" From the umbra to the penumbra of COVID-19"

It has been a calamitous eight months globally since the onset of the pandemic with just about every country facing severe headwinds. Nations across continents have responded in different ways and continue to fight the pandemic on one-hand and seek to orchestrate an economic recovery on the other.

Australia's economic response to COVID-19 has been huge

The response to the pandemic in March 2020 by the Federal Government through a series of stimulus packages for individuals, businesses, and the introduction of code of conducts across industries have been successful. Actually, Australia's response to COVID 19 has been brilliant.

The Federal Budget announced on 06 October 2020 continues this theme by spending big on tax cuts for business and individuals, increased spending on infrastructure, and a range of measures to support a business-led recovery and lower unemployment rates. A touch of 'Reganism' perhaps!

This level of stimulus essentially doubles the nation's net debt from around $500 billion as at 2019-2020 to nearly $1 trillion by 2024. However, the cost of servicing this debt is fallen. This effectively means that the net interest payments as a % of GDP is lower than the 20-21 estimate. To quote Mr. Chris Richardson, Partner at Deloitte Access Economics:

> *"I worry that people worry too much, they see the really big numbers and assume we're buggered, that the future is buggered, and spending will have to be chopped. There's lots of things to be worried about due to the pandemic but debt isn't one of them. "The cost of defending our lives and livelihoods has been much cheaper than people realise."*

Figure 1: Australian Federal Budget 2020-2021 Debt Statement

Table 9: Interest payments, interest receipts and net interest payments(a)

	Estimates			
	2020-21 $m	2021-22 $m	2022-23 $m	2023-24 $m
Interest payments on AGS	16,623	17,083	16,746	17,526
Per cent of GDP	0.9	0.8	0.8	0.8
Interest payments	17,230	17,655	17,333	18,122
Per cent of GDP	0.9	0.9	0.8	0.8
Interest receipts	4,133	4,202	4,221	4,475
Per cent of GDP	0.2	0.2	0.2	0.2
Net interest payments(b)	13,097	13,453	13,113	13,647
Per cent of GDP	0.7	0.7	0.6	0.6

(a) Interest payments and receipts are a cash measure, with the relevant amount recognised in the period in which the interest payment is made or interest is received.
(b) Net interest payments are equal to the difference between interest payments and interest receipts.

Source: Australian Federal Budget papers for 2020–2021, Statement 7: Debt Statement

So, is the low cost of borrowing, unending stimulus the panacea of our times!!!

Howard Marks of Oaktree Capital has been a prolific author of several thought pieces on investment markets through many cycles. He opines that the current environment is like none since World War II mainly because most recessions have been managed through economic tools and stimulus and exhibited cyclical behaviour.

Whereas previous recessions (a sweeping statement) were a function of supply/demand dynamics, the current recession is a result of a pandemic. While governments responded with extraordinary stimulus packages, this has only addressed the issue of replacing and maintaining lost revenue, loss of rent, and lost income rather than stimulate the economy. As such, Howard Marks argues that further stimulus is likely until such time we see economic activity increase and unemployment rates fall.

The lower of longer on interest rates is now the dominant theme given the indebtedness of governments, corporations, and individuals. In our opinion, this is a central theme for investment markets.

While these stimulatory measures work their way into mainstream Australia over the coming months, it does put a spotlight on how investment markets respond across asset classes. To date, it appears that the overall return expectations for each of the asset classes has been lowered mainly by lowering the 'risk free' rate and maintaining the risk premium for each of the asset classes.

