

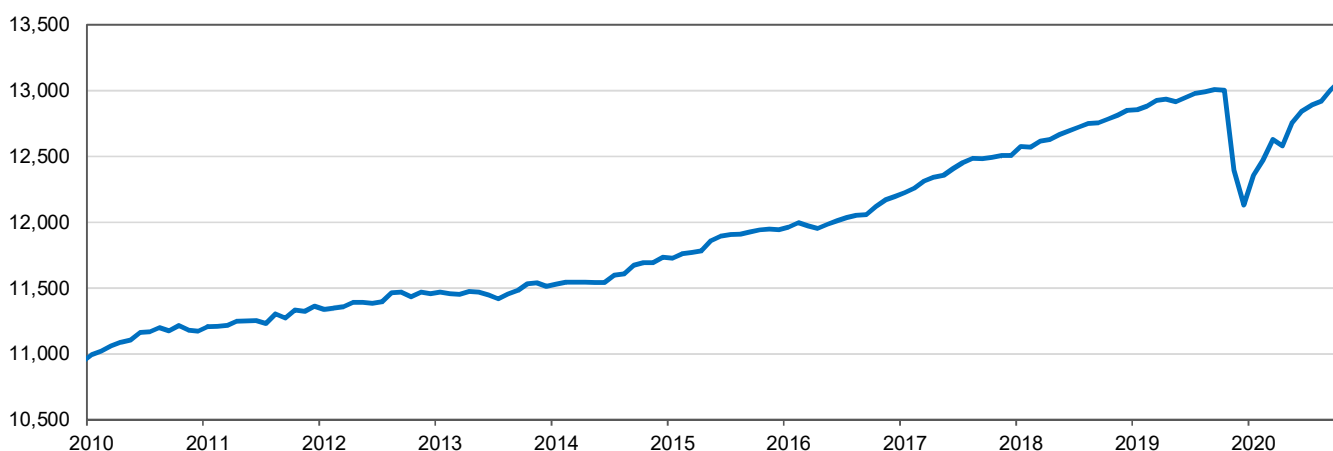
Unexpected Outcomes From COVID-19

Twelve months ago, COVID-19 was wreaking havoc on people's lives, financial markets and the economy. Significant uncertainty weighed on markets, with key questions around the probability of a vaccine, the impact on the economy and the size and duration of the global downturn, the timeline of a return to "normality" and the level and effect of government stimulus yet to be answered. While the health impact of COVID-19 is still severe in various parts of the world, developments in the interim, particularly in relation to the Australian economy, have positively surprised many market commentators and led to a number of unexpected outcomes. In this, the 100th Auscap newsletter, we discuss these developments and how they are shaping our thinking about the outlook for the domestic economy. We then take a closer look at one of the Fund's holdings, furniture retailer Nick Scali, as this quarter's "company in focus".

1. Employment rebound

Ahead of the October 2020 budget, Treasurer Josh Frydenberg pointed to a need for continued fiscal stimulus until the Australian unemployment rate was comfortably below 6%. Six months later, Australia's unemployment rate has already dropped through this level, with March unemployment down to 5.6% and more Australians currently in work than pre-COVID-19.

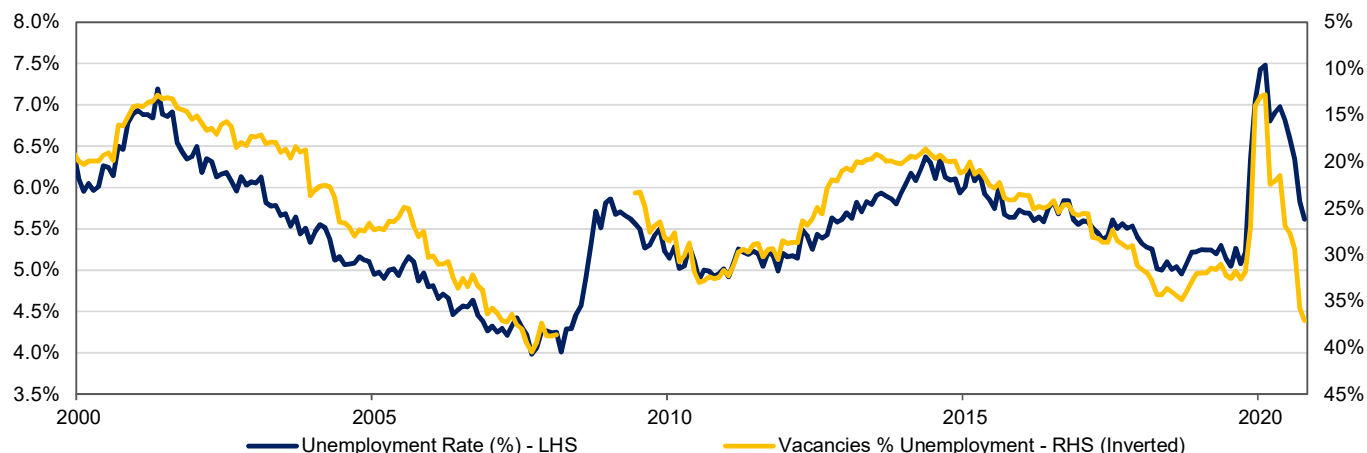
Australian Employed Persons ('000s)



Source: ABS, Auscap

This has been accompanied by an all-time high in Australian job vacancies. As per the below chart, job vacancies are highly correlated with the unemployment rate, with the latest data points suggesting the jobs recovery is likely to continue.

