CPG Research & Advisory Pty Ltd

ECONOMIC & MARKET COMMENTARY
SEPTEMBER 2020

US Election, and Property

With President Trump and several others hospitalised with COVID-19, it is timely to consider constitutional hypotheticals. We also highlight a significant fall in what was once the bluest of blue-chip property companies.

With the election a month away, and the President hospitalised with COVID-19, we consider some complications.

Election

In the Westminster system, **each electorate chooses a Member** of the lower house. **The party able to command a majority**, or able to lead a coalition able to demonstrate confidence of the House, **chooses a Prime Minister**. This is not always easy. But the principle is clear: **The lower house chooses the PM to lead a government**, usually with non-executive head of state wielding "reserve powers" to intervene. (Rarely, for example in South Africa, there is no separate president and an elected Head of Government is Head of State.)

If the PM is no longer able to command the confidence of the House (death, incapacity, retirement, scandal, or simply a party's change of heart) **a new PM is appointed**. Australia in 1975 showed that **Supply** – the ability to pass spending bills – can be as important a constraint as confidence of the House.

In US-style presidential systems, the elected President runs the executive branch ("the Administration"), outside the legislative / parliamentary branch (Congress). The US has a **complex system to both appoint the President**, and then to **exercise the equivalent of reserve powers**.

Just as the UK House of Commons elects the PM, **each US state elects Electors to the Electoral College** – it is they who constitutionally "elect" the President (and VP). It is too late to change the ballot if Pres Trump withdrew from the election. **In theory, Congress could legislate an election delay** but in practice it would seem in neither party's interest to push for this.

A state's electors would vote for the running mate, plus a **replacement VP nominated** by the party. While it would be possible for the part to nominate a completely new candidate, this is risky.

"Faithless elector" laws do not apply if the elected candidate is no longer available – the Supreme Court has already confirmed this. A nominee other than the running mate risks losing an election already won.

Tied Election

269-269 electors is unlikely but a number of plausible combinations from swing states exist.

A **tie-breaking vote** is cast by the (incoming) House, with the (incoming) Senate electing the VP. There lies plenty of scope for a constitutional crisis:

- **Different party control** could see a losing candidate elected VP
- The 12th Amendment's language does not have a mechanism for the (outgoing) VP to **break a 50/50 tie**, implying 51 are needed.
- In any case, **there may be no outgoing VP** in this scenario.

25th Amendment - Succession

If a President is unable or unwilling to continue serving (permanently, or temporarily), the Vice President steps in. The 25th Amendment provides for voluntary assignment of the powers, typically used during surgery, or forcibly:

> *Section 4. Whenever the **Vice President <u>and</u> a majority** of…the principal officers of the executive departments…transmit… their written declaration that the President is unable to discharge the powers and duties of his office , the Vice President shall immediately assume the powers and duties of the office as Acting President.*

Consider the permutations of the line of succession:

- If the VP succeeds to the presidency, his nomination to the vacant VP role would require confirmation by <u>both</u> Houses. Would Speaker Pelosi (D) really allow the ratification of (say) Sen Ted Cruz as VP or force a vacancy?
- With no VP in place, what would happen if Pres Pence was himself needing minor surgery?
- As well as leading the majority of the House and potentially able to block confirmation, Pelosi is also 2nd in succession. In a few hours as Acting President, she could presumably spend the entire time signing any pre-prepared Executive Orders (including those repealing all others since 2017).
- If Cabinet found such action unacceptable, could they invoke the 25th Amendment to remove her (next in line is a Republican, Senate president *pro tem* Grassley) with the VP role vacant? Section 4 specifies action by <u>both</u> Cabinet and the VP.

