2019-20 financial year in review

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Despite what the market recovery late in the financial year may imply, the economic fallout from COVID-19 will be long-lasting and the outlook remains highly uncertain.

The 2019-20 financial year was dominated by the COVID-19 pandemic

After initially appearing as a health issue limited to a province in China, the virus responsible for causing the COVID-19 disease began to spread rapidly across international borders in February 2020, eventually prompting the World Health Organisation (WHO) to declare a pandemic on 11 March. The global surge in infections and fatalities forced governments to impose limitations on personal mobility and business operations to protect public health. The economic consequences of these necessary actions were both dramatic and dire. Comparisons are being made with the distress experienced during the Global Financial Crisis (GFC) from 2007-09 and the Great Depression of the 1930s. The economic crisis caused share markets to collapse in the March quarter and created severe liquidity issues within fixed income markets. To limit the economic contraction and sustain the functioning of financial markets, central banks and governments implemented supportive policy measures on a massive scale. Share markets subsequently rallied from their lows in March, based in part on the belief (perhaps mistakenly) that the virus was manageable and that economic distress would be short lived. The financial year concluded with no vaccine in sight and rising infection rates in various parts of the world, especially in Brazil, India and the US.

Table 1: Asset class returns in Australian dollars – periods to 30 June 2020

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	0.8%	1.5%	1.7%	2.7%
Australian bonds	4.2%	5.6%	4.8%	5.6%
Global bonds (hedged)	5.2%	4.7%	4.8%	6.0%
Australian property securities	-20.7%	2.3%	4.7%	9.4%
Global property securities (hedged)	-17.6%	-1.9%	1.6%	8.1%
Australian shares	-7.7%	5.2%	6.0%	7.8%
Global shares (hedged)	0.8%	5.8%	6.9%	11.1%
Global shares (unhedged)	4.1%	10.0%	8.8%	11.4%
Emerging markets (unhedged)	-1.5%	5.6%	5.1%	5.4%

Benchmark data: Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Bloomberg Barclays Global Aggregate Index Hedged to $A (global bonds), S&P/ASX200 A-REIT Total Return Index (Australian property securities), FTSE EPRA/NAREIT Developed Index (gross) hedged to $A (global property securities), S&P/ASX200 Total Return Index (Aust shares), MSCI All Country World Indices hedged and unhedged (net) in $A (global shares), and MSCI Emerging Markets (gross, unhedged)

* Annualised returns. Past performance is not a reliable indicator of future performance.
Sources: FactSet, MLC Asset Management Services Limited.

The economic deterioration caused by COVID-19 was both extraordinary and sudden

The economic environment at the start of the 2020 calendar year was vastly better than conditions in June 2020. Global growth had moderated, with Australia, parts of Asia and Europe recording sluggish growth in early 2020. However, the US economy continued to perform well. Interest rate policy settings were generally supportive, underpinning the performance strength of share markets.

Some key issues remained contentious and some were resolved. In the UK, after an extended period of political instability, Boris Johnson replaced Theresa May as Prime Minister. The Conservative Party's election success with an increased parliamentary majority allowed the passing of the EU (Withdrawal Agreement) Bill early in 2020, setting out the terms of the UK's departure from the European Union. After a trade war lasting nearly two years, China and America appeared to reach a truce with the signing of a "phase-one" trade deal in January 2020. Under the agreement, the US reduced existing tariffs and deferred proposed new tariffs in return for China agreeing to buy an additional US$200 billion of US imports over the next two years. However, doubts remained as to its actual implementation and longevity, especially as the US decides to take a hard line against China's imposition of a national security law on Hong Kong.

The spread of COVID-19 infections beyond China to other countries such as Korea, Iran and Italy, and the rise in fatalities began to gain the attention of financial markets in February. The WHO increased their risk assessment to "very high at the global level" late in February, which was subsequently upgraded to global pandemic status on 11 March. By then, COVID-19 infections were accelerating throughout the world.

China's dire economic performance statistics early in 2020 resulting from the regime's implementation of strict community restriction measures to contain the virus spread was a sign of things to come for other economies. China's economy contracted by 6.8% year-on-year in the March quarter, its first quarterly contraction since 1992. Chinese factory activity plunged in February to levels below those experienced in the GFC. Industrial production fell 13.5% in January and February and retail sales declined by 20%.

In the US, the number of people unemployed increased by 15.9 million people to 23.1 million in April, with the unemployment rate surging from a near fifty years low of just 3.6% in February to a high of 14.7% in April. This was the highest unemployment rate recorded and the largest monthly increase since data collection began in April 1948. The unemployment rate could have been much worse. Congressional support for a Paycheck Protection Plan which provides US$660 billion in loans to small and medium businesses to support retaining employees helped mitigate the damage to employment. However, the job layoffs and business shutdowns contributed to the painful slump in US retail sales which fell by a record 14.7% in April after an 8.2% fall in March.