Unemployment and Job Vacancies Percentage of Unemployment

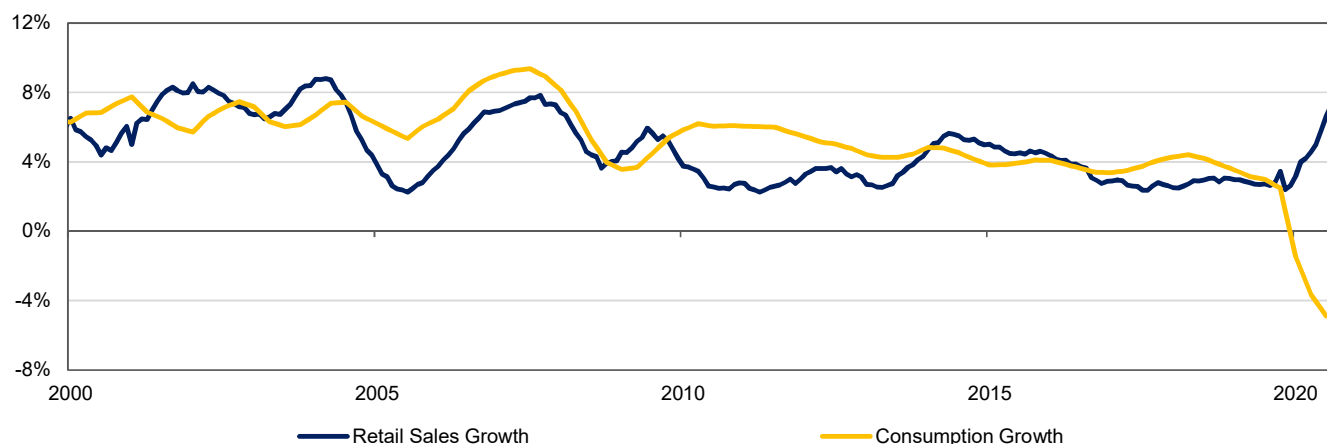


Source: ABS, Auscap

2. A savings boom, not a spending boom

A widely held view is that domestic consumption experienced unprecedented strength in 2020, underpinned by government stimulus and a reallocation of international travel spending. The data suggests that these factors supported retail spending over 2020, however whilst consumption growth in certain categories was strong, total consumption declined the most on record. In fact it is the only period that has seen an absolute decline in year on year aggregate consumption since the Australian Bureau of Statistics (ABS) starting publishing data over 60 years ago.

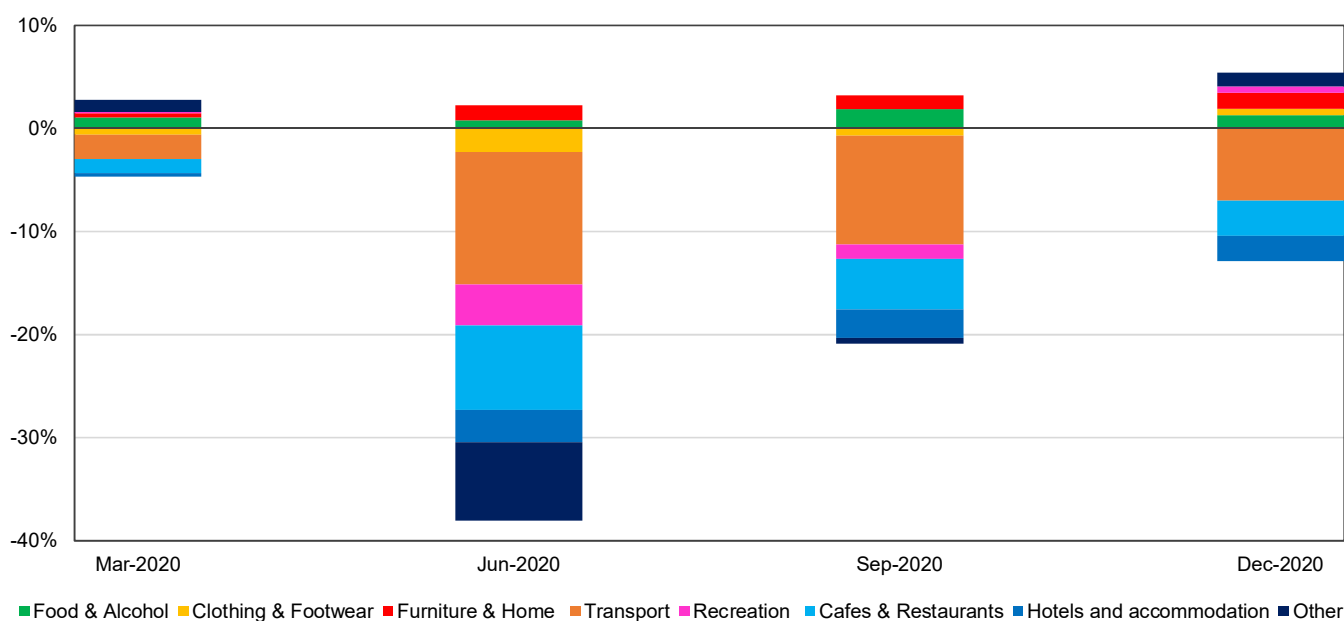
Retail Sales & Consumption Growth



Source: ABS, Auscap

This overall decline was led by huge falls in consumer spending on transportation, cafes, restaurants, hotels and accommodation.

