Client Newsletter

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Summary of Key Views

Scale of support has calmed market nerves for now

The March quarter of 2020 can only be described as one for the record books and will be revisited and studied many times in the years to come. We saw what was initially a health crisis turn into an economic crisis, with governments around the world shutting down their economies and inducing recession in order to prevent the spread of COVID-19 and save lives.

Markets responded savagely to the uncertainty, with all risk assets selling off in late February and into early March in an environment where only cash would do. Volatility hit record highs with even the most defensive parts of the market not immune to the indiscriminate selling. Even the most liquid parts of the bond market came under stress, with sellers of US Treasuries vastly exceeding buyers. Diversification was hard to find. Governments and central banks stepped in to provide unprecedented monetary and fiscal stimulus in efforts to ensure not only financial market stability, but to ensure there are viable businesses and places of employment to return to once the economic shutdown ceases. The size and scale of these measures comforted investors, and we saw a relief rally late in the quarter.

Looking ahead, economic activity is rapidly declining, and a recession has most likely already begun. We expect to see traditional sources of income such as equity dividends and government bond yields come under further pressure for at least the next six months. We continue to believe that there is a significant advantage in both being active and having a range of income sources from which to draw from during these uncertain times.

Market developments during March 2020 included:

Australian Equities

Australian shares faced a very tough March as measures to combat the spread of the coronavirus, along with the economic dislocation globally, hit businesses hard. The only good news was sign of a relief rally late in the month as markets began pricing in stimulus measures announced by the government, but no sector has made it through this period unscathed.

Measures such as travel bans and social distancing have taken a huge toll on airlines, travel, leisure, retail and hospitality businesses. Flight Centre (-69.6%) entered a trading halt in March while Qantas (-41.6%) has significantly reduced capacity and was forced to stand down two thirds of its workforce (around 20,000 people). Social distancing measures have also hit entertainment businesses like Star Entertainment Group (-41.1%), which owns Sydney's Star casino, and care providers like G8 Education (-48.6%), which owns a portfolio of childcare and early learning centre brands.

Winners amid the chaos include some consumer staples names including wholesale distributor Metcash (+27.5%) and Coles Group (+6.7%), which have seen a boost in sales due to consumers stocking up as they prepare for quarantine. Telstra (-10.5%), while it has also taken a hit, has stated it may meet the lower end of its guidance range and will maintain its dividend amid strong NBN demand.

Global Equities

While the extent of the fall is not unprecedented, the speed at which the market is falling certainly is. The tightening of liquidity conditions across a range of markets was symptomatic of severe stresses in the financial system, raising the risk of a more disorderly and precipitous decline in economic activity. The behaviour of financial markets in the period ahead and the ultimate depth of the economic downturn is highly uncertain. Market moves are not only dependent on the rate at which the virus spreads, but the fiscal, monetary and liquidity support that is provided by governments and central banks.

The US share market tripped circuit breakers three times in two weeks (these are triggered by a sudden 7% drop in the market, resulting in a 15-minute pause in trading), while volatility, measured by the CBOE Volatility Index, hit 82.7 points mid-March. Adding to the global coronavirus situation is the rapid fall in oil prices precipitated by a price war between Russia and Saudi Arabia. The WTI crude oil price finished March at US $20.1 per barrel – the lowest price since February 2002. The collapse in prices threatens the US shale oil industry, which relies on prices sitting above US $40 per barrel. Emerging markets may get caught up in a flight to quality, although they have generally held up better than developed markets in the current crisis, due in part to the relative fast and organised response in Asia.

Fixed Interest

Credit markets came under stress in March with little interest from market participants except in the highest quality names. There were concerns that default rates could rise broadly across multiple sectors, with services industries such as airlines (without sovereign backing) and hotels at a high risk of bankruptcy. Government bond markets also appear to be under stress with bid/ask spreads for US Treasuries stretched to 5–10 basis points (these are normally around 0.25 basis points or less).

Australian government bond markets saw a 10–20 basis point bid/ask spread, which has not been

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experienced in over 30 years. US Libor rates (the rate at which banks lend to each other) also rose, while corporate credit spreads spiked higher as a wave of selling exposed a lack of liquidity in that market. A combination of corporates drawing down credit lines to build cash reserves, banks becoming more cautious in lending, and investors seeking to redeem investments across all asset classes led to acute liquidity concerns. This in turn raised the risk of a more severe downturn in financial markets and an even more significant decline in economic activity.

REITs (listed property securities)

Listed property has been dealt a severe blow by social distancing measures and the need for people only to venture out of their homes for essential shopping. The effects have been particularly acute for Australia's retail REITs, which have experienced a fall in foot traffic and will need to negotiate with distressed tenants who will be asking for rent relief. Scentre Group (-54.8%), which operates under the Westfield brand in Australia, was the worst performing of the S&P/ASX A-REIT Index in March, followed closely by Vicinity Centres (-52.1%), whose Chadstone shopping centre has seen major tenants like Kmart and Coles close or drastically reduce their opening hours. Now that listed market values have plummeted, pressure has mounted on investment managers and super funds to update values on their unlisted assets more regularly than the usual quarterly cycle. In Australia, AMP Capital is leading the way with valuers now being asked to revalue property assets in their flagship AMP Capital Shopping Centre Fund and AMP Capital

Wholesale Office Fund. Globally, investors are cognisant that for sectors like Hotels, Offices and Shopping Centres, the impact of the virus could last six months or more due to physical distancing and working from home.

Alternatives

Preliminary estimates for March indicate that the index decreased by 3.7 per cent (on a monthly average basis) in SDR terms, after increasing by 1.0 per cent in February (revised). The base metals, rural and non-rural subindices all decreased in the month. In Australian dollar terms, the index increased by 3.5 per cent in March.

Over the past year, the index has decreased by 10.2 per cent in SDR terms, led by lower coal, LNG, oil and alumina prices. The index has increased by 0.7 per cent in Australian dollar terms.