European economies also recorded dramatic falls in economic activity. The most severely impacted countries – Italy, Spain and France – experienced a surge in infections and fatalities, placing immense strain on their hospital system. This prompted many European governments to impose lockdowns and restrictions on personal mobility, resulting in widespread factory shutdowns. French and German car manufacturers announced production closures across Europe. European business activity surveys plunged to levels below the GFC in 2008. Similarly, UK business surveys fell to a twenty-year low. News that the British Prime Minister Boris Johnson had contracted the virus only added further to financial market concerns.

The serious impact of COVID-19 on Australia's economy closely followed economic challenges caused by the devastating bushfires and the drought. Some industries such as travel, hospitality, education services and entertainment were immediately impacted by social distancing restrictions and other measures such as border closures implemented by the Federal and state governments. In the two months to the end of May, job losses totalled 838,000. Australia's March quarter Gross Domestic Product (GDP) fell 0.3% and the Reserve Bank of Australia (RBA) warned that unemployment could reach 10% in the June quarter.

Desperate times required desperate measures – central banks and governments ride to the rescue

Central banks and governments around the world are committed to implementing assertive policy measures to limit the economic and financial disruption caused by COVID-19. These important measures inject much needed stability into share and fixed income markets. The global scope of the stimulus measures is both extraordinary in nature and substantial in magnitude.

The US Congress passed the largest fiscal stimulus package in its history, with measures introduced in March and April. The US$2.8 trillion package was targeted to support households and businesses through a comprehensive range of initiatives including business loan guarantees, consumer cash payments, expanded unemployment insurance eligibility and payments, aid to affected industries (eg airlines) and increased hospital and local government spending. Total fiscal support initiatives so far amount to the equivalent of 14% of US nominal GDP.

Monetary policy measures announced by the US Federal Reserve (the Fed) were similarly large in scale. In March, the Fed cut the cash rate by 1.5% to a range of 0% to 0.25%, commenting that it was “prepared to use its full range of tools to support the flow of credit to households and businesses”. The Fed also signalled a massive expansion of its balance sheet via multiple asset purchase and lending programs, including standing in the market to buy US government bonds, mortgage backed securities, commercial paper, corporate bonds and municipal bonds. Capital reserve requirements for banks were reduced to encourage them to continue lending to households and businesses.

The European Central Bank (ECB) announced its own program labelled the Pandemic Emergency Purchase program to support markets and the eurozone economy. In March the ECB committed to purchase up to 750 billion euros in government and private sector bonds and vowed to keep interest rates low to support businesses and consumers. In June, the ECB added an extra 600 billion euros to its support program and extended the duration of its purchase program until at least June 2021. To augment the ECB support, individual eurozone governments launched their own fiscal stimulus measures. Germany’s measures, which include cash grants to families, a reduction in the VAT to encourage consumer spending and direct grants to support specific industries, so far amount to 29% of nominal GDP. France implemented a 45 billion euro package of measures to assist French businesses and workers.

In Asia, China’s central bank cut interest rates and provided guidance to the major banks to lend to small and medium enterprises. The Bank of Japan committed to buy corporate bonds, exchange trade funds (ETFs) and real estate investment trusts (REITs).

The RBA and Federal and state governments also announced extraordinary stimulus measures and assistance packages to support businesses and households. The RBA cut the cash interest rate twice in March to a historic low of 0.25% and committed to an expansion of its balance sheet through the purchase of Australian Federal and state government bonds. The RBA also provided a A$90 billion term funding facility at a fixed rate of 0.25% to the banking system for lending to businesses, especially small and medium sized companies. In support of this initiative by the RBA, the Australian Prudential Regulatory Authority announced a temporary relaxation of bank capital ratio requirements to help support credit availability to the economy. The Federal government also announced a range of fiscal support packages totalling A$213 billion (or circa 10% of nominal GDP). These measures included wage subsidies to encourage businesses to retain staff, extra payments to existing welfare recipients as well as direct financial grants and loan guarantees for small businesses. State governments launched their own initiatives to support households and businesses.

