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Investment Update – April 2020

COVID 19 Experience to Date

The prevalence of COVID 19 and government response to the virus has been unprecedented. As the virus spread globally countries have progressively entered stricter health regimes to combat the virus. This in turn has sparked economic disruption and the dislocation of markets. All assets classes have been impacted and no geography has been spared.

Looking forward the Chinese experience demonstrates that the virus can be contained, and that the death rate is not of a level that will result in the collapse of society. The city of Wuhan where the outbreak originated is due to lift transport restrictions on 8 April. Undoubtedly there will be an economic recovery, but the unknowns are how long will it be before this commences globally, what shape will economic recovery take and how will this be reflected in investment markets

Policy Responses

The policy response from governments to the virus threat has been rapid and progressively larger. The adequacy of the measures introduced together with unintended consequences will not be known for some time given the scale of the actions taken. Economic policy response has taken two forms: monetary stimulus applied by central banks and fiscal stimulus from central government. Monetary response has been in the form of even greater quantitative easing (cutting interest rates). This has been designed to keep bond markets liquid and drive down interest rates to near zero across the yield curve.

Fiscal policy has been in the short term in the form of short-term wage subsidies and helicopter money. These measures anticipate the quarantine restrictions being relatively short-dated and are designed to provide households and businesses with enough funding to remain afloat.

Longer term further direct expenditure measures can be anticipated in the form of construction projects etc. In order to fund this expenditure governments will either have to increase taxation, increase future austerity or borrow, with the latter the most likely with governments issuing large volumes of government bonds.

Market Impacts

The impact of the virus itself and the actions taken to restrict its spread can be divided into immediate market effects and secondary impacts Although a second round of infection cannot be discounted, first round effects have already been substantially experienced with the driving down of equity values as investors have been forced to seek liquidity by realizing investments and capital preservation fears have generated additional momentum. In debt markets a flight to safety has driven interest rates down to near zero in high quality bonds and a blow out of yields in high risk credit.

Second round impacts are yet to emerge. These will become apparent when/if businesses are unable to meet their ongoing obligations as a result of the suspension of commerce. Operating challenges include dwindling markets and supply chain disruption. Rent/wage/interest payment obligations continue despite the lack of business income. Immediate relief measures in a protracted shutdown will only provide a temporary reprieve. Inability to meet fixed costs will worsen the longer economies are unable to function on a normalised basis.

This in turn will result in debt defaults, business failure and unemployment. Those business' reliant on discretionary revenues and with extended balance sheets or the absence of realisable assets will be exposed. For these companies listed on the sharemarket, further share price declines may be in prospect, potential capital raisings and in a worse case liquidation. The temptation to re-enter financial markets if capital is available after a significant fall is substantial. Often rallies in share prices may occur as investors seek to acquire assets at 'bargain' prices. Caution needs to be exercised in these circumstances to avoid being caught by second round effects.

The extent of monetary stimulus is unprecedented. The 2007/2008 global financial crisis was also addressed by large scale monetary easing. It is possible that the massive monetary injection now occurring throughout the world will result in a burst of inflation. Based on that experience much of this monetary stimulus found its way into financial and real assets rather than direct consumption given that monetary is a blunt policy tool that takes months to be effective. It is possible therefore that financial markets could see a similar phenomenon in the latter part of the year. index returned a positive 1.5% in the month. Balanced and conservative portfolios have therefore been cushioned to a degree by the inclusion of fixed income securities or bond funds mitigating the larger negative price movements in equities.

Historical Context

The COVID 19 event initially appeared to be a market correction incident. Subsequent events have proven this assessment to be incorrect. The decline in equity markets has been the steepest since 1929. The reasons for this are likely to be myriad but will include the globalisation of markets, more rapid dissemination of information and possibly the existence of algorithmic trading strategies. Not only has the decline been steep but over the last month the decline in equity values has been one of the deepest on record although recent rallies have clawed back much of the immediate decline.

Given the speed of the decline and the rapid policy response it could therefore be argued that a V shaped recovery is in prospect, that is a steep decline and a market not languishing at its bottom for any extended length of time before a steep recovery occurs. Although this scenario is attractive to investors it is not one that a prudent investor can rely on.

As the fall has been deep it is probable that a more protracted U shape recovery is likely. This thesis is predicated on the second-round effects being slower to emerge and investor confidence taking a hit from the severity of the decline.

While it may be optimistic to expect and position for a sharp recovery in market values it is not a good strategy for investors to try and time the market further by either exiting entirely or seeking to cherry pick the timing of re-entry or deployment of uncommitted capital. The US equity market has experienced some of the worst daily falls since 1929 with the 9th of March 2020 fall of 7.6% in a day the 19th largest one day drop on the S&P 500. Offsetting this, the Dow's fifth best day since 1933 was 24 March 2020.

While it is not suggested that investors are on the cusp of a new bull market it should be recognised that bull market runs far exceeded bear market events both in terms of duration and ultimate gain versus loss. The best compound investment gains in percentage terms are experienced at the start or near inflection points.

Portfolio Rebalancing

The market movements recently experienced are well outside those normally experienced. As a result, the respective weightings between defensive/income assets and growth assets will likely have moved away from target levels for the risk tolerance specified. In view of events it may well be timely for investors to review the risk tolerance they have adopted and consider whether this continues to be appropriate. Over frequent portfolio rebalancing is generally to be avoided in order to minimise transaction costs but a rebalance to target levels given the magnitude of value shifts is good practice, acknowledging that timing can be impacted by tactical considerations.

Given the likely emergence of second round effects it is also timely that investors holding direct company investments evaluate the ability of those companies to absorb further economic shocks and divest those companies which may suffer further declines in favour of more robust businesses.

Recapitalisations are probable and these situations are both negative and positive for investors. Where a recapitalisation occurs, it is likely to be at a discount to market value and therefore represent a dilution of existing investors equity. Positively it can be an opportunity to gain or increase exposure at favourable value in a more financially robust business.

Outlook

The investment outlook is highly uncertain given the large number of variables at play and the novel nature of many of the factors influencing investment markets. In general, increased uncertainty gives rise to increased fear of loss.

Risk aversion increases as a result. Investment opportunity and the potential for investment gains does not necessary correlate with market declines and the risk reward proposition often improves.

Although the path ahead is fraught with potential hazards investors with a long-term view who adopt a disciplined and measured approach to the implementation of their investment goals can capture rare value. In summary though, from a capital preservation view, investors should err on the side of quality and caution.