Research Insights - Market update

Over the last few days, we have seen a severe dislocation of financial markets due to two black swan events that in reality were out of everyone's control, these are:

1. The Coronavirus (COVID-19) which is now a pandemic, spreading globally and severely disrupting supply chains, travel, entertainment, employment, consumer activity and global growth.
2. Oil price war between Russia and Saudi Arabia, whereby they are both prepared to increase supply in an environment where energy demand is falling due to the impact of COVID-19.

The impact of these two events has seen the following market reactions as at 9th March 2020:

- Australian Equities. The S&P/ASX 200 fell 7.3%, the biggest fall since October 2008
- US Equities. The S&P 500 fell 7.6%, the largest fall since October 2008.
- Oil down 31% biggest fall since the Gulf War in 1991.
- Government Bonds. US 10-year bond yields fell from 0.77% to 0.55% and touched as low as 0.31%. Australian 10-year bond yields fell from 0.68% to 0.62%.

Investment markets are pricing in the severity of these events and it is almost probable that we will enter into a recessionary period not only here in Australia but globally. Central Banks globally are stimulating by cutting interest rates and by using other unconventional monetary tools to lessen the impact to their economies.

Please find below an update and commentary from Australian Unity explaining the macro events, economic impacts, market reactions and what to do.

Coronavirus (COVID-19) Update

Since our previous update there has been a significant increase in identified cases globally and outside of China. There were 80,239 cases identified globally in our previous update (from the World Health Organization's Situation Report 36 – February 25, 2020). In the World Health Organization's Situation Report – 8th March 2020 the number of cases globally has risen to 105,586. Chinese cases have risen from 77,780 to 80,859. However, there have been significant increases in cases outside of China. South Korea has seen cases increase from 977 to 7,134 over this time. Italy has seen cases grow from 229 to 5,883. Fatalities because of COVID-19 outside of China have risen from 34 in our previous update to now stand at 484.

Australia to have first recession in 28 years?

A worsening situation regarding COVID-19 and its spread globally has led to heightened concerns around the economic impact and increasing probability of recession. Yesterday Westpac's Chief Economist Bill Evans forecasted that Australia was likely to have a technical recession (two consecutive quarters of negative growth) with the economy expected to contract by 0.30% in both the March and June quarters this year. Importantly, this forecast is contingent on the Federal Government not implementing fiscal stimulus. This qualification is important as the Federal Government is likely to announce a fiscal stimulus package later this week. A rebound in growth in the third quarter (+1.4%) and fourth quarter (+0.8%) has also been forecast by Evans.

Oil price plunges as much as 31% on Monday

Last Friday a meeting of OPEC (the Organization of the Petroleum Exporting Countries) could not reach agreement to maintain production quotas which were due to expire later this month.
Saudi Arabia and Russia could not agree on maintaining current production quotas and as a result Saudi Arabia slashed the price it was prepared to sell oil in April on Saturday. Furthermore, there was a threat that Saudi Arabian oil production would increase from current levels of around 9.7 million barrels of oil per day up to 10 million barrels of oil per day. It is believed Saudi Arabia has the capacity to increase production to a level of 12.5 million barrels of oil per day and importantly is one of the lowest cost producers of oil globally.
The sharp move lower in the oil price is due to a combination of increased uncertainty resulting from increasing supply at the same time as demand is being curtailed as economic growth globally is slowing. A lower oil price is not good for inflation; something central banks have been trying to achieve more of over the last 10 years. Additionally, higher cost energy producers that have issued bonds recently may be unable to repay borrowers should this lower oil price remain that could impact credit markets negatively.

Coordinated Central Bank Response Falls Flat

Last week the central banks of Malaysia, Hong Kong, Canada, Australia and the United States cut their official cash rates in response to slowing economic growth. The United States cut its official interest rate two weeks ahead of its next official meeting by 0.50% - the largest cut to the Fed Funds rate since 2008.
The lack of positive market response to these moves combined with the urgency of the US Federal Reserve's out- of- cycle cut to the official rate has increased investor nervousness in the near term. There is also concern about the limited ability by some central banks to further stimulate economies by cutting official rates given the current low levels. In Australia, the RBA cash rate now sits at just 0.50% following last week's 0.25% cut.

Inverted yield curve

The prospect of slowing economic growth has some pundits speculating about a global recession. With increasing uncertainty about the impact of COVID-19 on global growth investors have migrated to a “risk-off” stance.

