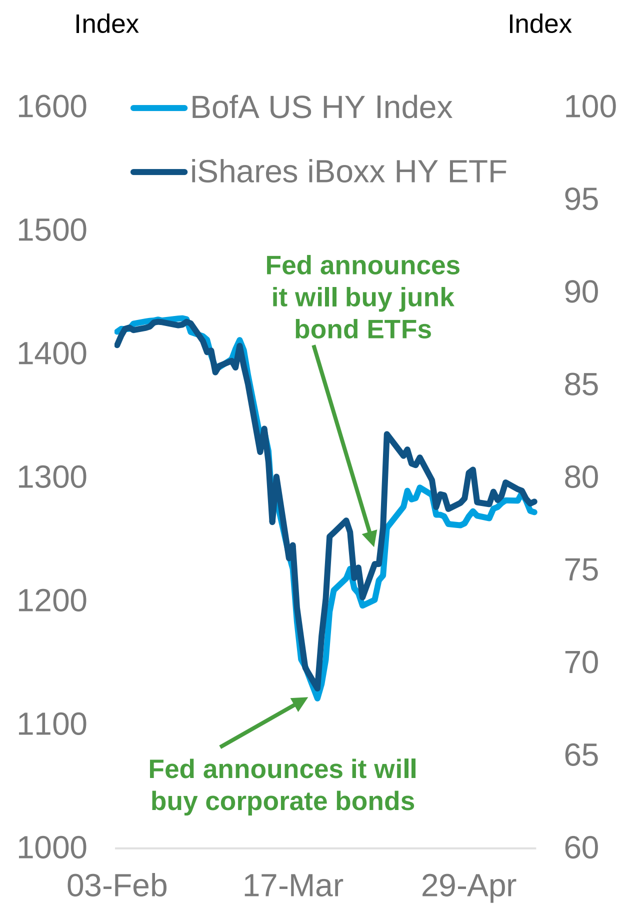
Fed balance sheet



ECB balance sheet



High yield ETFs – Impact of Fed

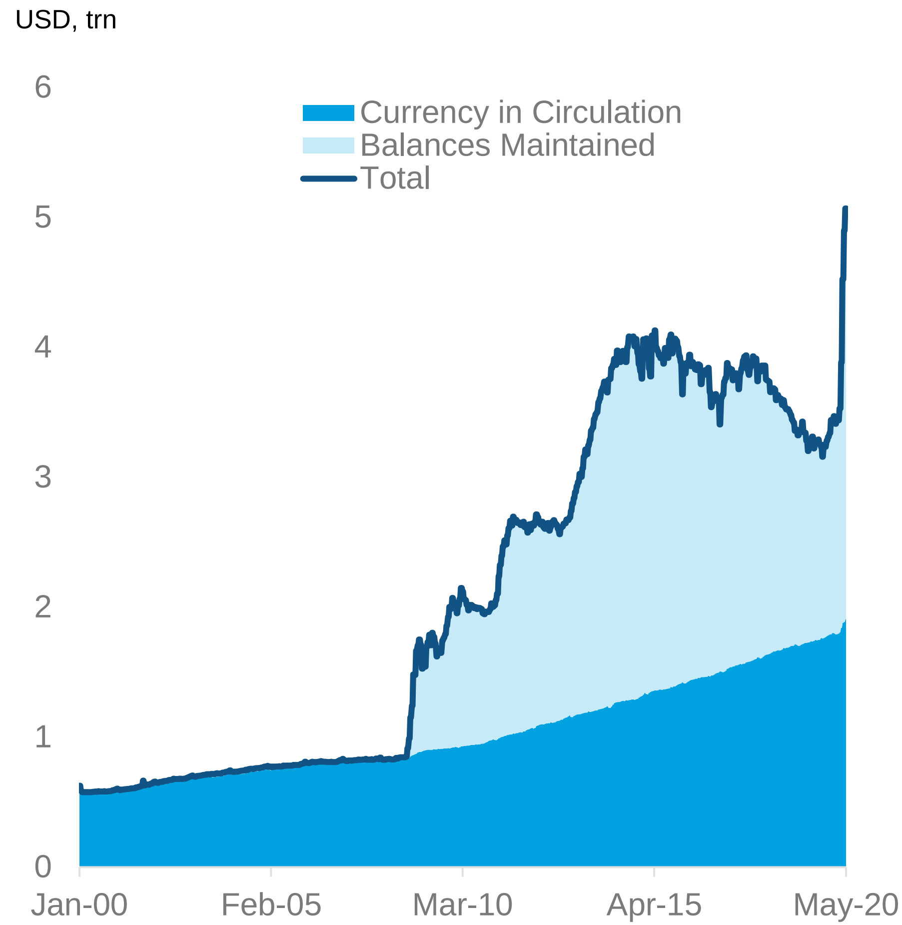


Source: CEIC, Bloomberg Finance LP

Inflation: Yes or no? The risks are rising

- Central banks commitments are *much* larger and, importantly, are unlimited in nature.
- Political pressure on banks to lend.
- Fiscal positions much weaker.
- Appetite for austerity rock bottom.
- External environment going from a strong disinflationary pulse to an inflationary pulse
- Supply side damage to the economy
- Debt monetisation being openly discussed
- **RBNZ Governor Orr** said he is “open minded” about direct monetization of government debt.
- **Andrew Bailey (BoE Governor)** said that he stands ready to help finance the governments spending.
- **Spain’s deputy prime minister**: “A certain [level of] debt mutualisation is a [necessary] condition of the continued existence of the EU”.
- **Rajan Raghuram, former Governor of the Bank of India**: "There is no alchemy here, unlike the views of some - so called monetisation is neither a game changer in stressed times nor a catastrophe.” “It helps a little at the margin, but does not solve the government's fiscal problems nor does it lead to runaway inflation.”