And Another Thing

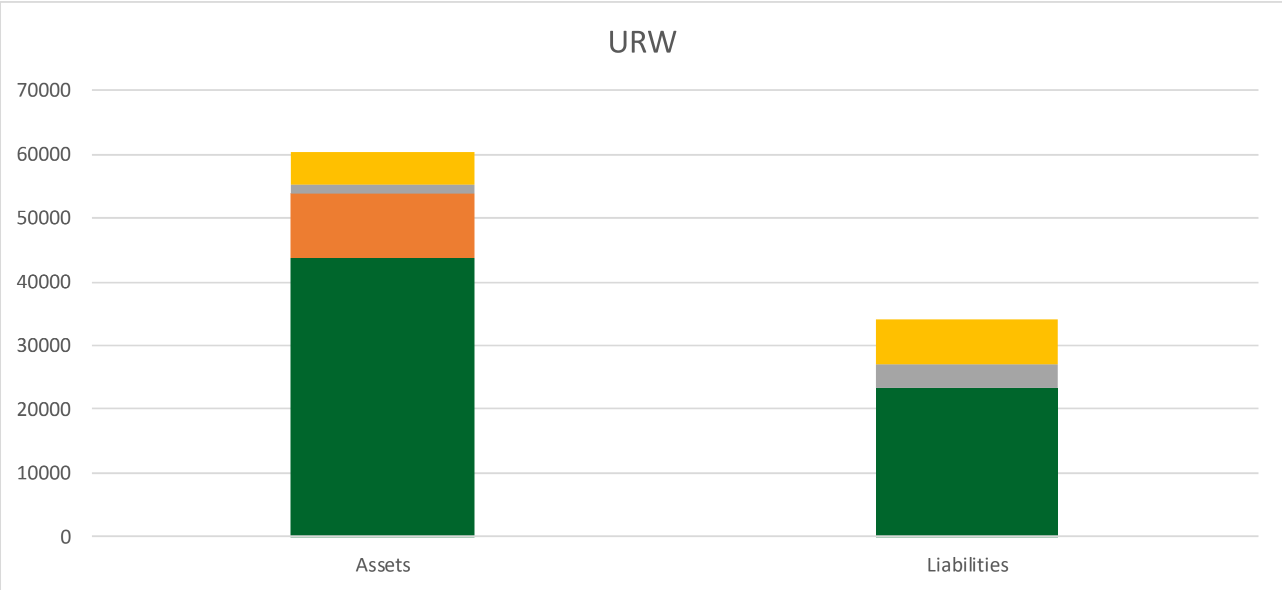
In 2008, the listed property index fell -55%, much worse than the ASX300's -42% - a calamitous result for what was traditionally considered a defensive income sector suited for retirees.

Incredibly, within 10 weeks even <u>that</u> price had fallen ***another 40%***. With no new information, the market was **crushed by dilution** as Board conducted recapitalisation at any price. Better to raise equity at 20c in the dollar and dilute shareholders than to preside over a bankruptcy.

But 2009 closed flat, with a **65% rebound**. And **priced doubled again** by the recent cyclical peak. The recapitalised survivors turned out to be **a spectacular buying opportunity** in 2008. Similarities include:

- Likely 1:1 rights issue, producing horrendous dilution as the current share price is less than 20% of the EUR190 asset backing.
- The recapitalised entity to target a split-A rating (A1 at S&P), with debt below 40% of assets after new capital and asset sales
- Assets have already been substantially written down, although we expect a further substantial writedown in December

The market is currently pricing for almost 50% fall in gross assets – as always, **it is not the writedown but the dilution** that is so feared, as the company is forced to issue more and more new equity.



(The market value is <u>less</u> than the thin gold sliver at the top.)

Maybe we are near the cyclical low point, and as economies reopen or vaccines become more mainstream, retailing returns to a pre-COVID model.

Maybe, catastrophic additional falls will occur, effectively wiping out all equity and justifying the market's current negligible valuation on these assets.

<u>Either way, it is not rational to buy the same assets in unlisted form at stated values.</u>

Our research process places great importance on divergences. Either the listed market is over-reacting, and the cheaper way to access the property asset class, <u>or</u> valuers are greatly lagging reality and valuations have far further to fall.