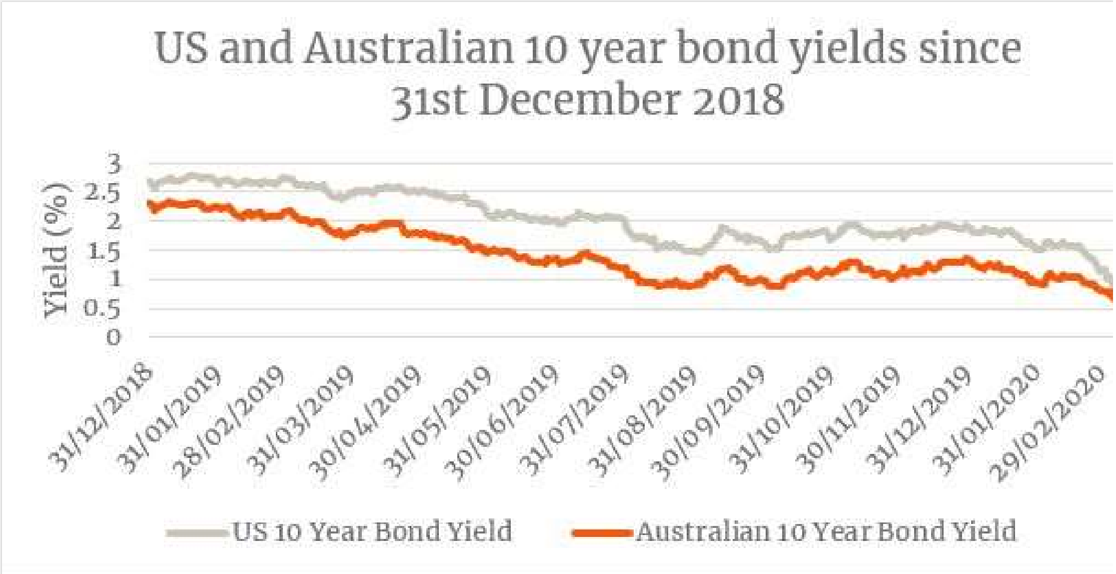
This has seen increased demand for government bonds and in the US this has seen the yield curve become inverted – a situation where longer dated debt instruments trade at a lower yield than shorter term debt instruments. At the time of writing the US 10-year bond was trading on a yield of 0.57% compared to the Fed Funds rate at 1.00%-1.25%. Whilst some pundits believe this portends a recession this is not always the case.

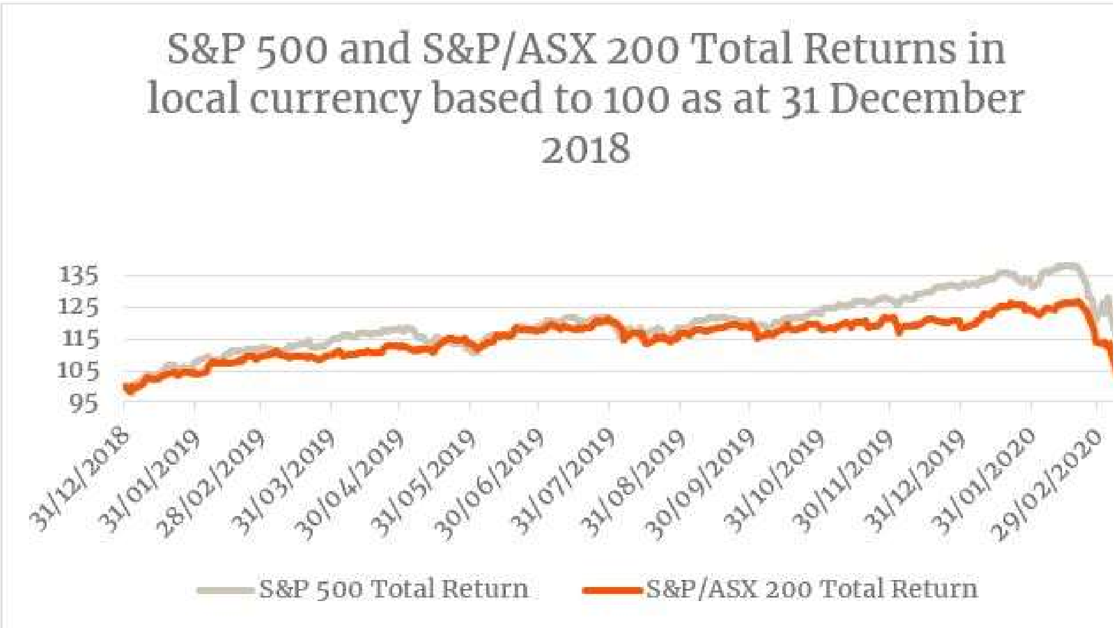
Changing relationship between bond yields and equity prices

We have seen substantial falls in share prices since the start of the year with the Australian sharemarket (S&P/ASX200) falling 12.75%, the US market (S&P500) falling 14.99% and UK’s FTSE 100 falling 20.9%. At the same time 10-year bond yields have fallen significantly with Australia’s 10-year bond yield falling from 1.37% to 0.62%, US 10-year bond yield falling from 1.92% to 0.55% and UK’s 10-year bond falling from 0.82% to 0.16%.