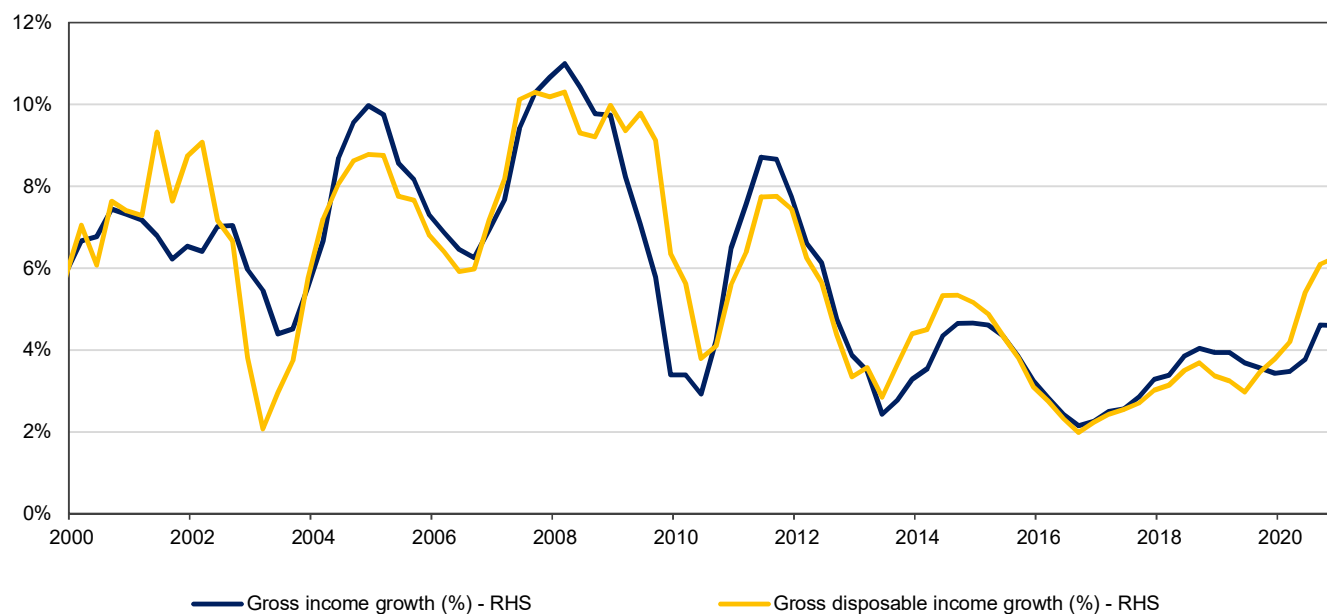
Australian Household Consumption - YoY Change



Source: ABS, Auscap

This reduction in consumption was combined with large increases in household incomes, largely due to government initiatives such as JobKeeper and JobSeeker. Disposable income experienced the fastest growth since 2011.

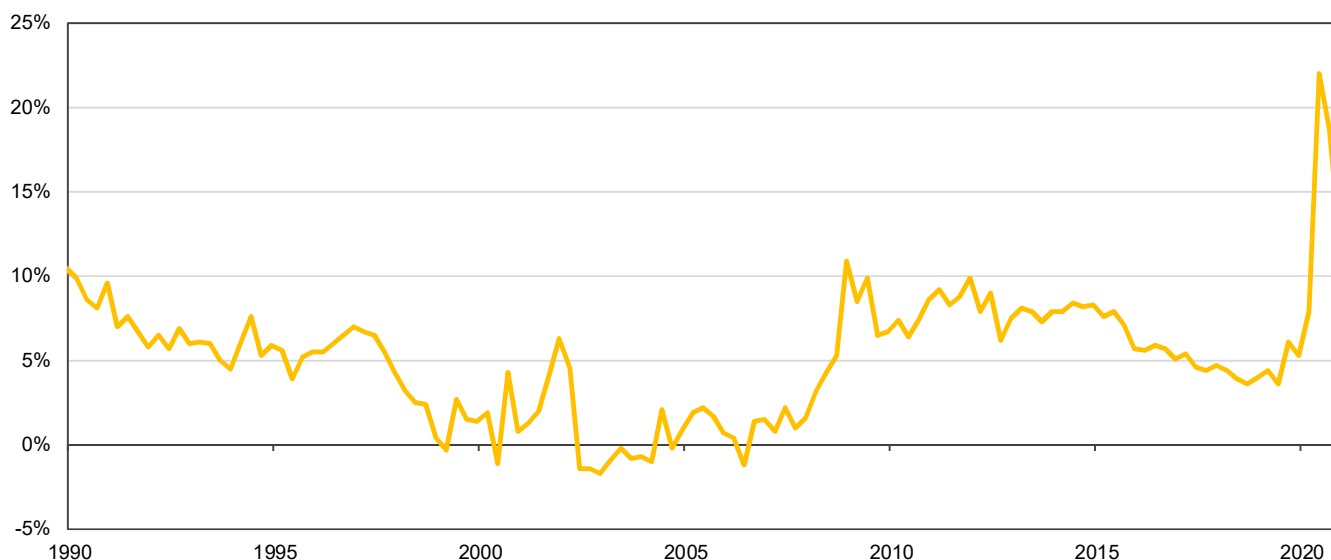
Gross Income Trends



Source: ABS, Auscap

The result was an elevated household savings ratio that peaked at 22%, the highest level since data collection began in 1959, and this is without incorporating the early access to superannuation as a savings measure.

