Client Newsletter

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Summary of Key Views

Markets in a pandemic

Stating the obvious, we've seen market volatility increase dramatically in recent weeks as the COVID-19 virus has spread across the world. The VIX index hovered around the mid teen percent mark-up until the middle of February to more than 82% in March as the market tries to price in the impact of the virus on the global economy and company earnings. Markets are well and truly in bear market territory (bear markets signify a fall of greater than 20%).

Central banks and governments have taken material measure to buffer economies with rate cuts and drastic fiscal measures. The acceleration of quantitative easing programs has been designed to pump liquidity into markets, most notably into credit markets which we have seen liquidity dry up in recent weeks. Many advisers would have received updates from various fund managers advising them of increases in buy-sell spreads as a result of liquidity constraints in some markets.

General deleveraging by investors is clearly taking place. Investors are selling any liquid assets they can – including bonds – to fund redemptions, margin calls or simply to move into cash. Some of the fixed income managers included in our portfolios have been taking profit, trimming their positions after building in additional duration in the second half of last year. Parts of the market are blaming hedge fund sellers (always the first and easiest to blame) and some are blaming social distancing, which is making it more difficult for bond traders to execute their trades working from home.

At the same time, we've seen companies drawing down their entire credit lines at banks in efforts to shore up their balance sheets and make it through the next few weeks, months or quarters with little to no revenue coming in. Access to cash (or credit) is essential to keeping these businesses alive and through to the other side of this shutdown. Bills, interest payments and fixed costs still need to be paid. Companies are hoarding cash, and those that held government bonds as part of their liquidity reserves are selling them. The demand for liquidity has been great and cash – or 'cashflow' – is king in this environment.

Market developments during February 2020 included:

Australian Equities

February saw heavy selling in local and global shares as markets priced in the risk of the coronavirus outbreak, which includes significant disruption to supply-chains due to lockdowns, travel restrictions and other efforts to contain the virus. Reporting season revealed a number of ASX companies have already been forced to make downward adjustments to guidance. Webjet (-18.6%) announced a cut to its FY20 EBITDA guidance in response to noticeable reductions in bookings and total transaction value (TTV) across its WebBeds and Webjet OTA divisions. Qantas (-13.7%) was unsurprisingly also affected, announcing temporary reductions to flights across Asia due to falling demand.

Software company WiseTech Global (-39.4%) said the virus is likely to have a significant effect on the global logistics supply chain, which their software caters to. Second-order effects were also evident in companies like Cochlear (-13.9%), which saw a decline in greater-China sales due to deferral of surgeries involving implants. That's not to say there were no winners from earnings season. Domino's (+1.3%) reported strong expansion in European markets, while Appen (-18.3%) reported strong underlying EBITDA growth, although it too was caught up in the risk-off selling.

Global Equities

Global markets were rocked by the spread of the coronavirus as investors struggled to keep up with the flow of information and price in the potential economic damage. In the United States, the CBOE Volatility Index (VIX), known as the 'fear gauge', spiked to 49.5 points, its highest level since 2009. In an extraordinary move, the Federal Reserve cut the funds rate by 50 basis points – its largest single move since 2008 – sparking a short-lived rally in equities, although selling quickly resumed as investors questioned the efficacy of monetary policy. With all sectors deep in the red, the Communications Services sector (-6.3%) was the best performing, thanks to a bump from T-Mobile (+13.9%) following the approval of its merger with rival Sprint, as well as momentum from Netflix (+7.0%) and a small gain from Twitter (+2.2%) as the stock rebuilds after revenue and earnings misses in October.

The situation in Europe was much the same, with the biggest falls hitting Lufthansa (-15.5%) and Siemens (-16.5%) in Germany and low-cost carrier easyJet (-21.0%) in the UK. In Asia, Japan's Nikkei 225 Index fell 8.8%, while China's CSI 300 Index fell a more modest 1.6% over February on the hopes that authorities will continue to lower financing costs and possibly provide additional support.

Fixed Interest

Fears of significant disruption to global economic growth in the short-term led to investors to move into safe-haven assets including bonds, while policy responses from central banks pushed yields to record lows. The yield on Australian 10-year Treasury bonds fell 13 basis points to 0.82% in February, and in the

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first week of March fell a further 8 points to 0.72%. Its US counterpart fell 36 basis points to 1.15% in February and since the start of 2020 has fallen from 1.92% to 0.91% (as at 5 March), a dramatic drop of 101 basis points.

At an unscheduled meeting, the US Fed made an emergency cut to the funds rate of half a percentage point in anticipation of the economic fallout. Markets recognise that monetary policy alone is limited in what it can achieve in terms of preventing supply-side damage to the economy, but lower rates may help to support sentiment or buy time for governments to determine an appropriate fiscal response. Weak growth and slowing core inflation have seen the yields on 10- year German government bonds fall from -0.19% to - 0.86% since the start of 2020. Most strikingly, Greek 10- year bonds were yielding less than 1.0% in mid-February, down from over 27% in mid-2012 and below that of Italian bonds.

REITs (listed property securities)

Listed property was unable to avoid the pain as fears of the coronavirus hit markets in February, sending the S&P/ASX 200 A-REIT Index down 4.9%. The hardest hit was retail shopping centre group Vicinity Centres (- 15.0%), which cut its guidance in February noting a material decline in foot traffic, most notably at its Chadstone centre. Fellow retail property manager Scentre Group (-10.4%) and integrated manager Mirvac (-10.6%) were also among the worst performers. The real estate sector is where the green shoots of Australia's recovery were most noticeable, as expected following a period of easing monetary policy. House prices in Melbourne are now just 1.2% off the 2017 peak, while Sydney house prices have surged 5.6% in the past three months. Housing finance for owner-occupiers increased by 17.9% over the year, pointing to further improvement in dwelling approvals.

In the US, REITs were down 7.1% in February, with Hotels (arguably the most exposed sector) down 13.8% and Office Property down 10.9%. The start of March saw a bounce-back in domestic-focused and yield-sensitive sectors, although this appears short-lived. Meanwhile, US mortgage rates dipped to historic lows, representing a potentially large natural stimulus to help boost the resurgent housing market.

Alternatives

Preliminary estimates for February indicate that the index decreased by 0.7 per cent (on a monthly average basis) in SDR terms, after increasing by 0.4 per cent in January (revised). The non-rural and base metals subindices decreased in the month, while the rural subindex was flat. In Australian dollar terms, the index increased by 1.5 per cent in February.

Over the past year, the index has decreased by 6.1 per cent in SDR terms, led by lower coal, LNG and alumina prices. The index has decreased by 1.1 per cent in Australian dollar terms.