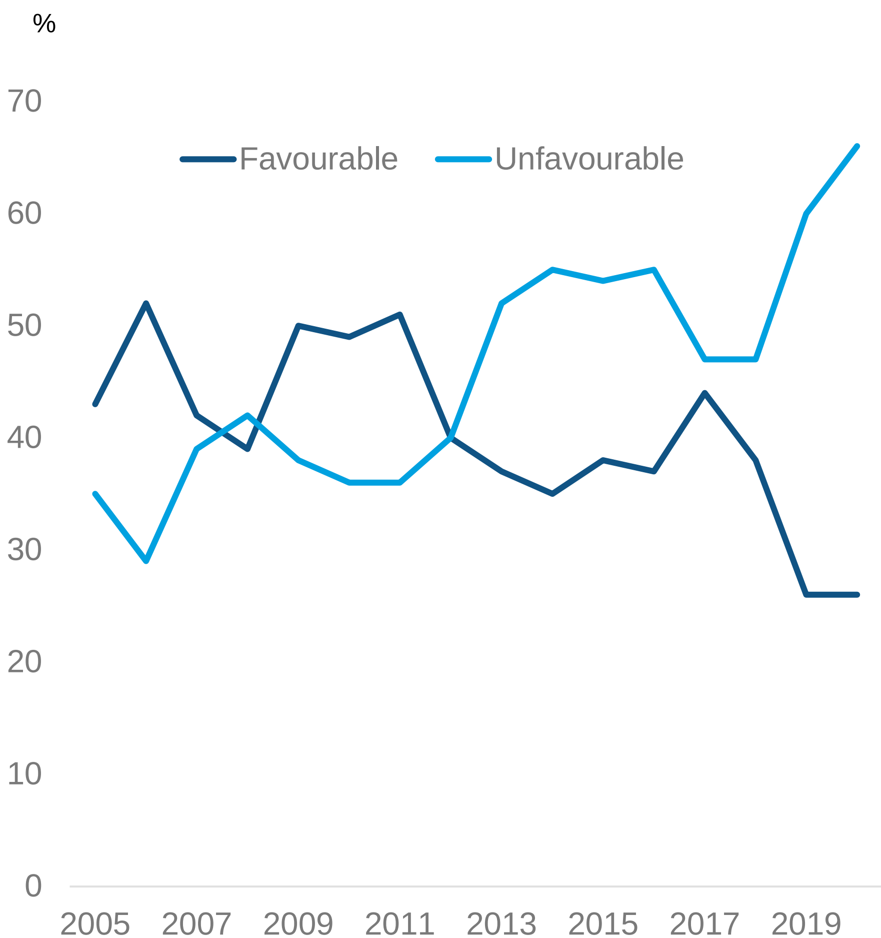
Banks hoarded the cash



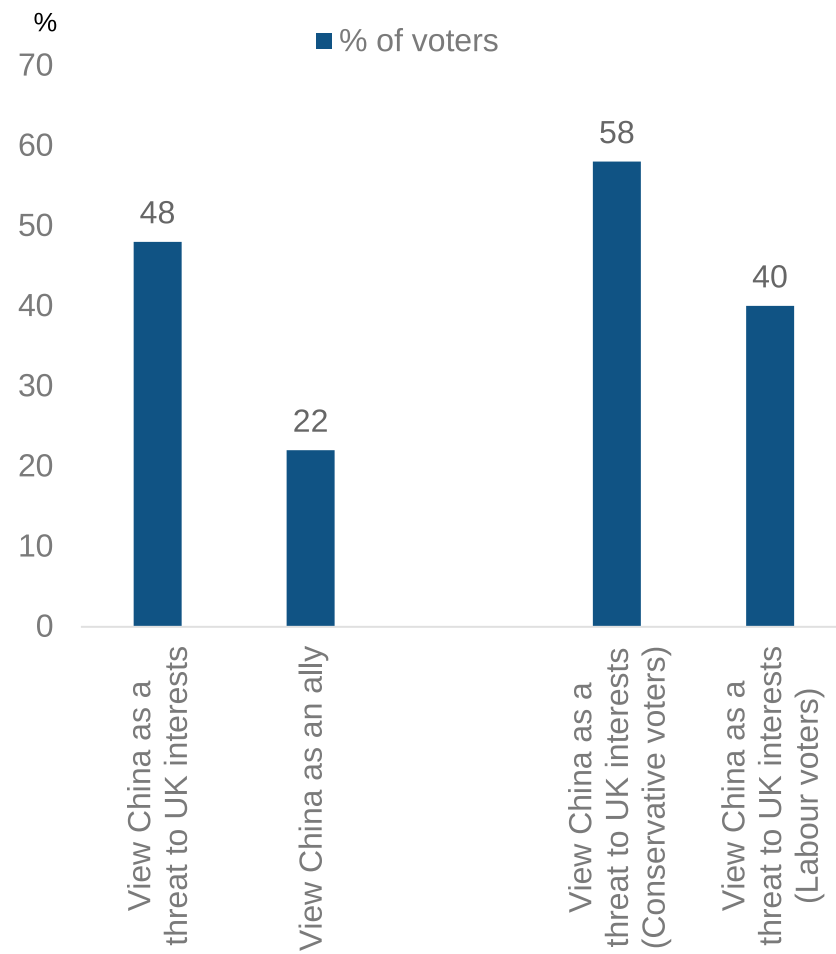
Source: CEIC

China and globalisation faces challenges

% of US adults with a favourable/unfavourable view of China



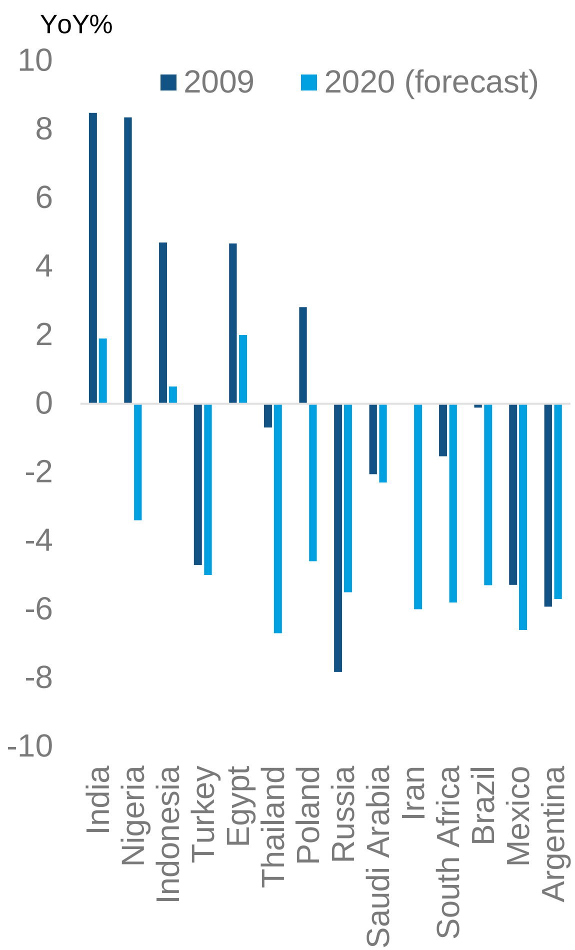
The UK is also shifting



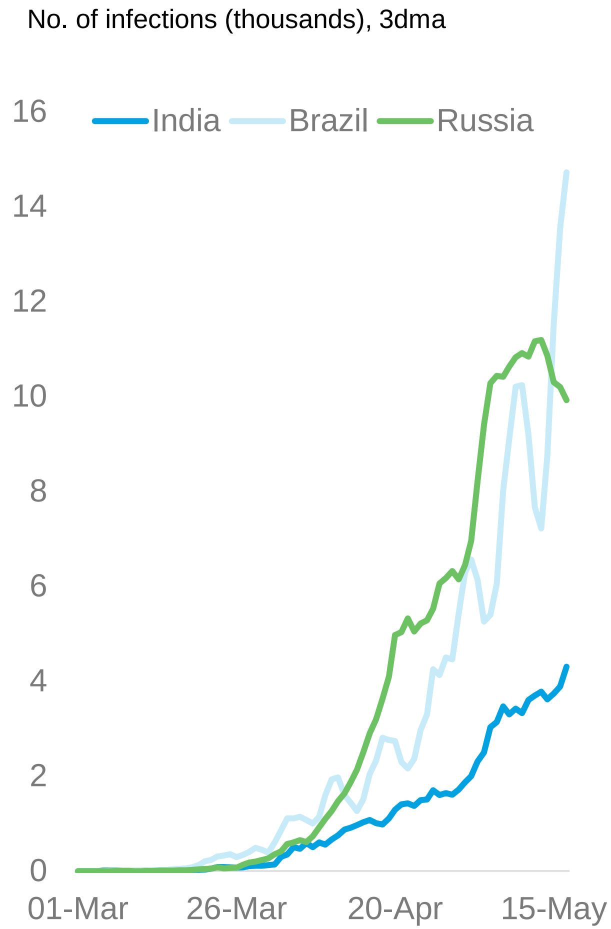
Source: https://www.pewresearch.org/global/2020/04/21/u-s-views-of-china-increasingly-negative-amid-coronavirus-outbreak/pg_2020-04-21_u-s-views-china_0-01/; https://www.newstatesman.com/politics/uk/2020/05/china-xi-coronavirus-response-voters-tory-labour-response

