Banks are at the point where they are simply not able to sensibly pass-on any further official rate cuts initiated by the RBA. Their retail funding base (ie deposits) already sit on, or close to, an effective interest rate of zero percent. So in the absence of being able to re-price their liabilities (lower), they will be in no hurry to pass on any rate reduction to their existing loan customers.

Our view is that any further reduction in official rates would potentially do more harm than good. The only real option might be for some form of targeted QE that could see the RBA offer loans to banks (secured by existing collateral) at concessional or below market rates.

Keynesian theory is now back in the spotlight – that is fiscal policy (or how the Government spends, taxes & borrows) potentially offers a more effective mechanism for managing economic demand at this point in the cycle.

A holy trinity of unforeseeable factors (ie drought, bushfire & Coronavirus) has now all but wiped out any chance the Morrison Government had of delivering its much vaunted budget surplus. As noted above, the RBA is effectively out of ammunition so it will fall to the Federal Government to offer an appropriate suite of measures to steer the economy through any period of future economic uncertainty.

As part of the May Federal Budget, or as a mini-budget in the short term designed to address any looming economic impacts from the "holy trinity", the Morrison government will need to consider the following policies:

- Cuts to personal tax rates (**not** tax rebates). Consumers need an on-going increase in their take-home pays, not a one-off, annual refund
- Reductions to corporate tax rates. Whilst this measure was previously taken off the agenda after sustained resistance from many quarters within the community, the economic circumstances might allow a bring forward of slated cuts together with an additional pared back version of the original plan (likely targeting small and medium sized business)
- Accelerated asset write-off provisions for business & rural producers.
- One-off payments or subsidies to welfare recipients (probably not favoured but the Government, but they will need a quid pro quo for concessions to business, farmers & wage earners)

There may also be some limited scope to bring forward Government spending on infrastructure, however, the pipeline here is already congested (there are finite resources for large scale projects) and the economic impact is likely to be longer term.

Given that the Government will now likely be handed a "get of jail free card" on the budget surplus, the Prime Minister has an opportunity to wrestle back the political agenda and lay down a blueprint for economic growth based on the prudent deployment of additional fiscal measures.

OUTLOOK

The fear around the Coronavirus is certainly unsettling markets and it may well have some time to run as countries take disruptive action to stem its spread. However, the virus will be brought under control at some point and attention will then switch back to macroeconomic & company fundamentals. The global economy is in a healthy underlying position and we expect **interest rates to remain very low** and for Central Banks & Governments to provide whatever support is necessary to maintain their economies.

What the last few years has highlighted about markets is that the equity risk premium is king. People talk about "FOMO" (fear of missing out) driving investor behavior, but we have now moved beyond this paradigm. Around one third of global bonds now yield negative returns – in other words, the safest bet in the market (holding a bond to maturity) actually costs you money. Accordingly, equities are now "the only game in town" (TOGIT) when it comes to long term investing.

At the end of the day, only one thing matters - its **all about interest rates**. Whilst interest rates remain at historic lows, and provided authorities don't drop the ball on monetary or fiscal policy, equities will continue to deliver solid financial returns over the foreseeable future.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** With the impact of the Coronavirus on markets and the resultant impact on valuations, we are now more comfortable to maintain a neutral position to equities.
- **Global Equities (Slightly Underweight):** The US market is now off more than 12% since early February and, whilst still somewhat over-valued, looks better value at current levels. Asian and European markets appear to have more headroom for growth.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro tailwinds have now abated.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little more in fixed interest instruments relative to cash.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, our net cash position is slightly overweight.

Regards

Andrew & Stephen
27 February 2020