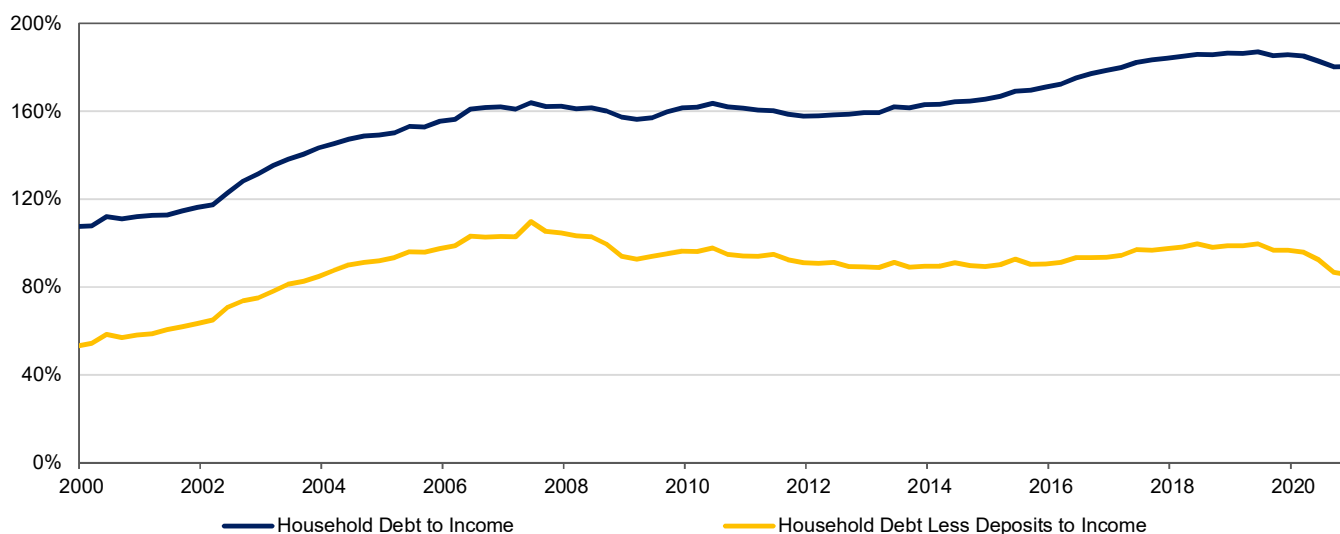
Household Savings Ratio



Source: ABS, RBA, Auscap

Instead of being a “consumption boom”, 2020 was representative of a “savings boom”, resulting in significant balance sheet repair and potential pent-up demand. Household debt net of deposits, an estimate of net household debt, relative to income has subsequently dropped back to late 2003 levels, at which time the Reserve Bank of Australia (RBA) cash rate was 5.25%.

Household Debt

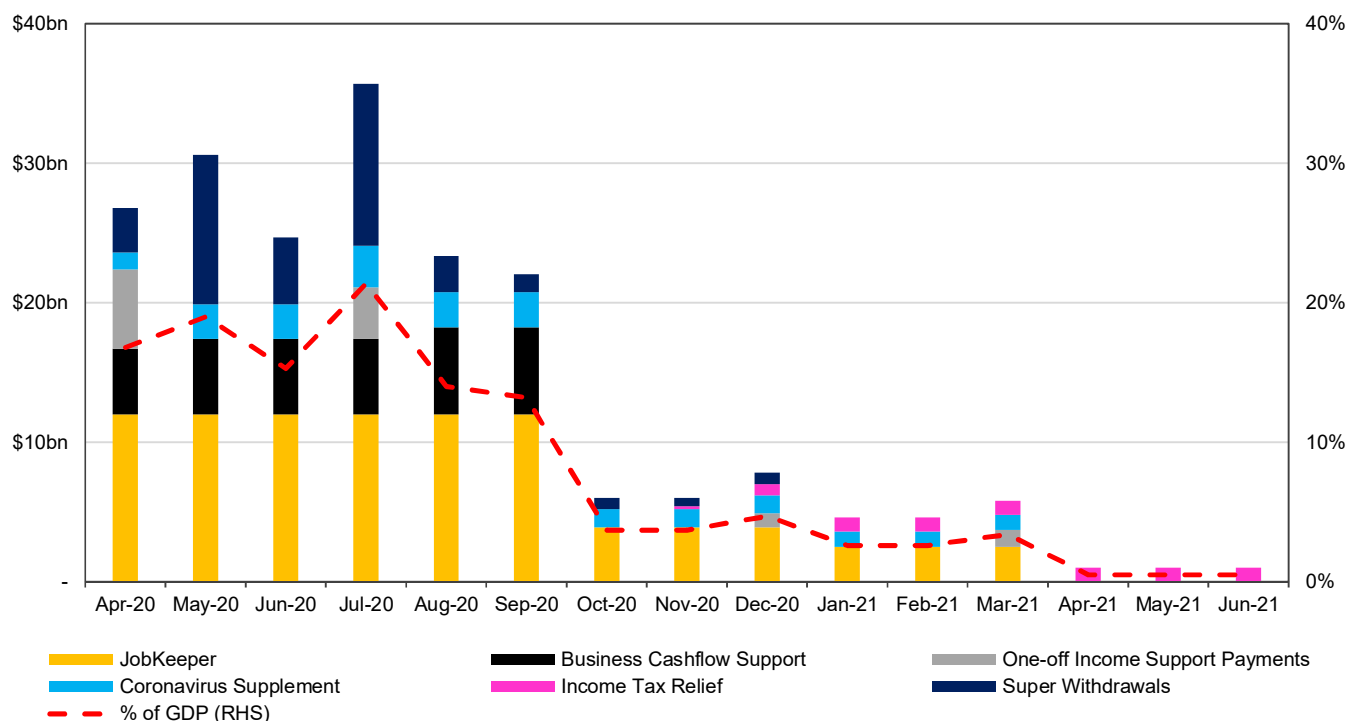


Source: ABS, RBA, Auscap

3. The “Fiscal Cliff” has been navigated

While the above data points are clearly positive, domestic household balance sheet repair was aided by extraordinary levels of support from government, the RBA and the Australian banking system. However, much of this support has already been removed. Macquarie estimates that federal fiscal support peaked at over 20% of GDP in July 2020. As of April 2021, this has dropped to less than 1% of GDP, with the biggest step change occurring between September and October 2020.