Emerging markets could be vulnerable

Growth hit larger than 2009



Virus is harder to control and manage in EMs



Structural challenges

Source: IMF, CEIC, Bloomberg Finance LP

Thematics and structural changes: Part 1

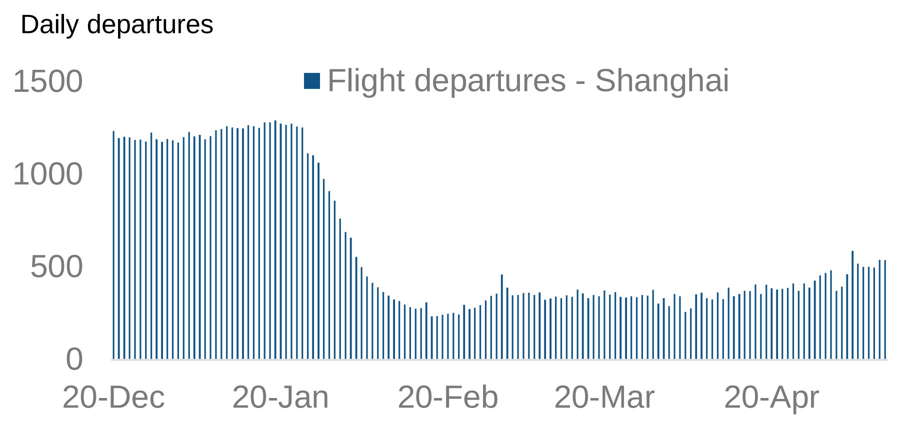
1. **Air travel is slow to recover**. Short-term: Travel restrictions of some form are expected to remain in place for some time; consumers will likely be reluctant to fly; supply side disruption. Longer-term: Virtual meetings and working online, as well as ESG considerations, slow growth in business travel.

2. **Supply chain re-organisation weakens trade growth.** Weaker growth in trade volumes as supply chains are unwound. The removal of a tailwind rather than a headwind. Cost increases for some sectors such as electronics and autos.

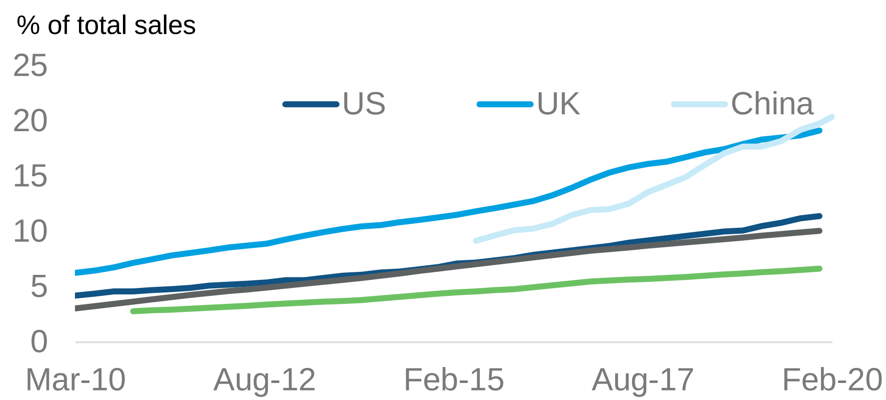
3. **Shift to online continues/accelerates**. Shopping, food, entertainment. Bad for bricks and mortar retail; good for logistics. Distribution and packaging benefit.

4. **Working from home increases.** This episode has proven it can work, both for the employer and the employee. Data, connectivity, cyber security becomes even more important. Telcos and data centres benefit.

Air travel – China



E-commerce sales



Sources: BNEF, Bloomberg Finance LP

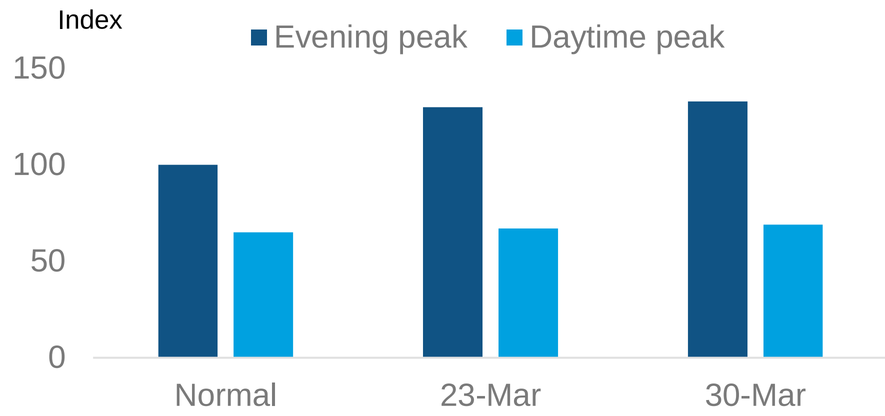
Thematics and structural changes: Part 2

5. **Automation and technology**. The shift to online supports robotics and transport automation. But more important is that governments are likely to double down on incentivising automation and technology. Lower migration increases pressure for investment to drive GDP. Strategic considerations may lead to a technology arms race. 3D-printing, autonomous vehicles, robotics, artificial intelligence, quantum computing.

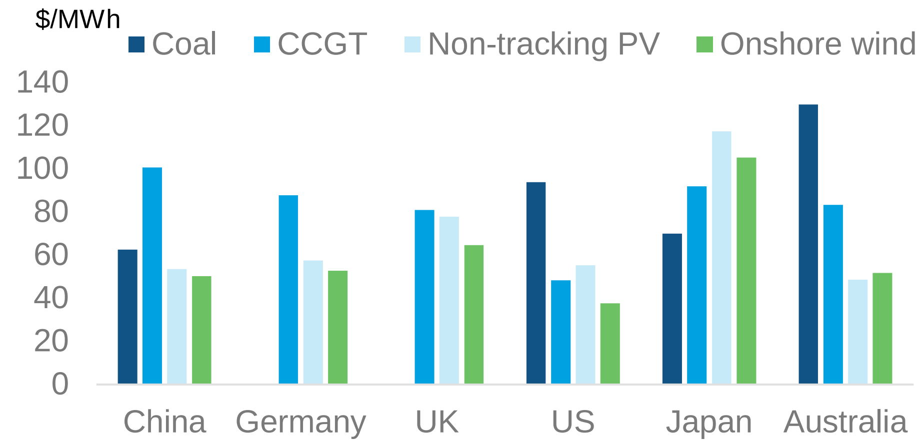
6. **Green revolution hits a speed bump, but continues.** The fall in energy prices and the weakness of government finances slows growth but the trend should continue. The cost situation is key. Renewables now the cheapest form of energy in many places while battery prices have fallen massively.

7. **Regulation intensifies, particularly for technology companies.** Technology may be increasingly viewed as a public good and the relationship between governments and technology companies could become closer. Some technology could be brought 'in-house' by governments, while some may be regulated more closely.