Fixed income markets became unstable but eventually recovered

Solid returns from most fixed income assets over the year to June 2020 disguise the extreme volatility and disruption experienced through the period. The first seven months, up to January 2020, were fairly benign. Despite worries about slow global growth, easy monetary policy provided the foundations for strong performance in government bonds and steady spread tightening in credit assets. By January a few of the bigger geopolitical concerns, like Brexit and the China-US trade war, had receded and the outlook appeared reasonably healthy. However, the emergence of COVID-19 led to one of the most rapid and severe market crashes ever seen in fixed income markets. The subsequent torrent of fiscal and monetary support was enough to reverse much of the damage to prices, although the recovery has been selective given that the outlook for corporate defaults remains concerning.

Relative to the rest of the world, fixed income markets in Australia weathered the storm relatively well allowing for some significant dislocations in March. Initially, government bonds performed well as concerns around the virus started rising. But in mid-March the concern turned to panic, riskier markets started to freeze up as investors rushed for cash by selling whatever assets they could. This led to a rapid drop in government bond prices, as the yield on ten-year bonds rose from a low of 0.6% on 9 March to 1.5% ten days later. At that point, the RBA stepped in to preserve market functioning, committing to direct purchases of government and semi-government bonds across the curve. With the RBA stating that negative interest rates were not appropriate for Australia, they were then forced into more unconventional measures through bond yield targeting, which entails the RBA buying as many bonds as it takes, to keep the three-year government bond yield at 0.25%. These measures were effective in restoring some calm to government bond markets, although it took some time for credit markets to unfreeze. Supported by fiscal stimulus from the Federal government, the last three months have seen a partial recovery, with transaction costs returning to more normal levels and a tightening of credit spreads.

In the US, the Fed was also cutting interest rates in the second half of 2019, from a cycle high of 2.5% to 1.75% at the start of March 2020. Like Australia, they also rapidly cut to their lower bound of 0.25% as the scale of the crisis became clear, and restarted asset purchases (ie quantitative easing). Credit spreads widened at the fastest pace in history, initially driven by fundamental concerns around corporate defaults, and then exacerbated by leveraged investors being forced to liquidate portfolios at the worst time. Credit spreads on US investment grade bonds rose from a low of 0.9% in mid-February to a peak of 3.7% by late March, while high yield spreads peaked above 10%. In response, the Fed and the US government rapidly began rolling out support programs, firstly those that were developed during the GFC, and then entirely new ones. Broadly speaking these came in three flavours: expanded unemployment insurance and cash grants to individuals; lending programs for businesses to allow them to retain workers and survive the lockdown; and, support for markets through asset purchase programs and liquidity provisions. While previously the Fed had limited its asset purchases to Treasuries and Agency securities, this time it committed to buying corporate bonds as well, even including those recently downgraded below investment grade rating. The programs were effective in restoring market functioning and sparking a recovery in asset prices. New issuance of debt was particularly strong in April and May, as companies took advantage of the backstop provided by the Fed to raise record amounts of funding to see them through the crisis. However, in some cases the recovery has been patchy, with certain parts of the credit markets (especially those sectors most impacted by the virus) still showing significant signs of distress, while corporate defaults have already begun to rise.

Europe followed a broadly similar path to the US in support measures but without the unified response provided by a single government. Europe entered the crisis in a weaker position than the US, with cash interest rates still firmly in negative territory, and high debt levels in the peripheral countries. Several long-standing fault lines were highlighted again, most notably the weakness of Italy, as reflected in a rapidly widening spread between the yield of Italian government bonds relative to Germany. Without the room to cut interest rates further, the ECB focussed its response on asset purchasing programs, as well as relaxing bank regulations to allow lending to companies and individuals. Again, markets recovered in the final two months of the financial year, helped by individual country responses as well as the prospect of further support for weaker member countries to be provided by wealthier members.

In terms of index performance, global government bonds delivered 5.3%, with investment grade corporate bonds higher at 5.6% over the year in Australian dollar (hedged) terms. Australian bonds (4.2%) slightly underperformed global bonds (5.2%). High yield bonds suffered a 15% drawdown in March, but recovered to deliver -3.6% (hedged) for the year to 30 June, in line with floating rate bank loans (-3.6%). Australian inflation-linked bonds returned 1.7%, underperforming nominal bonds as inflation expectations collapsed due to the crisis.

Global share markets climbed the ‘wall of worry’

For the year to 30 June, global shares returned 0.8% on an Australian dollar hedged basis. There was a higher 4.1% return for global shares that were unhedged given the weakness of the Australian dollar against some currencies.

Share investors had to endure extraordinary market gyrations this financial year. Most developed markets recorded large double digit returns in the 2019 calendar year. For instance, the US S&P500 Index returned 30.7% (in local currency terms) in 2019 while Australia’s ASX200 Total Return Index was up by 23.4%. Markets extended their positive trajectory into February with both the US and Australian markets reaching new all-time highs.