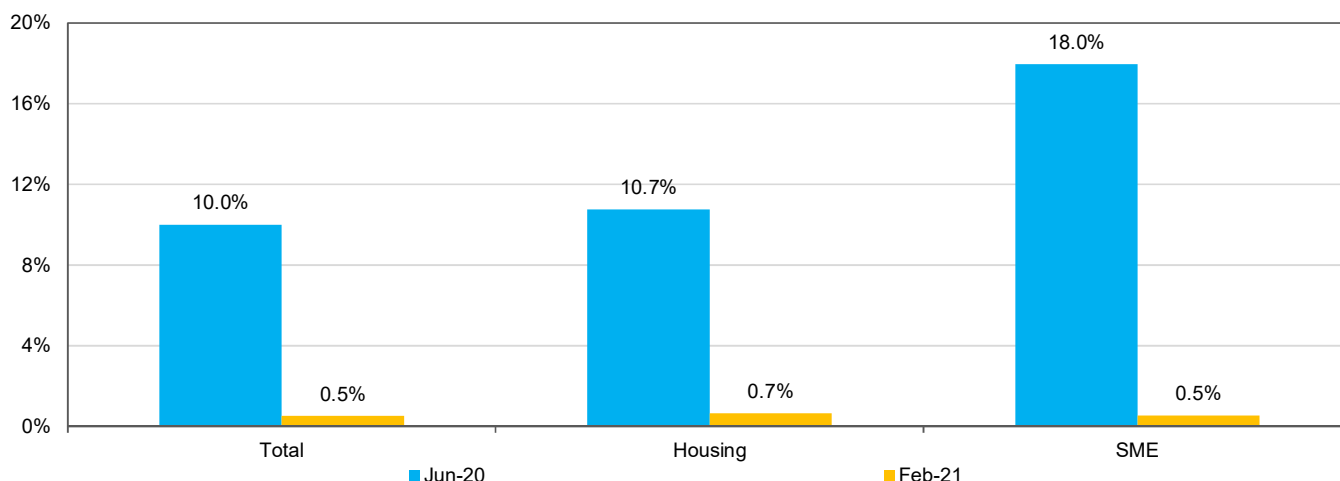
Federal Fiscal Support Measures & Super Withdrawals



Source: Macquarie, Auscap

Similarly, loan deferrals provided by banks have reduced from 10% of Australian loans in June 2020 to 0.5% in February 2021, with the largest drop occurring after the initial blanket six-month loan deferrals were wound back at the end of September 2020. Given the RBA has repeatedly committed to keeping the cash rate unchanged until 2024, the Australian economy appears to have successfully weaned itself off the major stimulus initiatives that were intended to be temporary.

Loan Deferrals % of Loan Book

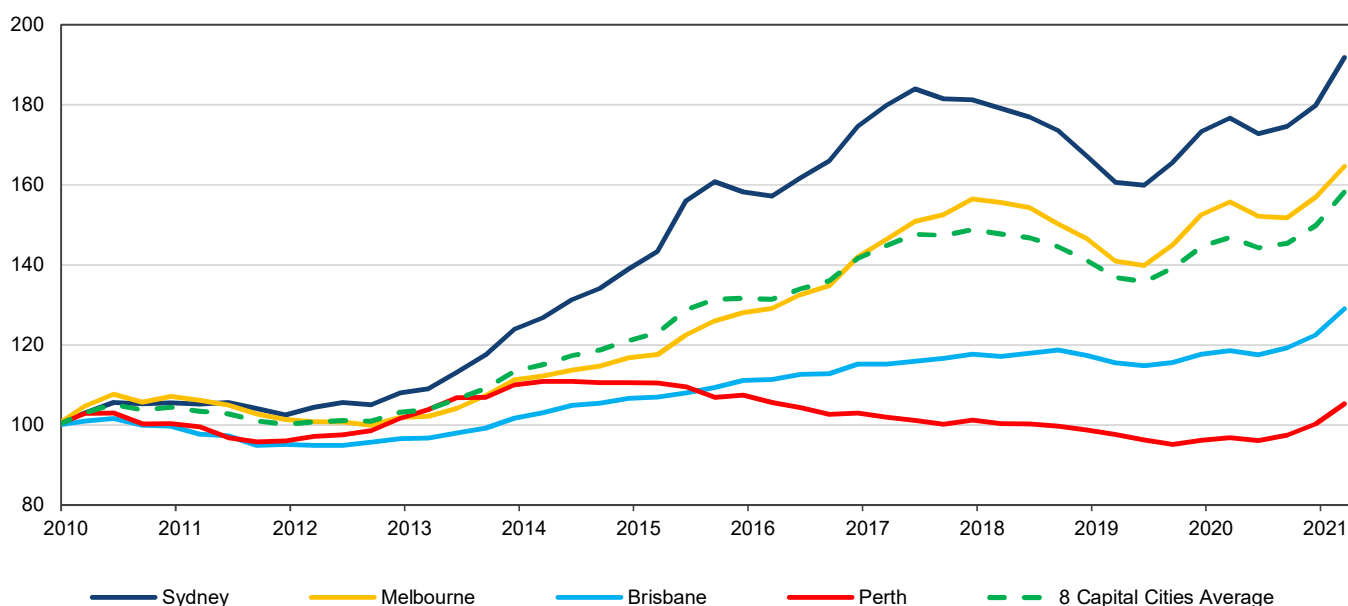


Source: APRA, Auscap

4. Housing prices making new highs

Trends in the Australian housing market are positive, with national property prices now back above pre-COVID levels. It is worth noting the multi-year softening of the housing market in the years prior to COVID-19.