Data usage has increased



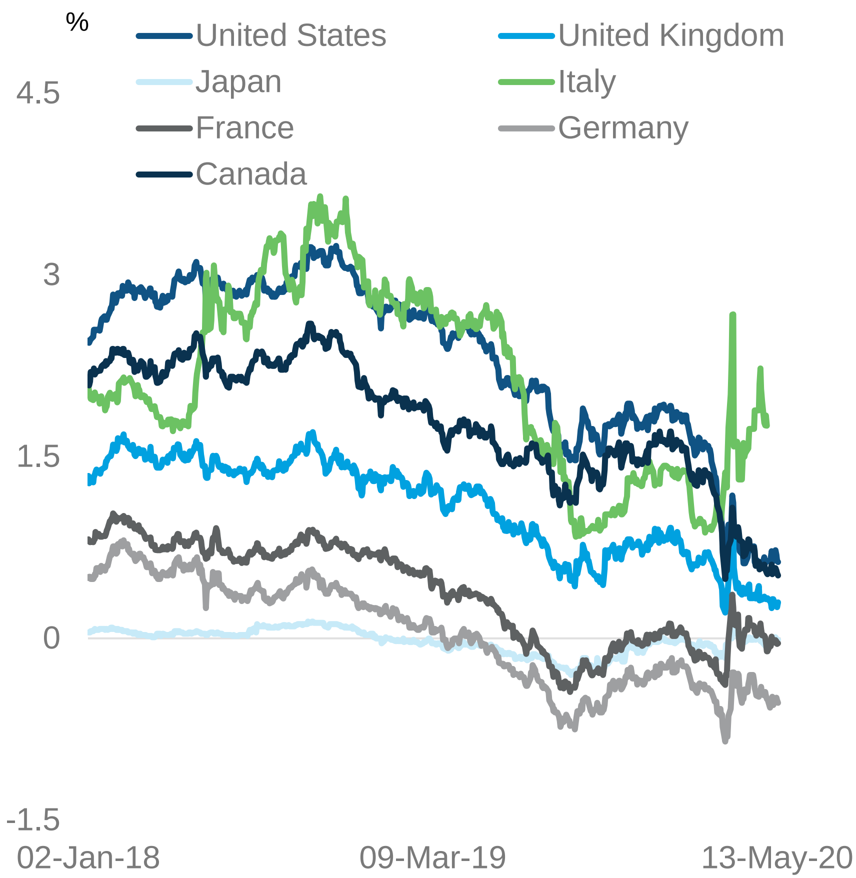
Green energy now increasingly the cheapest energy



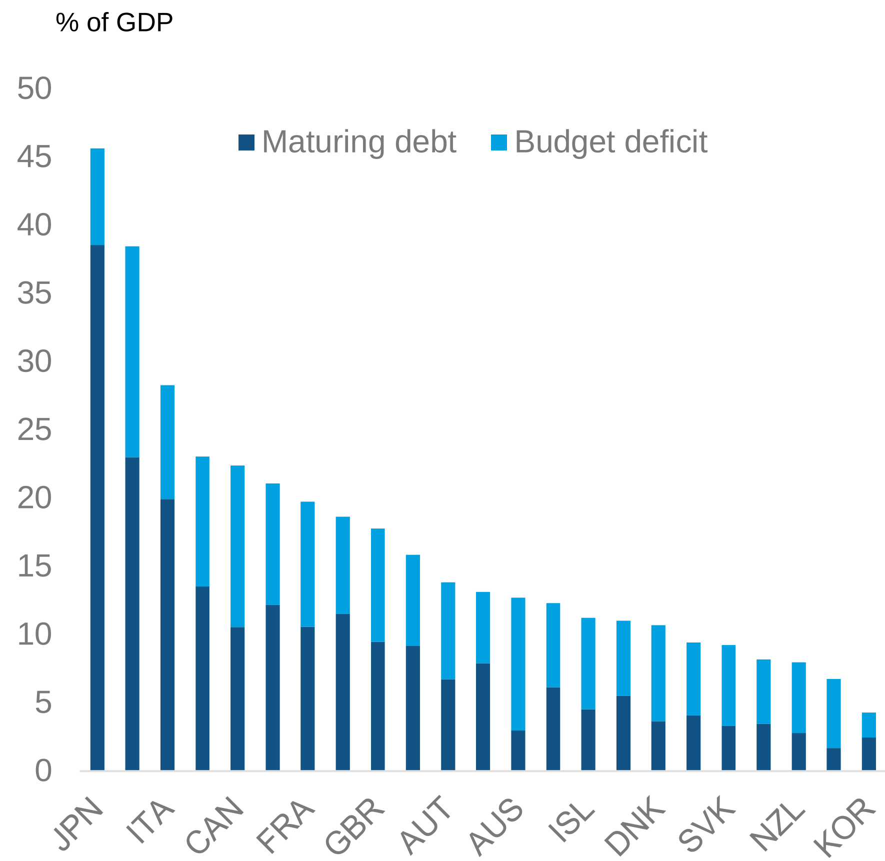
Source: BNEF, MIRA

Government debt: Beware the inflation risk

G7 yields



Funding need - 2020

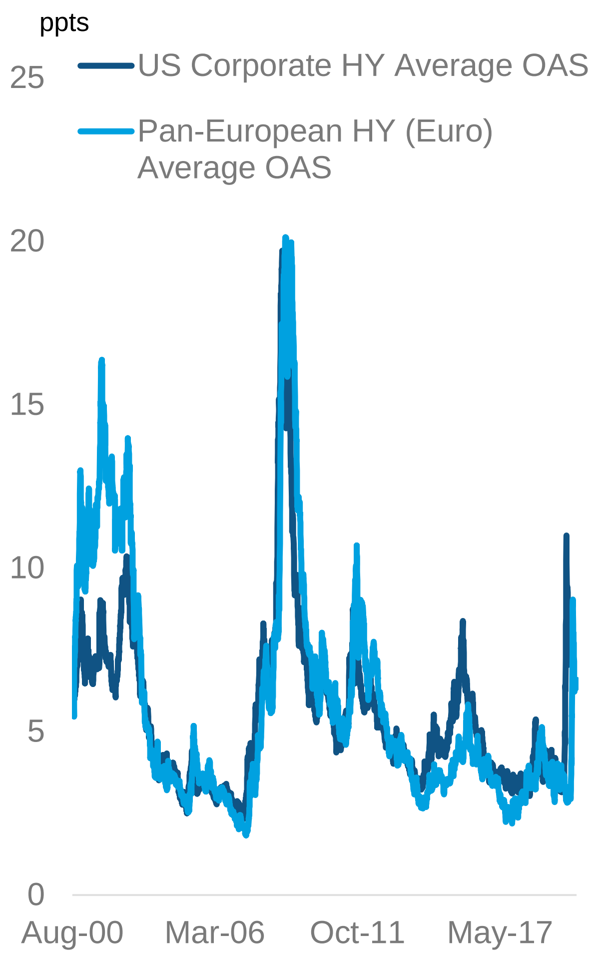


Sources: IMF, Bloomberg Finance LP

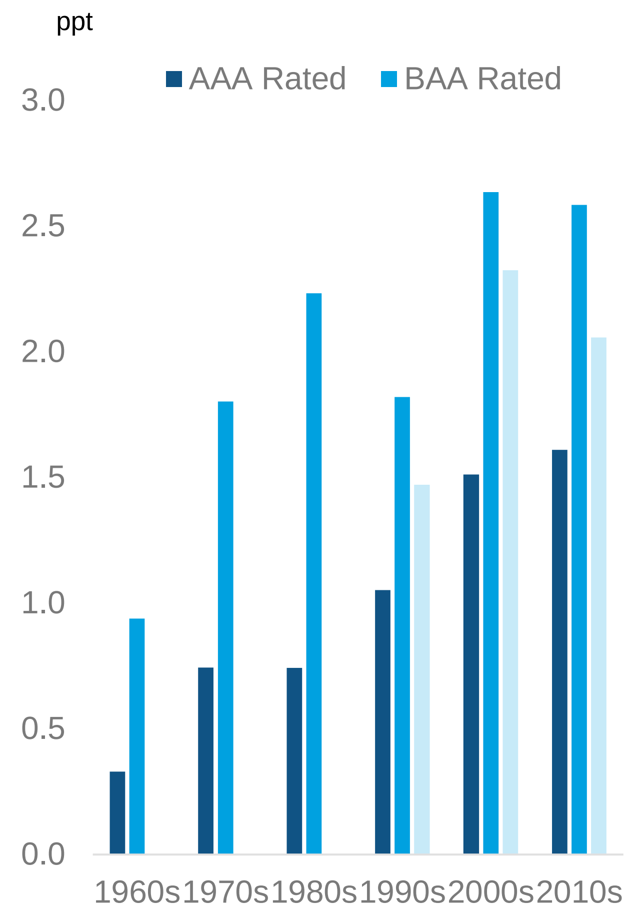
Private credit: Good fundamentals and risk spreads have been relatively high