These gains implied a degree of complacency by markets towards the potential social and economic threats posed by COVID-19 and it became clear very quickly that COVID-19 was not just China’s problem. The rapid increase in the number of infection cases beyond China became evident late in February. The acceleration in cases in Europe and New York and the declaration by the WHO characterising COVID-19 as a global pandemic resulted in sharp and substantial falls by share markets in March. The S&P500 Index fell by 9.5% on 12 March, its largest one day fall since the October 1987 crash. March quarter returns were deep in negative territory with the S&P500 Index down by 19.7% and the German and Japanese share markets returning -25% and -19.2% respectively. Australia’s ASX200 Total Return Index fell -23.1% and the UK’s FT100 Index returned -23.8%.

However, global share markets in the June quarter staged an astonishing recovery. This was based on many economies moving towards a relaxation of social distancing measures, raising expectations (probably seriously misplaced) that the economic dislocation will be temporary and a ‘V’ shaped recovery will eventuate. In the June quarter, the US S&P500 Index rebounded by 20.4%, pushing its one-year return (6.9%) back into positive territory. In Europe, Germany’s DAX increased by 23.9% and the French CAC Index gained 13.5% though their one-year returns were still marginally negative at -0.7% and -9.2% respectively. In Asia, Japan’s Nikkei Index June quarter return was 18.0%, bringing its return for the year to 7.0%. China took early steps to reopen its economy and while the 2.5% rise by the MSCI China Index in the June quarter looked comparatively modest, its 15.3% rise over the year was certainly superior to most peer markets.

Our share market also recovered some of the lost ground

Australian shares returned -7.7% in the year to 30 June after rising 11.5% in the previous financial year. Market conditions were volatile through the first half of the financial year due to a lacklustre profit reporting period in August/September plus continuing concerns about the US-China trade dispute. After a good start to the new calendar year with a new all-time high recorded in February, the onset of COVID-19 and a dramatic drop in economic activity caused by the measures implemented to contain its spread resulted in our market falling -20.7% in March.

The speed and magnitude of the economic decline that occurred was alarming and distressing. Some industries (travel, gaming, hospitality) effectively shut down overnight, while companies operating in sectors normally considered to have defensive characteristics experienced a sudden fall in demand for their products. Because of the economic decline and precarious outlook, a significant number of companies withdrew their earnings guidance for fear of misleading investors. Many companies chose to preserve capital by cutting dividends, deferring them or cancelling them altogether while some initiated capital raisings to underpin their balance sheet and position for the eventual recovery.

Industry sector returns varied with some managing to record gains for the year. The best performer was Health Care (27.4%) due to the perceived earnings resilience of companies like CSL in the sector, followed by Information Technology (+19.4%). Consumer Staples (+12.7%) also did well as supermarket operators Woolworths, Coles Group and Metcash experienced strong sales growth in the second half of the year when households stock-piled food and other essentials. Some stocks within Consumer Discretionary (+2.8%) also benefitted from consumer behaviour trends in response to the COVID-19 outbreak. Wesfarmers, JB Hi-Fi and Harvey Norman experienced significant demand growth as people spending more time from home undertook maintenance and put in place work-from-home office infrastructure. However, the experience elsewhere in the retail sector was less favourable as households observed restricted community movement measures and curtailed spending on non-essentials.

Resource based sectors experienced mixed fortunes. Energy was our market's worst sector performer, falling -28.7%. The price for Brent crude fell 38.2% over the year due to both adverse supply and demand influences. The closure of businesses worldwide, severely curtailed air travel and fewer cars on roads as people self-isolated, led to a collapse in demand for crude oil and petroleum products worldwide. Supply side issues including the surge in US shale oil production and bloated inventories were exacerbated by the initial failure of OPEC and Russia to agree on cuts to production.

The Financials ex-AREIT index returned -21.4%, underperforming the market's return by a significant margin. This was a very challenging year for the major banks (and AMP) following the conclusion of the Banking, Superannuation and Financial Services Royal Commission early in 2019. The weaker Australian economy, substantial remediation and compliance costs and the downturn in the housing sector led to fears of lower earnings and dividend cuts. These concerns were realised in the second half of the financial year as the economic decline caused by COVID-19 resulted in substantially lower bank profitability, forcing ANZ and Westpac to defer a decision on the payment of an interim dividend and National Australia Bank to cut its interim dividend by 64% compared to the previous year's.