Corelogic Property Index (rebased as at Dec-2009)



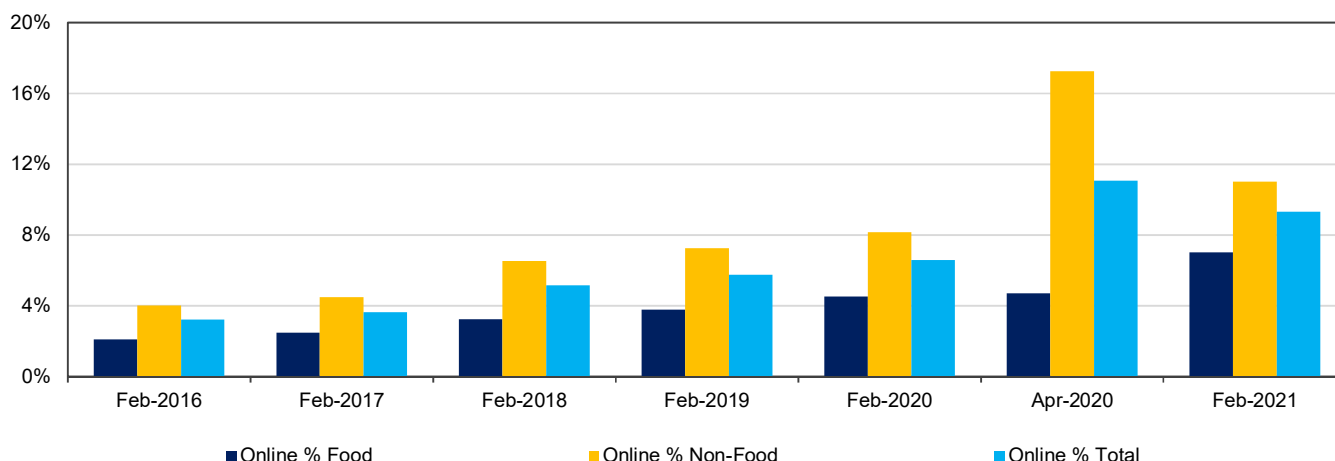
Source: Corelogic, Auscap

In addition, COVID-19 has led to record housing stimulus, record low interest rates and the aforementioned boost to consumer balance sheets. Given this environment, in the absence of another external shock, continued housing market strength might be anticipated.

5. Shopping habits have changed – but by how much?

With lockdowns sweeping the world in the early stages of COVID-19, it was no surprise to see e-commerce penetration across the world accelerate. Australian online retail penetration surged from 6.6% in February 2020 to 11.1% by April 2020. Given e-commerce penetration in Australia has lagged most other developed markets, Australian e-commerce is likely to continue to grow. However, it is interesting to note that e-commerce penetration appears to have reverted to close to its longer-term trend in recent months.

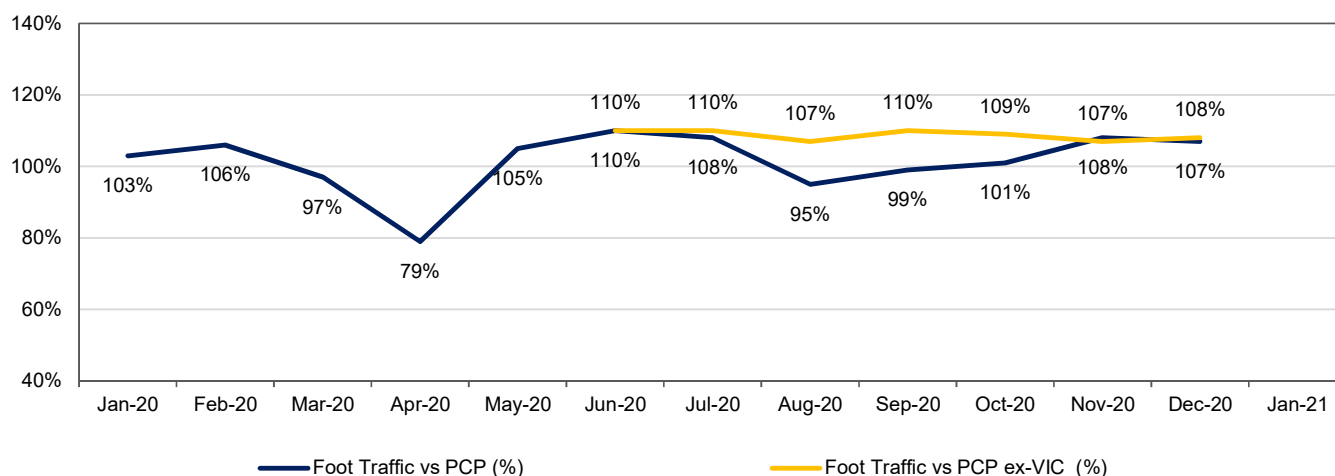
Online Retail Penetration (%)