- Inflation remains a concern but there a range of other considerations, most of which are positive:
  - **Risk spreads** are not low by historical standards, despite an increasingly benign economic cycle and policy environment in recent decades.
  - **Central bank policy**. The buying of non-investment grade credit is a change of huge importance for markets. It should ~~means~~ fewer defaults than would normally be expected in this space, which means the sector could emerge from the crisis with a better than otherwise risk-reward proposition.
  - **Fund flows.** Life insurers and pension funds are expected to shift out of governments and into private credit, investment and non-investment grade. At the same time some of the money likely to come out of emerging markets could go into this space.
  - **Financial institutions.** If banks are damaged through the downturn this is one of the areas they are likely to pull back on. This may ~~opens~~ up space / opportunities for this sector.

HY spreads



Risk spreads generally not low



Source: Bloomberg Finance LP

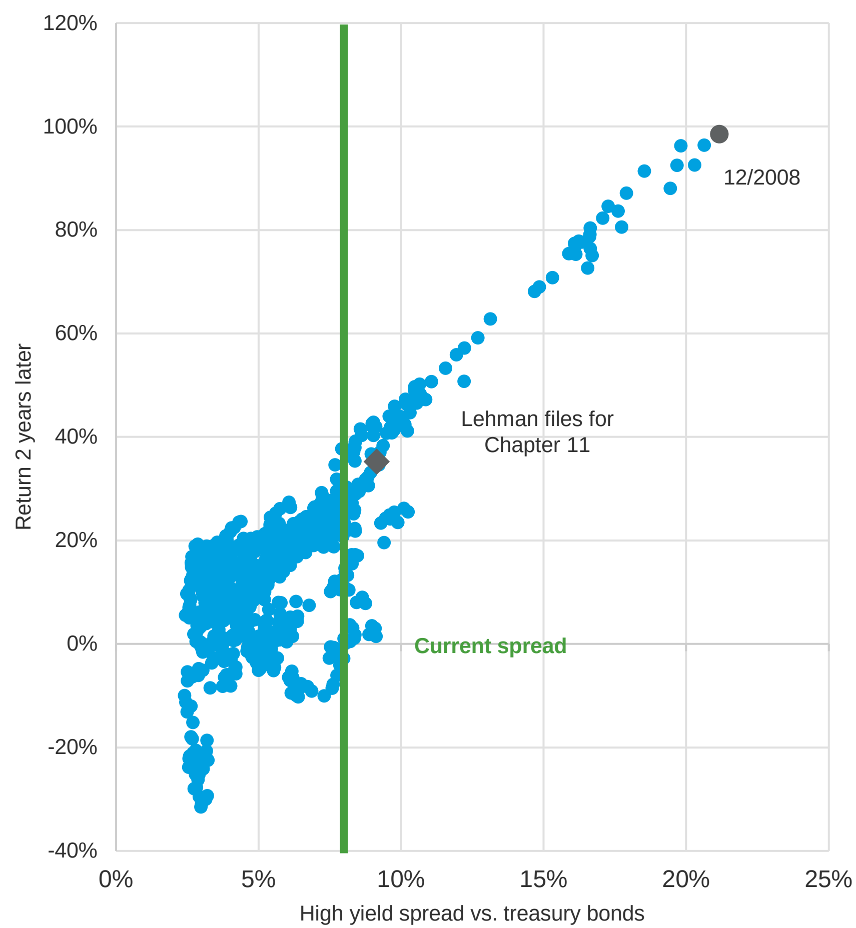
Private credit: Implied default rates and returns history

Implied default rates are very high

		Current spread	Implied default rate	Historic worst	Historic average	# Issuers	% Market cap**
EUR	IG All	198	**11.6%**	2.4%	0.4%	2,934	89%
	AA	121	**7.3%**	0.0%	0.0%	166	7%
	A	164	**9.7%**	1.8%	0.2%	932	36%
	BBB	230	**13.4%**	5.8%	0.8%	1,361	46%
	HY All	732	**36.7%**	38.8%	11.5%	592	11%
	BB	517	**27.6%**	27.3%	5.0%	279	7%
	B	952	**44.8%**	47.6%	13.4%	155	3%
	CCC	1,765	**66.8%**	75.0%	38.4%	47	1%
USD	IG All	279	**16.0%**	2.4%	0.9%	6,208	83%
	AA	170	**10.1%**	0.5%	0.2%	372	6%
	A	213	**12.5%**	1.3%	0.4%	2,354	37%
	BBB	351	**19.7%**	4.2%	1.6%	3,241	40%
	HY All	899	**43.0%**	30.9%	17.0%	2,019	17%
	BB	654	**33.6%**	17.3%	8.0%	957	9%
	B	932	**44.1%**	38.4%	19.2%	673	6%
	CCC	1,646	**64.3%**	72.5%	51.1%	287	2%