However, despite the seriousness of the economic decline caused by COVID-19, the market gained 16.5% in the June quarter, offsetting some of the March quarter loss. The market's recovery was due in part to the successful containment of the virus in most Australian states and the progressive easing of restrictions which enabled some parts of the economy to reopen. The substantial stimulus measures provided by the Federal and state governments plus the measures initiated by the RBA led to expectations that the economic decline may not be as deep or long-lasting as originally feared. However, the recovery was not sufficient to push the market's financial year return into positive territory.

Signs of recovery emerged late in the year – false hope?

Encouraging signs of a resumption of economic activity emerged late in the financial year as many economies began to ease social mobility and distancing measures, allowing some industries and businesses to reopen. A marked improvement in surveys of global manufacturing activity suggest the deep economic downturn may be ending. The June Purchasing Managers Indexes which survey business conditions, employment, prices and new orders were markedly higher for the US and Europe. Promising economic signals in the US included the 18% surge in retail sales in May after falling by 15% in April. US labour market conditions improved with the unemployment rate falling to 11.1% in June after reaching a high of 14.7% in April. In China, industrial production recorded a 4.4% annual rise in May. While Chinese retail sales remain in negative territory with a -2.8% annual decline in May, it is vastly better than the -20% declines recorded in January and February.

Early signs of a turnaround have also occurred in Australia as success in containing the virus and the relaxation of social restrictions have enabled some sectors of the economy to restart. Retail turnover increased by 16.3% in May, the largest monthly rise in the thirty-eight years' history of the Retail Trade survey, which follows the largest ever fall of 17.7% in April. Surveys of consumer sentiment and business confidence also rebounded. The RBA commented that the downturn may not be as severe as was originally anticipated in March and April

However, there are still considerable risks. In parts of the world, COVID-19 infections either continue to rise or have reaccelerated. In the US, COVID-19 is spreading at an alarming rate and is forcing some states to reimpose restrictions. This may jeopardize recovery in the US and require another bout of fiscal stimulus. The infection rate in South America and India continues to accelerate, suggesting the pandemic is intensifying on a global scale. In Australia, an acceleration in locally transmitted infections in Victoria is a reminder that the outlook remains contingent on containing the virus. Until a widely accessible and affordable vaccine is available globally, economic activity and financial market returns will remain vulnerable to COVID-19.

MLC portfolios remain defensively positioned while looking for attractive risk-reward opportunities

Leading up to the crisis created by COVID-19, risk management had been our priority in the management of the MLC multi-asset portfolios – the MLC Inflation Plus, MLC Horizon, and MLC Index Plus portfolios. They had been defensively positioned for some time as the potential reward for taking risk looked unattractive to us. Share market valuations in particular looked stretched, as did parts of the fixed income universe. Prior to the emergence of COVID-19, this defensive positioning presented challenges as most asset classes had been providing high returns.

The MLC Horizon portfolios gained a great degree of defensiveness when markets fell, through their allocation to the MLC Inflation Plus portfolios. The MLC Inflation Plus portfolios performed exceptionally well in the market decline this year due to their elevated holdings of cash, a low exposure to Australian shares, derivatives-based portfolio protection, unhedged global shares and a range of alternative managers and strategies. The MLC Index Plus portfolios benefited from their investment in the Real Return strategy (a scaled down version of Inflation Plus) and actively managed fixed income.

Looking ahead, we think the recent complacency of markets towards the ongoing presence and spread of the virus and the economic dislocation it is causing is concerning. Economic uncertainty will persist until either the virus is contained or a widely available and affordable vaccine is developed. The dispersion of market earnings forecasts is very wide and share valuations look as stretched as they were going into this crisis. How the pandemic could evolve from here dominates our investment scenarios thinking.

Our portfolio response has been part defensive and part offensive. We increased our exposure to hedged global shares when the Australian dollar fell during the crisis and market correction. The portfolios profited from this decision and now the Australian dollar has risen back to pre-COVID-19 levels, we've again reduced the hedging. We continue to employ alternative investments such as risk-controlled real return strategies to help preserve investors' capital in a very uncertain future. Innovative derivatives-based strategies have been implemented through our in-house derivatives team to gain share market exposure but with downside protection to cushion against possible further market falls. The allocation to investment grade credit (bonds issued by companies with strong finances) within our multi-assets portfolios' actively managed fixed income strategies has been increased.

How does MLC's investment process deal with an uncertain future?

Rather than basing portfolio decisions on a single future, we attempt to understand the many ways in which the future may unfold and the trade-offs between risk and return that each future may entail. A continuation of the current environment is only one of many scenarios that could unfold. By understanding how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad, we can adjust their asset mix to manage possible risks and take advantage of potential return opportunities. This careful analysis means our portfolios are prepared for the range of outcomes that may occur, including having adequate diversification, being risk-aware and being positioned for a range of future market environments.