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**Randal Jenneke**  
portfolio manager and  
head of Australian  
equities  
T. Rowe Price

# Big government, low growth and inflation: The new normal for markets

The COVID-19 pandemic is a very unusual event, and the recession Australia is currently experiencing is caused by the government shutdown due to the pandemic. It's not a recession caused by an asset bubble, or high interest rates or high inflation. As a result, it really falls back on government to step into the breach and support the economy until it can stand on its own two feet.

We are currently in a context where monetary policy has run its course and government will play a more supportive role through fiscal policy. Central banks including the Reserve Bank of Australia (RBA) have been supporting the economy through monetary policy, but having reached the limits of monetary policy, the RBA has a choice – do they go down an unconventional policy path with quantitative easing, or do they ask the government to do more?

## The end of monetary policy influence

The RBA had been banging the table pre-pandemic for a fiscal policy response. We were already set up for monetary policy to run its course, and the RBA did not want to go down the unconventional path. COVID-19 has merely sped this process up.

The response to the COVID-19-driven recession in Australia has resulted in fiscal policy and government support - JobKeeper, JobSeeker, and a Team Australia approach to the crisis where banks and landlords are part of the strategy, and we've also had changes to bankruptcy laws to support the economy.

But the question going forward is, what is going to continue to be the policy to manage the cycle, and how this will influence markets?

We believe what comes next is a fiscal policy-driven approach to managing the economy, which we haven't seen in a long time. There are calls for government to manage income inequality, and other societal issues. A bigger role for government means government driving a bigger percentage of GDP, with the potential for more regulation and more intrusion into corporate lives.

Most economists would say that big government is associated with slower growth. If you have a bigger government that is going to crowd out the private sector, or even just slow down its ability to hire effectively and innovate, and this is one of the things that we're trying to grapple with.

## A new era of big government

If you're thinking about what drives markets, it's three things - profitability, policy and positioning. How does a policy of government support affect profitability, and how do we position ourselves as a result of that.

Government taking a bigger position of GDP growth is a headwind to profitability, and more interventionist government will impact markets. We are seeing that not only in regulation, but in other areas, such as Treasurer Josh Frydenberg's call that the next chief executive of Rio Tinto be Australian, along with a majority of the board. This wouldn't have happened 10 to 20 years ago. That will make business more cautious, and from a corporate profitability perspective, we have to watch that very carefully.

From our perspective, you want to be invested in companies that continue to grow irrespective of the broader growth backdrop. This environment is still one that favours structural growth sectors such as healthcare and technology, for example. But we also believe cyclical growth stocks will do well as we recover from the pandemic.

There are other considerations from our perspective as well. We look at the state of supply chains, where a company has its manufacturing base, is it going to be close to key markets and key consumers. We are moving away from a supply chain that is "just in time" to one that is "just in case," and that will also impact growth.

As governments around the world try to look after their own citizens, there is definitely the risk of increased economic nationalism with more frictional costs, which translates to lower growth or lower economic outcomes.

## The implicit role of ESG

Much like other trends, the focus on environmental, social and governance issues has only accelerated through the pandemic, and the heightened focus of ESG will also impact markets. There will be winners and losers. On the climate, we know that as we transition away from fossil fuels, we have to have the conversation about what is the long term value of an oil and gas company going forward? It's hard to see anything but value going down.

The strategy which we run is not an ESG strategy per se – ESG is integrated in the process. We're thinking about the risks to compa-

It is undoubtedly true that we are in uncharted waters for markets and economies. Having reached the limits of what monetary policy can achieve in keeping the economic juices flowing, governments will have to employ fiscal policy to counteract the effects of the COVID-19-induced recession.

Randal Jenneke of T. Rowe Price identifies the three "Ps" that shape markets – profitability, policy and positioning. Governments will turn on the fiscal policy taps, which will impact corporate profitability, and investors need to seek new positioning to find value in unfamiliar territory.

With all this as backdrop, Jenneke explores how to identify the sectors that are likely to continue to perform well, and the well governed companies that will continue to chart a course through these waters.

*Michelle Baltazar*

Michelle Baltazar  
Director of Media & Publishing



### The quote

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nies, the risks to valuations and the investment value. If we're looking at the energy sector, long term, our view is negative, so therefore you'd expect our portfolios to be underweight the sector. Coal is a sector that has largely disappeared from listed markets, and that will only accelerate going forward.

There is no doubt that there is real investment risk around these factors, which is why we have a big ESG team in London who work closely with our analysts and portfolio managers, in order to assess these risks. Governance in particular is an area we spend time analysing, and it reinforces the point that we think we are in a world of bigger government and that is a very different environment for corporate governance.

## Growth, not value, to dominate

We think you want to be in the growth part of the market, but you want to hedge the bets a little bit away from structural and towards cyclical growth. As we recover from the pandemic, our employment rates should increase, and that will help. The housing market will recover. We've seen indications that car sales are recovering. This favours growth companies, but more cyclical growth companies.

Pulling all of these strands together, we think we are in a very different environment. We are in a world of big government response, and we think both growth and inflation rates, while likely to improve somewhat are going to be on the lower side compared to historic levels. With that as the backdrop, and being mindful of where valuations are, we believe cyclical growth will outperform, while value will continue to struggle. **FS**

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