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Investment Update – May 2020

Outlook Remains Opaque

April was a month of lockdown for New Zealand and much of the globe. Actions to contain the spread and effects of the COVID 19 virus appear to have been successful with New Zealand moving from Level 4 Lockdown to Level 3. The share markets have taken the decline in the rate of infection positively and it appears that the population health effects can be contained. Investors are shifting the focus of their investment lens beyond the immediate to the longer-term impacts. Price movements in equity markets suggest that a recovery is in prospect and that share prices had been too severely discounted for the virus.

Although price erosion in March was severe a reasonable proportion was made up in April. The S&P/NZX 50 Portfolio index was up 8.71% in April. In the United States the NASDAQ Composite index experienced an increase of 15.5% in April, the biggest 1 month gain since June 2000. For Balanced and Conservative portfolios bonds performed their capital preservation function. Is the market moving into a new bull phase or is the current upside a bear market rally?

Potential Recovery Shape

Current market movements suggest that investors anticipate a rapid improvement in the economy over a truncated time period (several months) without lingering economic impacts. In part this interpretation is driven by medical research success with the development of an effective treatment (potentially Remdesivir although other projects show potential) or longer term a vaccine. As a result, security values have bounced substantially from March lows. This type of recovery is characterised as V shaped and is the best possible outcome looking forward. Alternative scenarios exist that postulate that the current sentiment is too optimistic, and that the economic recovery will either be W, U or L shaped. The W shape implies that the market experiences several up and down legs before a more lasting uplift occurs and a new investment environment emerges. The U shape expects a more prolonged downturn with the recovery more gradual. The L shape is the least optimistic and assumes that the downturn is semi -permanent and continues on a sustained basis. In this scenario the COVID 19 virus persists and recurrent waves of infection occur. Past history suggests that that the day to day volatility experienced in the equity markets is not unusual and that it may be prudent to be cautious in relation to participation. Since 1929 the largest daily gains in the Dow have been made during bear markets, examples have included plus 15.3% in 1933, plus 11.1% in 2008, plus 10.1% in 1987 and plus 11.4% on 24 March 2020.

A return to long-term economic growth and with-it appreciation in portfolios is the base assumption in evaluating the investment outlook. The uncertainties associated with this are how long a recovery takes and which sectors are likely to improve earliest and to the greatest extent - the two characteristics not necessarily being mutual. Potential factors in determining whether an economic inflection point has been reached include: • Has policy intervention been sufficient to act as a circuit breaker, • Has the root cause of the economic disruption i.e. virus infection rates peaked, • Are economic slowdown measures decelerating, and • Are valuations inexpensive. Equity markets will anticipate a recovery before it occurs with share prices moving up prior to confirmation of normalisation in terms of economic data.

At present the value of first quarter economic statistics is negligible in that the data is largely pre-COVID 19. It will only be subsequent data points that will be useful in extrapolating probable economic trends. Some essential service providers may be little affected by the pandemic or in fact net beneficiaries of the outbreak, investments in this category might include healthcare, consumer staples and online service providers. In contrast the New Zealand tourism industry (transport, accommodation and attractions) is likely to take the longest to recover as borders remain potentially closed for 12 months (as per NZ Treasury's base case) whereas nondiscretionary retailing may be largely unaffected or a net beneficiary. Eventual recovery in tourism for survivors will probably generate larger percentage returns for investors if entry is well timed. The Chinese experience is the best comparative we have currently. Economic activity in China having faltered – in the first quarter GDP growth shrank 6.8%, the first quarterly decline since 1992, is now returning. Electricity demand has rebounded but not to the extent prior to the shutdown. China is finding that although its factories can produce, overseas demand is largely absent, retarding China's exports. Supply can be ramped up quickly, but demand returns more slowly.

Oil Market Price Crash

The price of US oil plunged into the negative during the month. West Texas Intermediate crude for May delivery fell more than 100% to settle at negative $37.63 per barrel. The price of Brent crude also moved down in tandem but maintained a premium to US prices. The unusual circumstances reflected the interaction of supply and demand. OPEC + had agreed to reduce global supply but any such reductions take time and in the interim production in the United States has continued largely unabated. US exploration drilling has halved since January, but this does not impact existing supply. Combined with the drying up of demand the surplus production ballooned to the extent that an absence of storage converted the future price of oil to a liability. With some irony the price of fuel for the New Zealand consumer has fallen but travel restrictions prevent them from using vehicles. The low price of oil is a factor in expectations that inflation will remain low over the next 12 months.

Monetary Effects

The extent of monetary easing has been massive in the New Zealand market and globally. The RBNZ continues to have the objectives of inflation between 1 and 3% and full employment. This has led Westpac to forecast the potential for negative interest rates in New Zealand with the Official Cash Rate (OCR) reduced to minus 0.5%. There is considerable debate as to whether this measure is necessary or desirable and as to when it might be implemented. Consensus opinion appears to be directionally consistent with a further reduction in the OCR. If correct this implies further downward pressure on term deposit rates and mortgage rates. In turn this would tend to be supportive of share prices which generally provide better income yield and capital growth even in the heightened uncertainty of a COVID 19 world. Additional flow through implications would arise for the New Zealand dollar and funding of the economy with New Zealand remaining a net debtor nation. Overall investor interest rates look set to remain at low levels for a prolonged period.

Consistent with the degree of monetary stimulus occurring in the economy the issue of inflation has been raised. All other things being equal increased money supply for a given or declining level of economic activity and fixed velocity of money should be inflationary. This in turn being reflected in the value of real assets (property and precious metals) and shares. The consensus amongst economists is that the decline in demand resulting from the virus has far exceeded the decline in supply. As a result, inflation in the next quarter will drop dramatically and remain minimal in the year ahead despite the efforts of central banks.

A low fixed interest environment should remain positive for income producing shares, but some caution is still warranted. Investors must not consider dividend yield from shares as an annuity as recent events have demonstrated. Traditional income stocks such as Australian banks and property companies have elected to reduce or pass dividend entirely in the most recent reporting period. Investment in bonds must similarly be discriminating. The changing dynamics have seen previously investment grade securities migrate to high yield or ‘fallen angel’ status. An example of this is Ford in the US which successfully concluded a 10-year bond issue in April at 9.625%.

Summary

Investors should be mindful of the quote attributed to economist John Maynard Keynes “When the facts change, I change my mind”. The investment market outlook remains fluid and uncertain. Although the overall investment thesis is for improvement, the full impact of the shutdown is yet to emerge e.g. what will the true extent of unemployment be post the cessation of the current wage subsidy scheme and what impact will this have on demand? These types of issues are likely to retard values in some instances and potentially create permanent impairment. However, the economic chaos is creating opportunities in terms of new forms of commerce and in terms of beaten down values. Immediate and concentrated investment has a high level of risk associated with it but prudent and measured investment maintaining exposure is likely to serve investors well over the longer term.