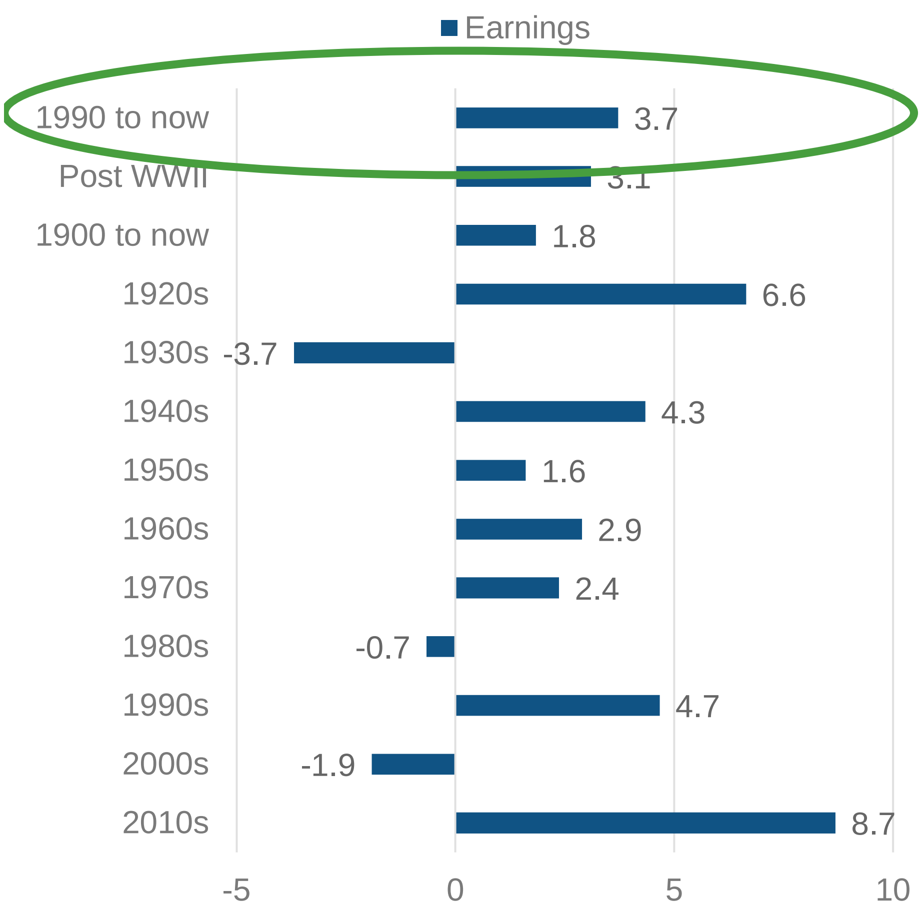
Source: Bloomberg Finance LP

HY Spread vs. return 2 years later

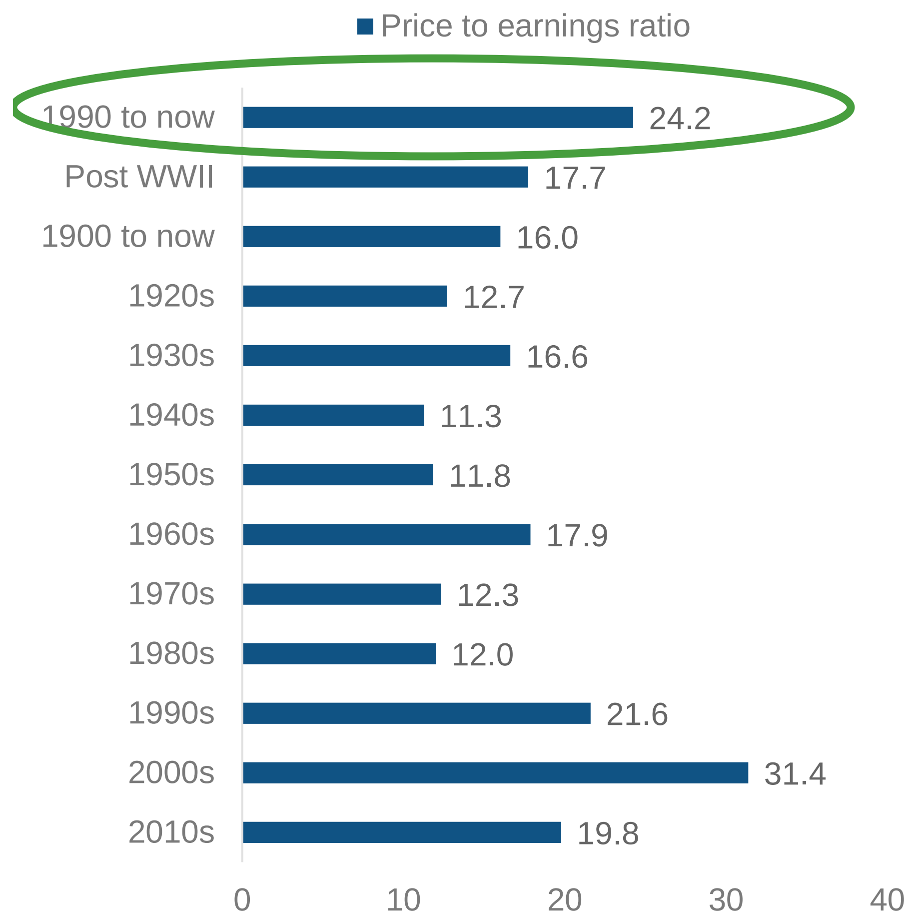


Equities: More earnings, less multiple

Real earnings by period



Price to earnings ratio by period



Source: http://www.econ.yale.edu/~shiller/data.htm

Equities: More earnings, less multiple

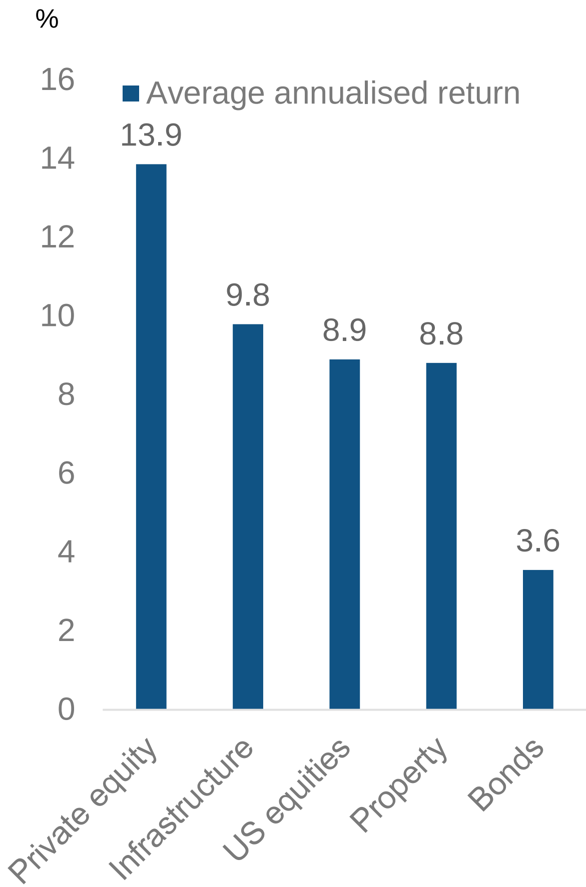
- Equity returns could face ~~a~~ **multiple headwinds** but earnings may be good enough to drive decent returns.
- **Pricing power and margin control** could be very important for consistent returns – brand power; or some monopsony power.
- **Supply chain exposed sectors** (autos, electronics) could face increasing costs and disruption.
- **Emerging market exposed** companies could be exposed to weaker growth than the last cycle.
- The environment ahead could favour **value over growth**, although definitions matter.
- Quality companies with **a strong industry position, robust balance sheets, healthy dividends** and good valuations.

Shiller CAPE vs. real return 10 years later

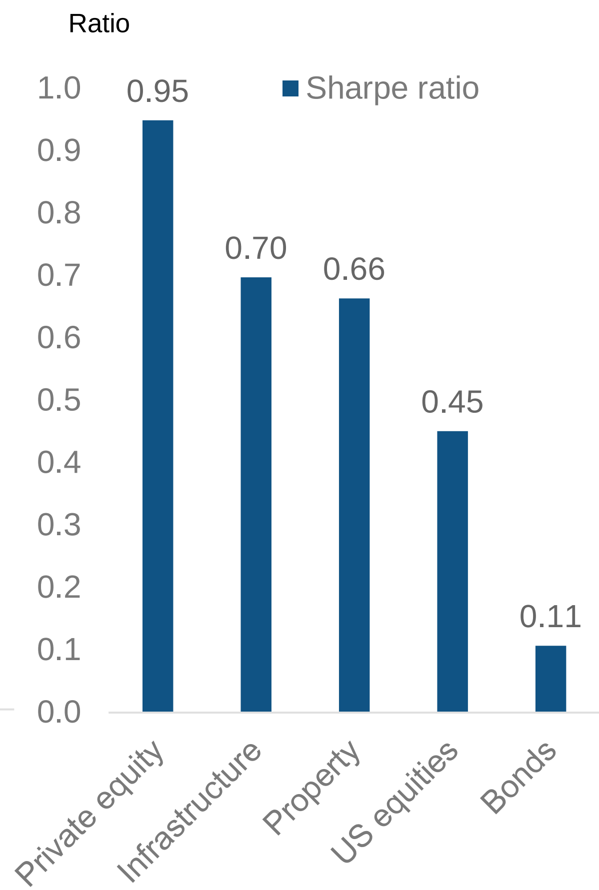
Sources: http://www.econ.yale.edu/~shiller/