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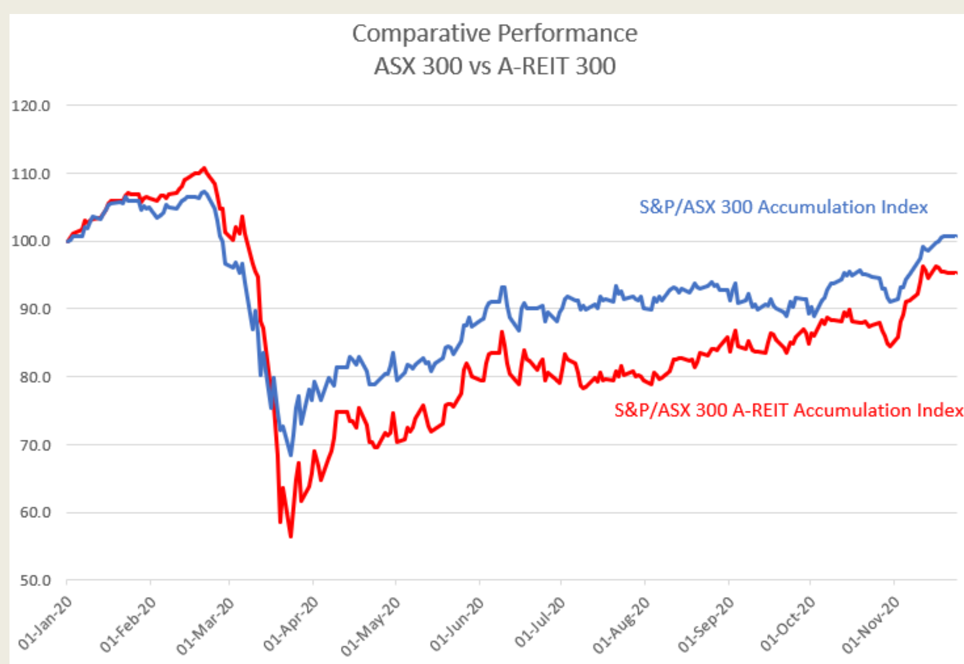
Again, as Howard Marks notes:

> *"Thus, today, it seems to me that most assets are offering expected returns that are fair relative to their expected risk, relative to everything else. But the prospective returns on everything are about the lowest they've ever been."*

Australian commercial real estate through the pandemic

As we highlight in the chart below, the economic stimulus packages since the pandemic has certainly led to a revival in the S&P/ASX300 property and broader equity indices. The recovery has also been supported by pretty reasonable half yearly/ annual results through the August reporting season (financials as at end June 2020).

Comparative performance of S&P/ASX300 versus S&P/ASX A-REIT Indices



Source: IRESS, for period 1 January 2020 - 23 November 2020. Assumes a starting point of 100.

Consensus view of A-REITs that reported in August 2020

The focus essentially was four-fold:
Impact of the pandemic on:
1.rental income;
2.asset values;
3.balance sheet metrics; and
4.Outlook on distributions (or dividends) to investors for the 12-months ahead.

Core Property Research compiled statistics on 33 A-REITs that reported during August 2020 on each of the above and note the broad conclusions below

Impact on rent income from COVID-19 mostly in line with expectations

The retail property sector suffered the most during the June quarter with large format shopping centre rent collections falling below 60% of total rent. Non-discretionary retail, suburban office assets, and industrial assets had rent collections of over 80% of collectable rent. This was pretty much expected. Trading conditions have since improved based on the quarterly updates from large format retail A-REITs.

Impact on asset values as expected

Again, large format retail A-REITs saw portfolio values decline by around 10% whereas industrial AREITs saw little or no decline in valuations. The office sector was a bit more mixed albeit valuations declines were less than 5% across high quality office assets and suburban office assets.

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From a market pricing perspective, the implied premium or discount to an A-REIT's net tangible asset (NTA) also supports the theme that large format Retail A-REITs remain out of favour, and trade at material discounts to reported NTAs. Meanwhile, industrial A-REITs, Office A-REITs, and Specialist A-REITs continue to trade at a premium or small discount (<10%) to reported NTAs.

Balance sheet metrics remain robust

A highlight of the Australian A-REIT sector has been that leverage across the sector has been low relative to pre GFC levels. As at June 2020, the average sector gearing is around 25%, slightly lower than gearing levels seen as at December 2019. A-REITs remain in great shape to service their debt with Interest cover sitting well above the Interest Cover Ratio (ICR) covenant imposed by lenders.

Guidance on forward earnings and distributions remain cautionary

Of the 33 A-REITs that reported its results, only 22 A-REITs or 66% of A-REITs provided earnings guidance for FY21. Perhaps, a very cautious approach to earnings outlook for the next few months. Even fewer A-REITs, 14 out of 33 or 42% provided guidance on distributions for FY21.

Overall, the reported results and outlook statements provided by A-REIT managers suggest that the downside risks as a result of the pandemic have been managed well. Economic stimulus packages which run until March 2021 provide a floor to any weakness in company earnings. However, the unwinding of stimulus packages and the consequent impacts remain uncertain beyond this period.

But a low interest rate environment and an environment of relative low returns could be the new normal while we move from the umbra to the penumbra of COVID-19.

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