<u>We recommend great scepticism of unlisted property in retail or other COVID-affected sectors. Look for deep revaluations, distressed purchase of new assets, or sectors benefitting from COVID-19.</u>

Leading Markets

The US S&P500, Dow Jones and NASDAQ fell -3.80%, -2.18% and -5.10% respectively, declining from record levels.

MSCI World ex-AUS fell -2.87% in local terms. Emerging Markets fell -1.65% in $US led by Europe and Latin America but Frontier Markets rose +0.74%.

US 10-year bonds firmed to 0.69% (-3bp) on lingering worries about the pandemic.

High yield was +39bp weaker at +541bp.

Other Highlights

COVID-19 deaths passed 1m, with alarming increases in areas like Spain. Talk turned to "COVID bubbles," enabling limited travel.

Q3 is expected to see record growth in USA and Europe although Q4's outlook is cloudier.

The Federal Reserve forecast record low rates to 2023 and capped its target rate to 0-0.25% until full employment and inflation averaging 2%.

Congress argued about stimulus measures, blocking state bailouts seen as favouring Democrat states.

US unemployment shrank to 8.4% (-1.8%) after +1.37m jobs in August. CPI rose to +1.3% YoY (from +1%) after a +0.4% month. Retail sales rose +0.6%.

US personal income fell -2.7% and consumer savings eased to 14.1%.

US building permits were -0.9% lower in August after a six-month high in July.

While the first election debate produced controversy, it provided little insight to policy platforms.

Eurozone unemployment reached 8.1%. YoY inflation remained negative (-0.2%). The ECB followed the US Fed's new "catch-up" approach to periods of low CPI.

Japanese unemployment edged up to a 3 year high of 3.0% in August. PM Suga replaced PM Abe in September, with no change to the policy direction.

FTSE will add Chinese bonds to their global indices in 2021, matching Bloomberg and JPMorgan. Meanwhile, USA banned a number of Chinese tech giants.

The EU plans to sue the UK for violating the Northern Ireland border agreement.

Domestic

The ASX200 lost -3.66%, dragged down by big banks and miners. Smallcaps fell -2.82%. The 10-year bond closed stronger at 0.84% (-15bp).

The RBA minutes discussed the continuing housing weakness and limited consumer recovery. Many improving statistics approximated a "50% rebound" pattern. The $A was seen as fair value against fundamentals, but a more stimulatory level may be preferred.

The RBA expanded its Term Financing Facility (at 0.25%) to 2% of bank assets – around $200bn. They debated other easing measures such as negative rates (as has the RBNZ). The 3-year bond target will shift to the 2024 bond.

The Federal Government will invest around $1.5bn into the manufacturing sector in a plan to boost local production and strengthen supply chains.

Retail sales closed -4% in August, mostly from Victoria. Private sector credit was unchanged in August. Housing credit rose +0.2% while both personal and business credit fell -1.1% and -0.4% respectively in August.

Building approvals fell -1.6% in August.

Unemployment fell to 6.8% (-0.7%) on +111k jobs in August. Participation rose to 64.8% (+0.1%); underemployment was flat at 11.2%. Hours works rose +1.6%.

Business confidence rose to -8 in August while consumer confidence surged +18% to 93.8. Manufacturing and Services PMIs both fell to 46.7 and 43.5 respectively, again impacted by Melbourne.

Australia's trade surplus slumped to +$4.6n from +$8.2bn as exports fell -4% while imports jumped +7%.

Commodities and Currency

WTI oil fell to $US38.37/bbl (-10.6%) on limited demand recovery. Gold closed lower at $1899/oz (-4.29%), hit by a rising $US. Iron ore closed -1.13% lower at $121.15.

Base metals fell: Nickel (-6.68%), Zinc (-4.61%), Tin (-1.90%), Copper (-1.75%) and Aluminium (-1.42%) were all lower.

The $A closed at a US71.08c (-3.35%) after a 12-month high the previous month.