Real assets: Risk-adjusted returns, inflation protection

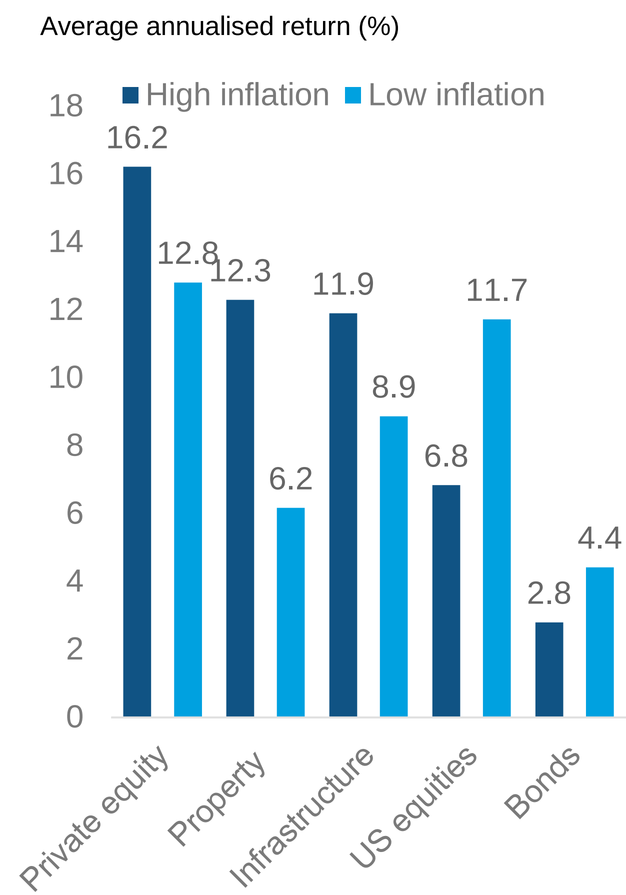
Returns



Sharpe ratio



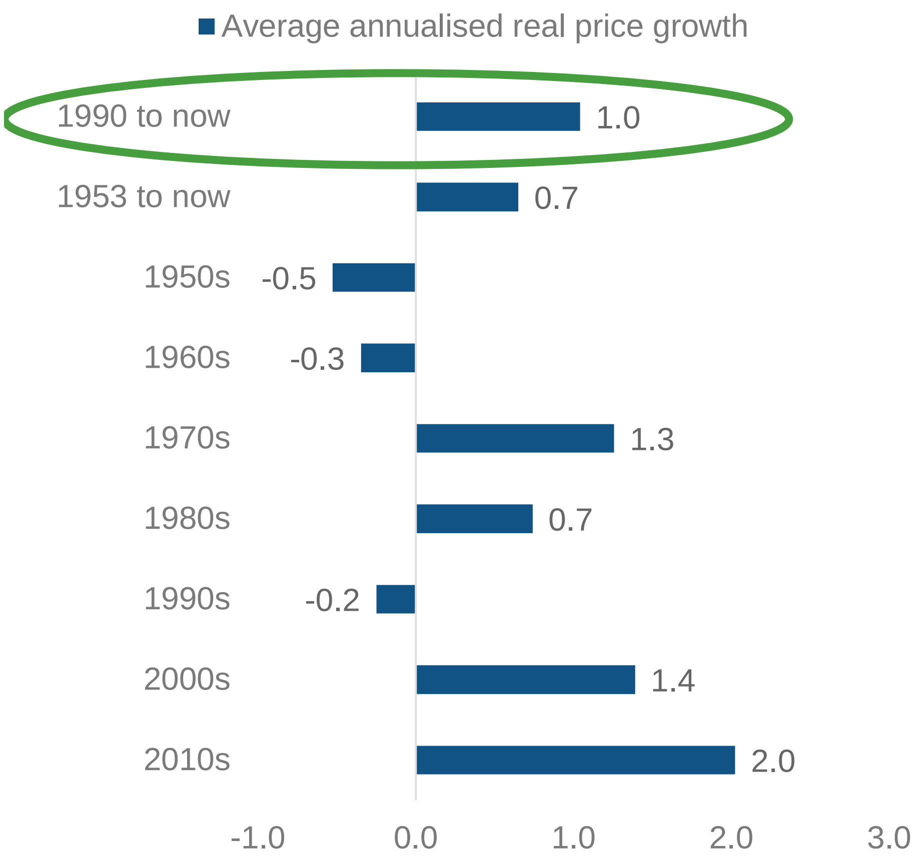
Inflation protection



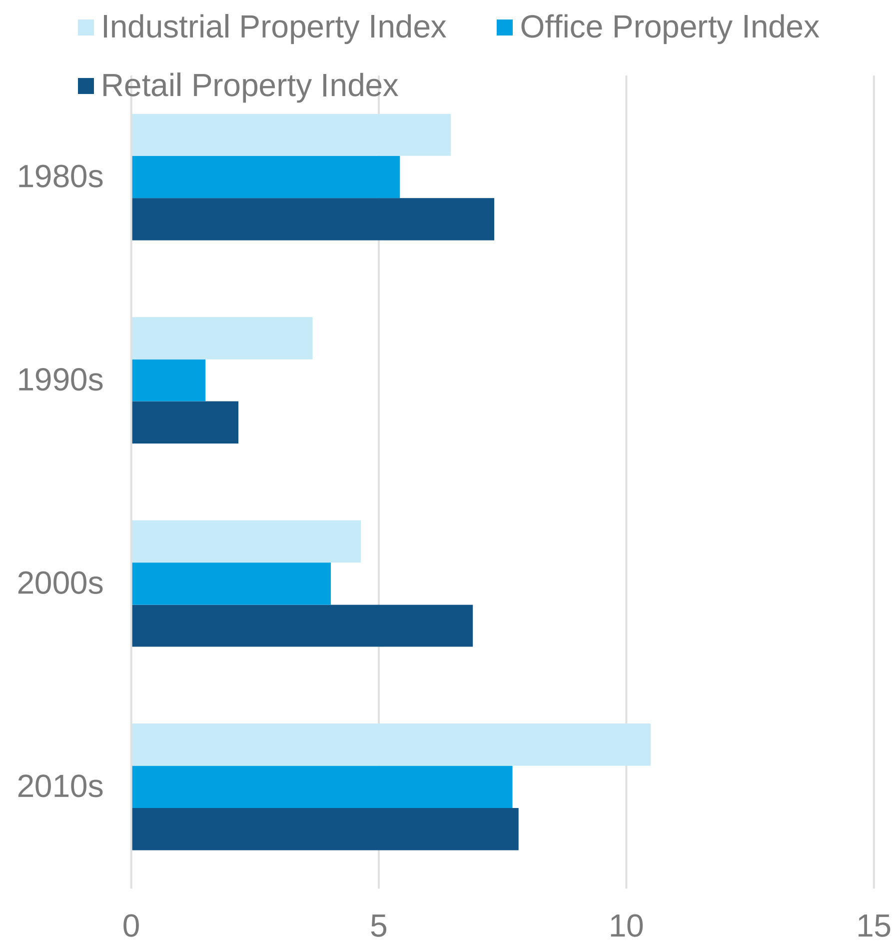
Sources: Bloomberg Finance LP, Cambridge Associates

