Five questions for the Chief Investment Officer—February 2019

Video transcript

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Victoria Place (VP): Welcome to *Five questions for the CIO*. My name is Victoria Place and I'm an analyst, working with our Chief Investment Officer, John Pearce, in the Investment team.

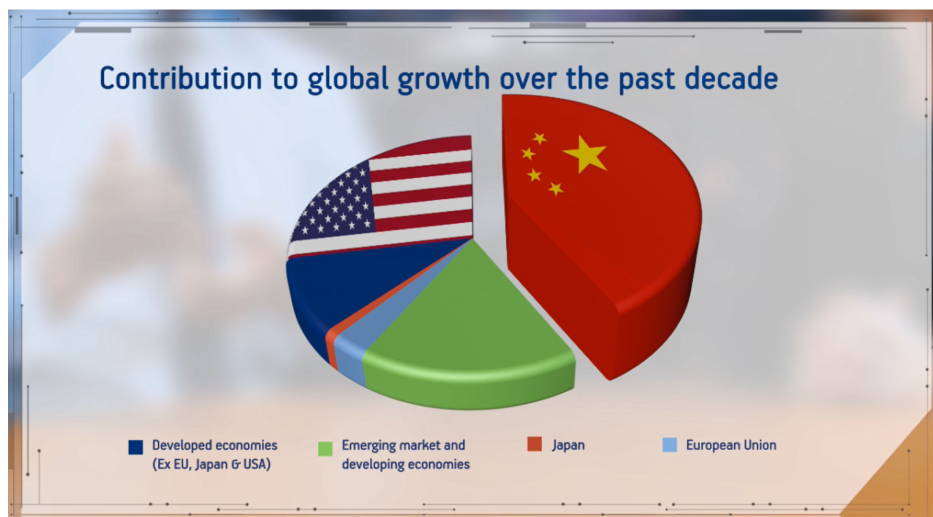
John, it's been an interesting couple of months since our last interview. The US market recorded its worst December since the Great Depression, then bounced back and had its best January since 1987. Why the rebound?

John Pearce (JP): It's been incredible, actually, Vicky, particularly given that the concerns that drove the market down 10% in December were, by and large, still around in January. So, fears of Brexit, trade war, global growth slowdown also hovered around in January, yet we have this V-shaped recovery. What's the difference? Well, Jeremy Powell, who's the chairman of the US Federal Reserve, came out with these magic words: "We will be patient." What he was saying is that US interest rates—that have been rising now for a couple of years—are on hold. Previously, you might recall that we talked about the importance of the US currency in the global economy. It really greases the wheels of the economy and financial markets. And when the Federal Reserve is saying that rates are on hold, what they're saying is that borrowing costs are not going up. That immediately spurred a rally in the US stock market, and as is usually the case, other major markets followed.

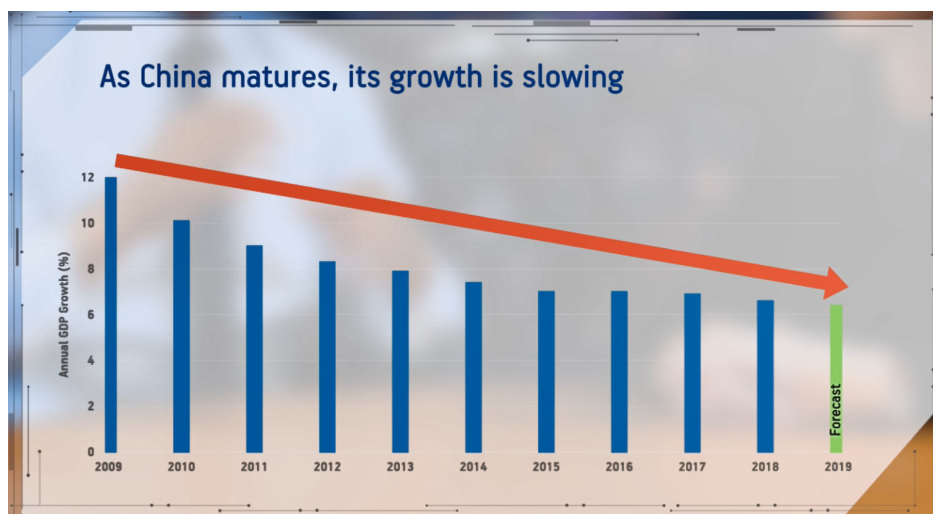
VP: On the point of global growth, the forecasts I've seen represent a meaningful downgrade. How concerned should we be about this?