KEY FINANCIAL MARKET DATA – AS AT 30TH SEPTEMBER 2020 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.01%	0.03%	0.09%	0.58%	1.16%	1.40%	1.63%

Key Rates	Sep-20	Aug-20	Jul-20
Australian Cash Rate	0.25%	0.25%	0.25%
90 day BBSW	0.09%	0.09%	0.10%
3 Yr Commonwealth Bonds	0.17%	0.28%	0.28%
10 Yr Commonwealth Bonds	0.84%	0.98%	0.82%
CDX North American 5 Yr CDS	59bp	65bp	69bp
iTraxx Europe 5 Yr CDS	59bp	54bp	60bp
iTraxx Australia 5 Yr CDS	76bp	64bp	76bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	0.69%	0.72%	0.55%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	-3.66%	-0.44%	15.97%	-10.21%	0.49%	4.80%	7.31%
S&P/ASX Small Ord Acc. Index	-2.82%	5.67%	30.93%	-3.33%	0.24%	6.53%	9.97%
S&P/ASX 200 A-REIT Acc. Index	-1.50%	6.96%	28.27%	-16.65%	-0.72%	3.72%	5.56%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	-3.80%	8.93%	31.31%	15.15%	9.57%	12.28%	14.15%
US: NASDAQ ($US)	-5.10%	11.24%	45.66%	40.96%	19.04%	21.05%	20.63%
MSCI World Acc. (Local Currency)	-2.89%	6.70%	26.40%	8.55%	5.69%	7.85%	10.32%
MSCI World Acc. (AUD)	-0.38%	3.67%	10.00%	3.89%	6.53%	11.04%	10.02%
FTSE 100 (£)	-1.54%	-4.02%	4.76%	-18.07%	-8.03%	-3.55%	3.38%
MSCI Emerging Markets ($US)	-1.60%	9.56%	29.37%	10.54%	4.07%	2.42%	8.97%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (Hgd AUD)	0.37%	0.68%	2.96%	3.47%	6.59%	4.66%	4.52%
AusBond Composite Bond Acc.	1.08%	1.02%	1.55%	3.21%	7.10%	5.96%	4.53%
ICE BoAML High Yield TR ($US)	0.98%	6.84%	2.34%	3.71%	5.13%	4.51%	6.28%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	August	12,583	July	12,461
Unemployment Rate	August	6.80%	July	7.50%
Participation Rate	August	64.80%	July	64.70%
Lending Finance				
Housing Finance	July	8.90%	June	6.20%
Personal Finance	July	6.90%	June	5.20%
Business Finance	July	-25.10%	June	57.30%
Other				
Balance on goods and services	August	2,643m	July	4,607m
Retail Sales	August	-4.00%	July	3.20%
Building Approvals	August	0.60%	July	6.30%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	-4.50%	-0.25%	19.95%	-15.14%	-3.89%	2.01%	5.53%
Australian Equity Small Cap	-1.37%	8.49%	37.35%	-0.84%	1.48%	6.37%	8.92%
Global Equity Large Cap	0.20%	2.96%	8.38%	1.78%	4.74%	8.78%	8.32%
Global Equity Small Cap	0.94%	3.97%	16.86%	-1.35%	-2.07%	3.43%	5.92%
Australian Fixed Income	1.06%	1.30%	2.44%	2.97%	6.54%	5.50%	4.06%
Global Fixed Income	0.28%	1.06%	4.19%	3.25%	6.22%	4.29%	3.90%
Australian Listed Property	-1.21%	6.80%	27.83%	-17.18%	-1.77%	2.36%	4.46%
Australian Cash	0.01%	0.05%	0.12%	0.46%	1.01%	1.21%	1.53%
Conservative[1]	-0.07%	0.80%	3.52%	-0.53%	2.64%	3.06%	2.97%
Moderate[2]	-0.29%	1.11%	5.09%	-0.93%	2.57%	3.11%	3.39%
Balanced[3]	-0.81%	1.40%	7.65%	-2.11%	2.07%	3.49%	4.50%
Growth[4]	-1.21%	1.71%	10.17%	-3.31%	1.48%	3.84%	5.11%
Aggressive[5]	-1.75%	2.11%	12.72%	-4.12%	0.90%	4.33%	6.05%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

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