Source: ABS, Auscap

Foot traffic in major indoor shopping centres proved heavily sensitive to spikes in COVID cases, driven by a combination of government restrictions and consumer unease. However, Australian foot traffic has since been recovering. Foot traffic at the shopping malls owned by listed company Vicinity had recovered to 93.4% by January 2021 excluding its assets in Victoria, the state which had experienced the most severe lockdowns, and Central Business Districts (CBD), which have been slow to see a recovery in office occupancy. By contrast, Aventus Group, an owner of homemaker centres and a Fund holding, has experienced strong visitation since June 2020, with like-for-like foot traffic well above the prior year. Multiple major retailers and landlords have noted that the conversion of foot traffic into sales has increased post-COVID. This data suggests that whilst CBDs continue to suffer, COVID-19's likely ongoing impact to traditional bricks and mortar retail appears to be less than feared.

Aventus Homemaker Centre Foot Traffic vs PCP (%)

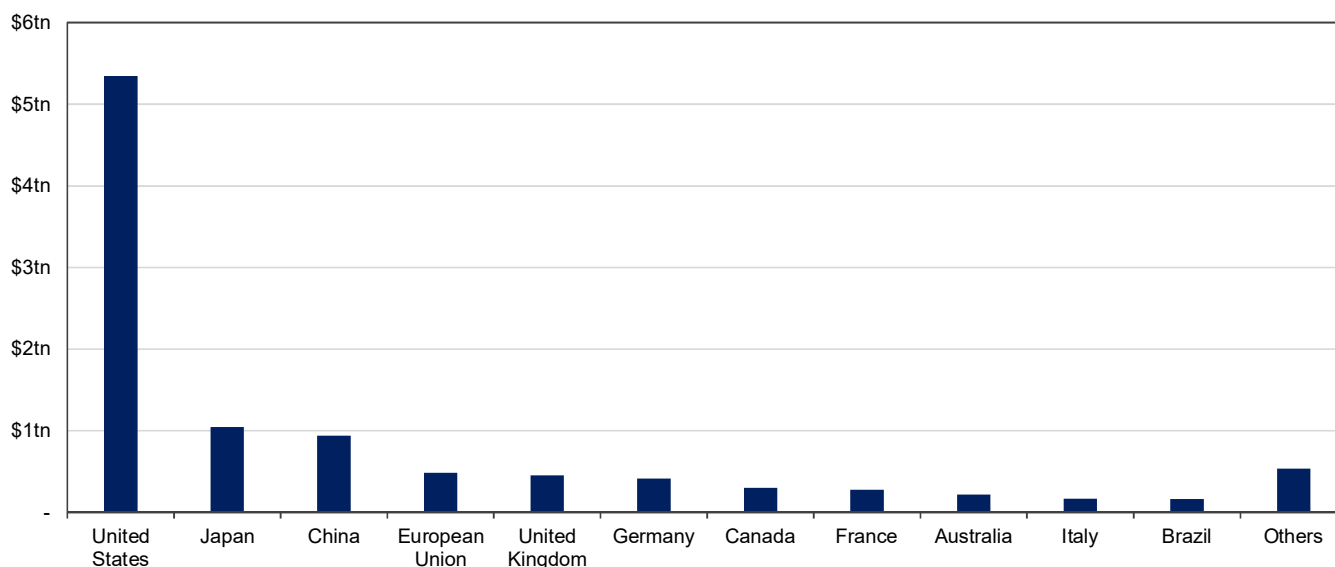


Source: Company disclosures, Auscap

6. Investment demand is lifting commodity prices

Global fiscal stimulus in relation to COVID-19 has been immense, with the G20 spending approximately US\$10 trillion.

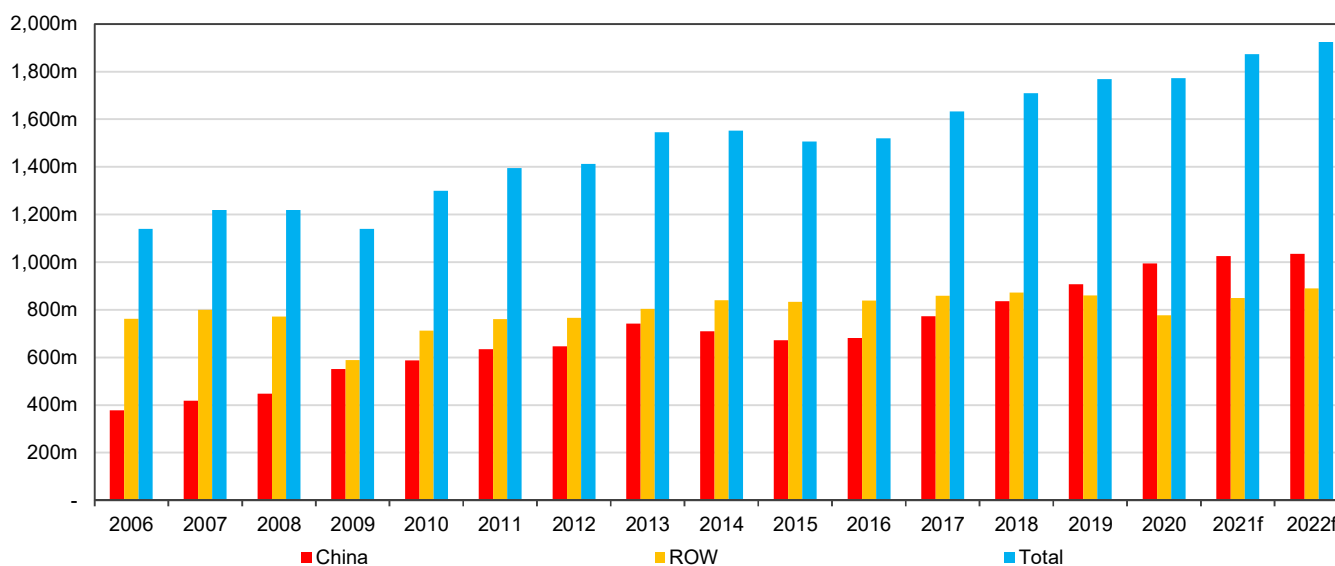
G20 COVID-19 Direct Additional Spending or Forgone Revenue (US\$tn)