JP: Let's leave aside the accuracy of these forecasts. To your point, the IMF recently downgraded their forecast from close to 4% to 3.5%, so you're right, that is quite meaningful. But let's bear in mind, 3.5% gets us to about long-term trend. So that in itself is not a major concern, it's certainly nowhere near a recession. I think the main concern for investors, and particularly Australian investors, is when we look at the impact of China and the fears of a hard landing in China. And we really can't overstate the importance of China to the global economy.

Have a look at this pie chart.



Over the last decade, if we look at the contributors to global growth, it might surprise some people. Europe and Japan are pretty much negligible. It's all been about the US, China and all these other emerging markets. China itself has contributed over 40% to global growth in the last decade. And now we have a situation where the engine to global growth is slowing. Look at this bar graph here.



Now, this shouldn't come as a surprise. China is a maturing economy, it's huge, and it can't sustain double digit or high single digit growth rates forever. So it's now down from those high levels back to around 6%, which in itself is not a major issue. The problem is that the pessimists are saying this is the beginning of the end for China. There have always been doubts about China's state-based capitalist system, and to the pessimists, this is all going to come to the fore now. Let's bear in mind, however—predictions of China's doom have been around for decades. Indeed, I don't think a year goes by without some expert predicting the collapse of China. But if we go back two decades, China was about 7% of the world economy—today, it's about 22% of the world economy. So I think the Chinese policymakers have got it right. They've certainly done a better job than most western governments. So, I'm certainly prepared to give them the benefit of the doubt at this stage.

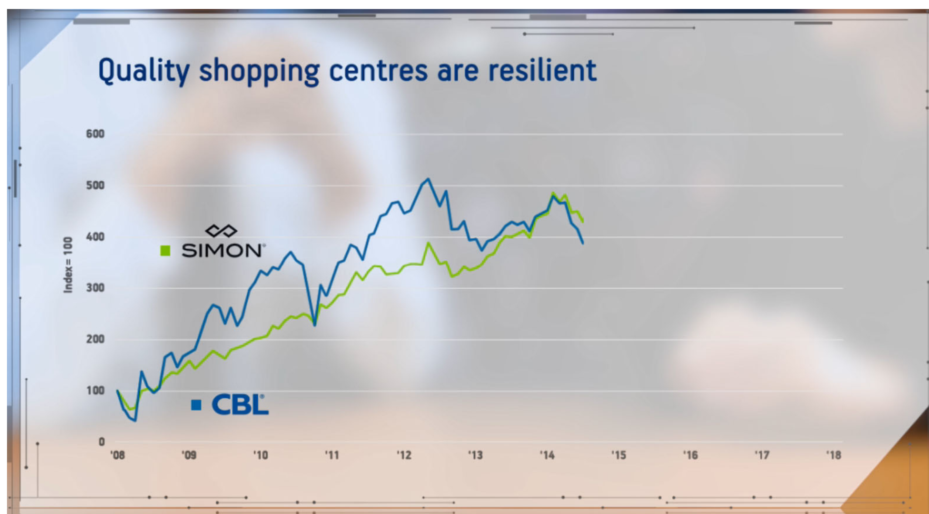
VP: And I noticed that the Reserve Bank of Australia is sounding more cautious of late.

JP: Last week, the RBA governor, Philip Lowe, announced that the reserve bank has changed its stance from a tightening bias to a neutral bias. This is pretty important, and what the governor's basically saying is that the next move in rates could actually be down, which is quite an about turn. So on top of the global concerns that we have, Australia has its own domestic concerns, with falling house prices and slower credit growth. Ironically, however, the Australian market has actually been doing pretty well. And why is this? Firstly, the prospect of low rates and lower rates is always good for share prices, because it makes shares relatively more attractive. Secondly, we have a lower currency and a lower currency means that our assets are relatively more attractive to foreign investors, and our exports are cheaper to foreign purchasers. And finally, we have the outcome of the Royal Commission. The worst fears were not realised and that's actually put a support to bank prices, and we know that banks are a very important part of the Australian market. They've actually staged a bit of a rally. So we see some tailwinds for the Australian market over the short term. Over the medium term, a lot will depend on how falling house prices play out, and the impact it's going to have on consumer confidence.