Property: Residential price growth has been strong in recent decades

US - Residential



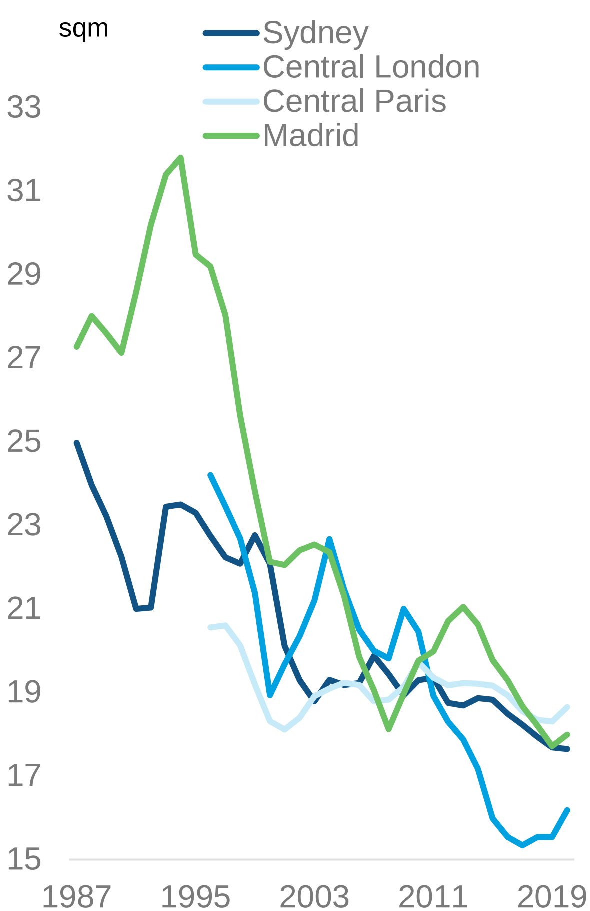
US – Non-residential



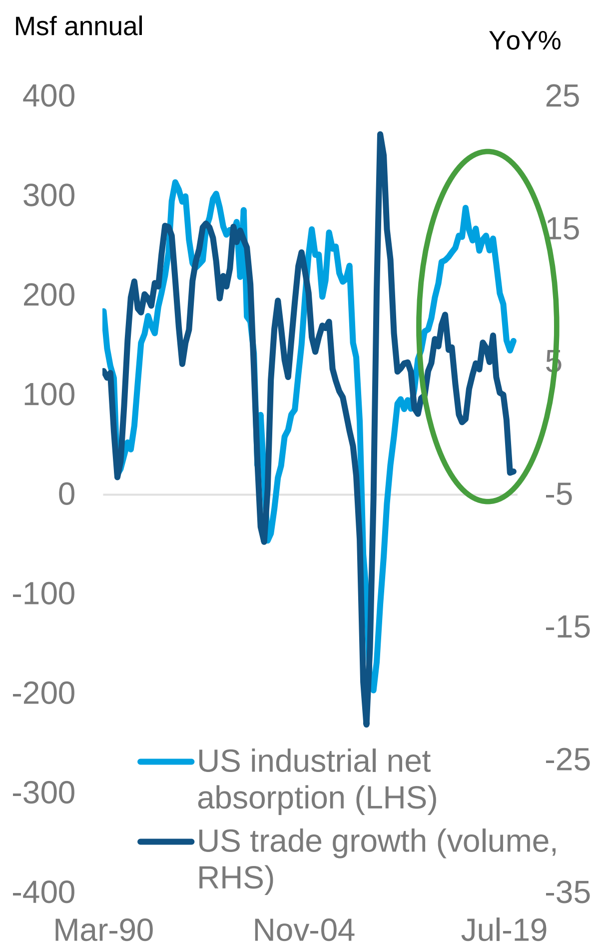
Source: Bloomberg Finance LP, CEIC, http://www.econ.yale.edu/~shiller/

Within property demand for office may be mixed, while demand for industrial remains strong

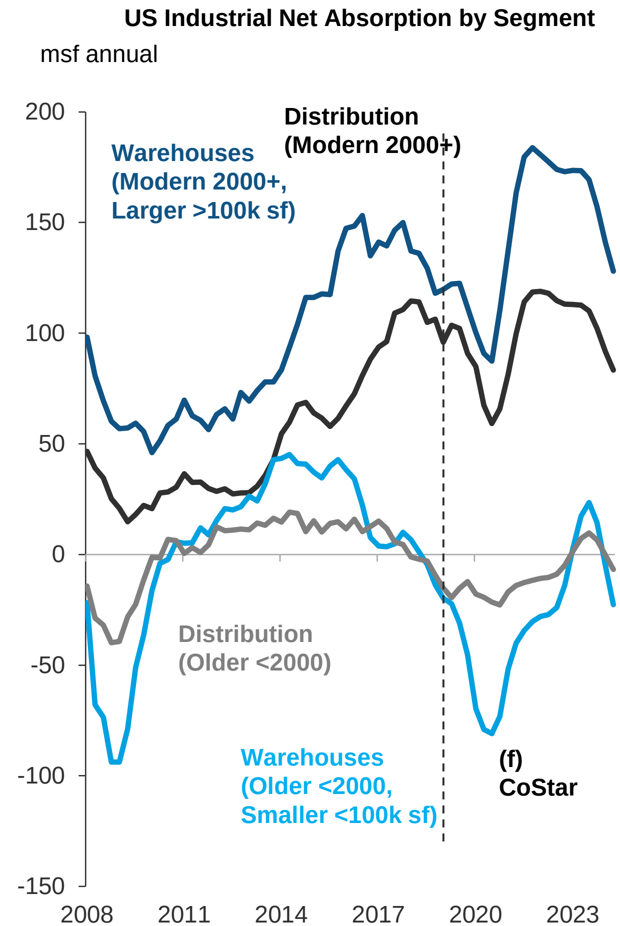
Office space per person



Industrial net absorption strong



Leasing concentrated in modern industrial



Source: Macquarie, Bloomberg, Oxford Economics, CoStar, as at May 2020.

Conclusions

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Key points

- **Inflation protection.** Unlimited quantitative easing, open talk of debt monetisation, supply side damage and increased pressure on banks may be increasing inflation risks. Different asset classes provide different degrees of protection.
- **Risk premiums and multiples.** With economic and geopolitical risks rising the multiples on which equity is priced may come under pressure. Less of an issue in private credit markets.
- **Emerging markets**. A growth slowdown, vulnerabilities to the virus and weaker institutions and policy frameworks may create risks. Any tension between the West and China could make the next cycle less good for emerging markets.
- **Technology arms race may lie ahead.** National competition, falling migration levels, ageing and general productivity demands could all enhance investment in technology and its speed of advance.
- **Working from home increases**. More people working from home reduces demand for office although we may now require more office space per person. Could be less demand for inner city property – residential and retail – more generally. Supports data and broadband networks, although increased regulation may be part of the deal.
- **The shift to online continues**. This is a trend that has been underway for some time but this crisis reinforces it. Means weaker demand for bricks and mortar retail properties and continued strong demand for logistics and distribution.
- **Green revolution hits a speed bump, but continues.** The sharp fall in energy prices could see growth in renewables and electric vehicles slow for a while. But ultimately the trend continues, driven by the lowest cost level and ongoing potential cost gains.