Source: IMF, Auscap

We expect this level of stimulus to lead to a pick-up in private and public investment globally. Such investment is likely to lead to an increase in demand for steel and various commodities. The World Steel Association forecasts that global steel demand will reach record levels over the next two years even without a meaningful increase in steel demand on pre-COVID levels for the world excluding China. Given the investment in residential property and infrastructure we anticipate as a result of government stimulus, record low interest rates and global household balance sheet repair, the demand outlook for iron ore appears favourable. Yet iron ore supply looks constrained, with limited near-term scalable substitutes and its production dominated by just four companies in Rio, BHP, Fortescue and Vale. Given this backdrop, we expect the outlook for iron ore to remain strong. Iron ore is Australia's largest export by value.

Steel Use (Tonnes)

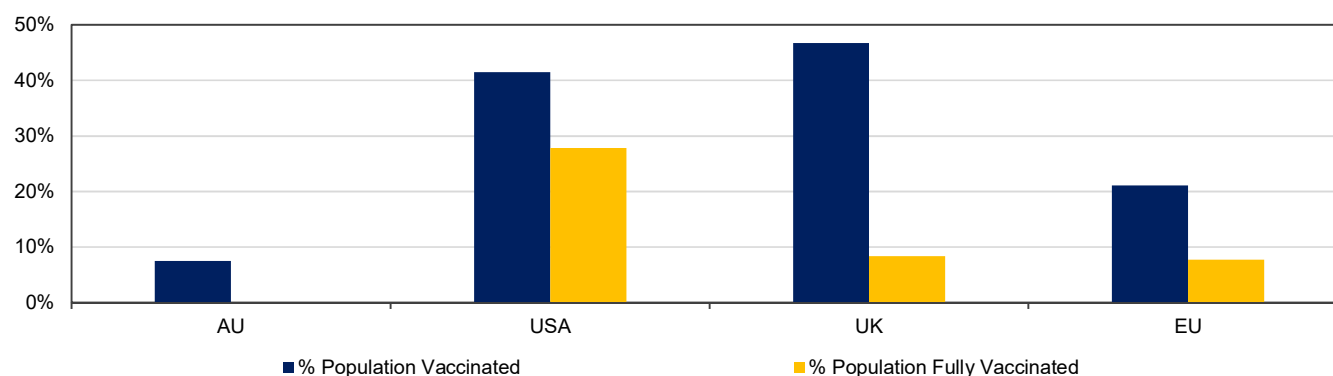


Source: World Steel Association, Auscap

7. The impact of closed borders has been less than expected

Australia has had considerable success in controlling COVID-19, partly due to the closure of borders. By contrast, the vaccine rollout has been slow to this point. This month, Prime Minister Scott Morrison admitted that “*while we would like to see [first] doses completed before the end of the year, it is not possible to set such targets given the many uncertainties involved.*” At present less than 8% of Australians have received their first dose of a vaccine.

Vaccinations



Source: Our World in Data, Auscap

This raises the obvious question of whether closed borders are, in aggregate, hurting the economy. While undoubtedly negative for particular businesses, the impact on the overall economy is surprisingly small. In 2019, Australian GDP received a \$39.8bn contribution from net education-related travel exports. This was offset by a drag from travel related net imports, with Australians spending \$26bn more overseas than international tourists spent in Australia. Given international travel has fallen considerably further than education related-travel, the direct impact of closed borders was a net *benefit* to Australia. In addition, the ABS estimates that three quarters of domestic Australian tourism spend is consistently by Australians. So while acknowledging the lower near term net immigration, the short term impact of closed borders appears manageable.

Net travel exports / (imports)	CY19	CY20	Change
Travel ex-education	(\$25.9bn)	(\$3.8bn)	+\$22.0bn
Education travel	\$39.8bn	\$31.5bn	(\$8.3bn)
Total	\$14.0bn	\$27.7bn	+\$13.7bn

Source: ABS, Auscap

In contrast to the dire health and economic forecasts as the COVID-19 threat emerged, the current outlook for the domestic economy, assuming the health threat remains well managed, appears remarkably robust. Household and corporate balance sheets have experienced significant repair, hence retail spending appears likely to remain elevated. Job vacancies are pointing to continuing declines in the unemployment rate. Government debt remains manageable with coming budgets expected to be stimulatory. Interest rates are at record lows, seeing an improvement in property prices, consumer confidence and business conditions. Business forward orders recently reached multi-decade highs. Australia's terms of trade are extremely beneficial due to elevated commodity prices that show no signs of abating, and closed borders are not having the negative impact on the economy in the short term that many envisaged. This would appear to be a powerful cocktail of economic drivers for strong growth over coming years. In this context we remain enthusiastic about the Fund's portfolio of market leading businesses. One example of such a business is Nick Scali, which we discuss below.