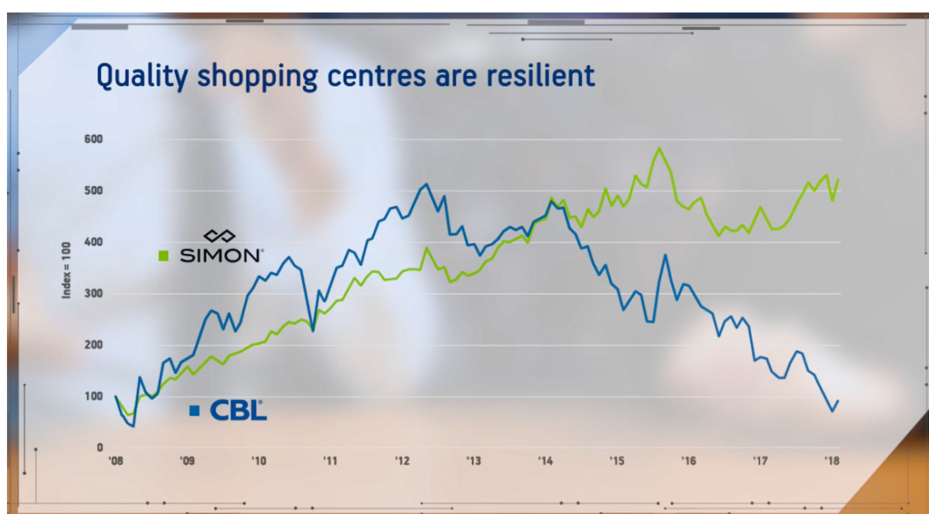
If you look at the Sydney market, for example, we've had a 12% reduction on house prices. It seems like a big deal until you remember that Sydney house prices went up by over 70% since 2011. To us, it's still a very orderly, healthy correction. Whether this continues to fall and really impacts consumer sentiment remains to be seen. At the moment, we are speaking to a range of executives across the corporate landscape in Australia, because earnings have been announced, and the feedback has been pretty consistent. The consumer has not gone on strike. There are certainly areas of softness, but we're still chugging along. Our base case now is a slower economy but certainly not a recession.

VP: John, let's change tack now. One of the most talked-about themes over the past decade has been the threat online retailers, particularly Amazon, have had on traditional retail. We have a large shopping centre exposure. How do you see this theme playing out?

JP: Well firstly, the Amazon juggernaut just continues. Amazon's growing its retail sales by somewhere between 20% and 30%, so it absolutely dwarfs the growth rates of traditional retail. But it's not all doom and gloom for traditional shopping centres, and we're seeing a real divide in the market between the quality, premium centres that can Amazon-proof themselves and the lower-quality centres. And I think it's instructive to have a look at the US experience, because that's where Amazon really is a powerful force. It hasn't been as successful in Australia to date. And I want to show you the fortunes of two big property groups in the US—Simon Group, which operates in the quality end of the spectrum, and CBL, which operates what we call B, C, and D grade malls. Now up to around 2014, you can see the share prices of both these groups pretty much tracked each other. In around 2014, you saw global property stocks generally experiencing a bit of softness because the US Federal Reserve started tightening rates, and that impacts property.



Around that time, Simon Group—and I don't know if it was good luck or very good management—but they actually divested a lot of their B grade shopping centres. So what they were left with was a prime portfolio. Have a look at the share price performance since that time—Simon has proved to be very resilient, whereas CBL has absolutely plummeted.



If we look for parallels in Australia, we would regard Scentre Group—which is where we have our largest exposure to shopping centres—as the best quality shopping centre portfolio in Australia. It's up there with the best in the world, and it's proving to be quite resilient. If you look at another big investment, Vicinity, there's two stories here. One, they've got shopping centres like Chadstone, and Chadstone has proven to be remarkably resilient. And as a matter of fact, the recent revaluations of Chadstone were up. But Vicinity also has some B and C grade shopping centres, and their revaluations have been negative. So we're seeing that divide happening in Australia.

VP: And in that context, our members will be interested to know of our big plans to develop Karrinyup Shopping Centre in Perth.

JP: Well, I hope that most of our West Australian members know that we are the proud owners of what we believe to be the premier shopping centre in Perth, Karrinyup Shopping Centre. And despite that it is a great shopping centre, we have to invest, once again, to Amazon-proof it, but also to make

sure that we're competitive with other shopping centres in the region. And we're embarking on a very ambitious investment, over $700 million, to transform it into a genuine experience destination.

And how do we do this? Well, the relative composition of the different retailers in Karrinyup Shopping Centre will change quite markedly. What are we going to decrease? Fashion and apparel. These are two lines that Amazon clearly will attack. What are we going to increase? Entertainment and leisure. So in a few years' time, our Perth members will not only be able to do their shopping, they'll be able to go to the movies, have a range of restaurants to choose from, head off to the gym, and maybe even go to a bowling alley. Try doing that on Amazon.

VP: Thanks for answering these questions, John. If you have any questions you'd like answered, please email us at **superinformed@unisuper.com.au**. Thanks for watching.

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