As we can see from the graphs below and overleaf it appears the nexus between lower bond yields driving up equity valuations (and prices) has broken in the near term.

Changing relationship between bond yields and equity prices





*Source Bloomberg LLP

Earnings downgrades yet to be quantified

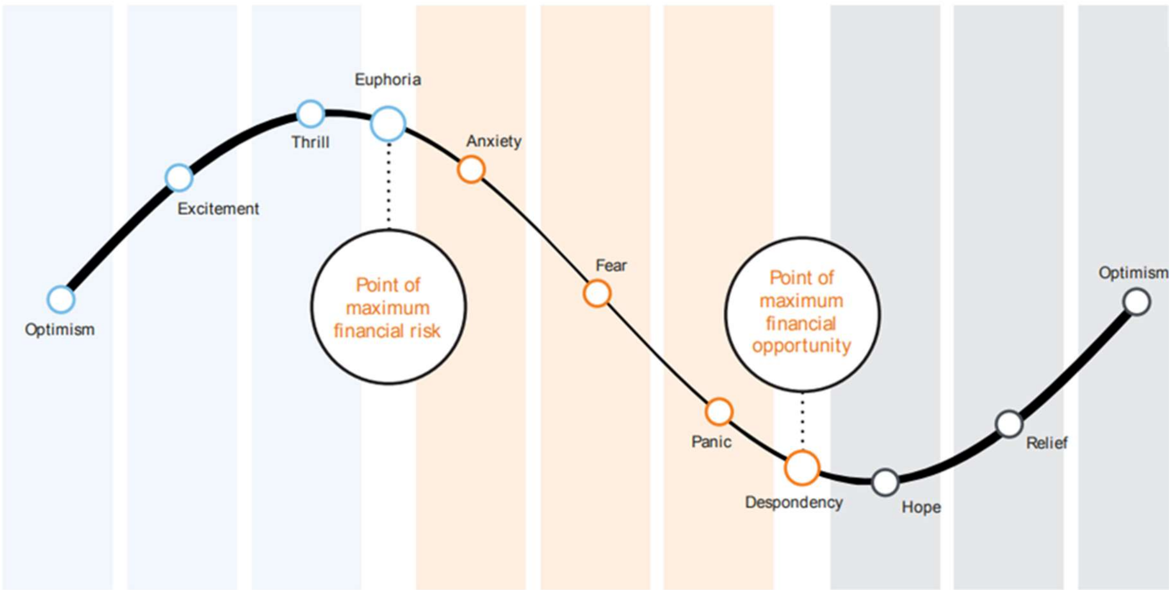
Investor confidence in valuations (despite significant price falls) is waning given there will be more announcements by companies negatively impacted by the impact of COVID-19 on consumer demand and supply chain disruption.

As a result, caution in the near term is warranted as markets go through a “re-calibration” phase in determining appropriate valuations for the current environment.

Investor Anxiety

It is reasonable that investors experience increased levels of anxiety when investment markets fall. It is a natural reaction to rapidly changing circumstances particularly when you have experienced positive market returns consistently in recent years.

The chart below from Russell Investments titled “The Market Cycle of Emotions” captures emotional reaction to market movements and helps to put some context around current anxieties and “the way forward”.



Source: Russell Investments.

Conclusion

We believe in a disciplined approach to investing over the long term can help avoid reacting emotionally to short-term events. Deploying an adequately diversified portfolio and focusing on long term asset valuations allows us to make clear decisions at times when markets choose to re-calibrate. Investor positioning can move from the current “risk-off” stance to “risk-on” very quickly.

Signposts we are monitoring include:

- Progress in developing a cure for COVID-19
- An agreement between Saudi Arabia and Russia regarding production quotas for oil into the future.
- Further central bank stimulus including official interest rate cuts and/or quantitative easing
- Fiscal stimulus initiatives from governments including Australia
- Merger and Acquisition activity in equity markets increases which underpins certainty around valuation levels.

In an environment where the reward for holding cash is minimal in terms of yield (but significant in terms of capital preservation) there is substantial risk in liquidating assets and holding cash if these two macro events abate sooner than the market is currently anticipating.

Whilst our forecast valuations indicate significant returns above cash over the next 10 years for all major asset classes our preference is to continue to hold a well-diversified portfolio of assets during these volatile times and not forego an improvement in asset prices when sentiment changes.
The timing of negative sentiment changing from this is unclear at this stage and we expect markets to remain volatile in the near term but it is important not to panic.