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Investment Strategy Group
Implications of Covid-19

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The outbreak of coronavirus (COVID-19) continues to dominate markets and our thoughts are with those impacted by this terrible situation. Because there is still much about this virus that is unknown, even by medical experts, the situation, and therefore our view on markets, remains highly fluid. That said, our base case is that the disruption to economic activity, while meaningful, will be temporary and global recession will be avoided. We therefore view any significant market decline as a buying opportunity in time.

Background:

Prior to this tragic development, equity markets had recovered from earlier trade war concerns, which had dominated much of 2019. In addition, this trade war de-escalation occurred at a time when there were increased signs that global economic growth was beginning to stabilise. Investor sentiment increased and corporate profits continued to grow. Strong market performance was justified but it did mean the market was more vulnerable to any potential future bad news (which has unfortunately eventuated).

While unprecedented containment efforts had been successful in limiting the spread of the virus on the Chinese mainland (new cases have fallen meaningfully and there are encouraging signs that activity is beginning to gradually normalise), the sharp rise in cases outside of China is a development that, while not unexpected, was hoped wouldn't occur. It is seeing the market move from pricing what was a large regional shock to one that is now clearly a global one.

Impact of the virus:

The bottom line is that this is a highly uncertain event. No one – even experts on viral outbreaks – can say with any certainty how this outbreak will progress, and therefore it is impossible to gauge the economic impact with any certainty. Government containment efforts may work, an early Northern Hemisphere spring could help limit its spread, or a full-blown pandemic could ensue. A number of scenarios remain possible. That uncertainty obviously justifies some caution on the part of investors. But what is clear is that the economic shock will be large and global growth will be weaker than what was expected only a few weeks ago. Some near-term impact on corporate earnings will be unavoidable.

History is never a perfect guide, but it can provide some steer on the possible path of markets from here. Past viral outbreaks (as with things like natural disasters, etc) suggest that these types of events are usually sharp temporary shocks rather than cycle-ending events. Economic activity may fall sharply, but will likely rapidly rebound once the outbreak stabilises. For this reason (and in line with the view of our research partners), we believe investors should treat this as a temporary (albeit very large) shock. In fact, given the fall in equity markets already seen, some of our research partners have already turned more positive on the market direction from here. We are not ready to say that the worst of the market falls are behind us yet, but we are comforted by the positive reaction of policymakers. They are not sitting still. Chinese officials have announced large stimulus measures, as have other governments in Asia and Europe. We fully expect more stimulus if economic distruption continued (which looks to be the risk). There is also speculation of co-ordinated central bank easing. While monetary policy is not really designed for these types of shocks, and more onus will fall on governments and fiscal policy, at the very least that should help to support market sentiment.

The full impact of Covid-19 remains uncertain, but we don't believe current concerns warrant any major alterations to asset allocation, especially for those investors with a long-term focus. In fact, we are more inclined to view this as a buying opportunity in time in quality based investments that have stood the test of time. Nevertheless, it is clear that volatility will be elevated over the coming weeks and for some investors it may be a healthy reminder to revisit their risk tolerances.

What would shift us to become more concerned about this outbreak having a longer-lasting impact on economies? For us, the key is labour markets. If we start to see widespread job layoffs as firms are forced to respond to cash flow pressures, that would have flow-on implications to spending, confidence and asset prices. This would clearly result in a more damaging and longer-lasting impact on the cycle. We reiterate though, at this stage, we are not expecting this. Furthermore, this is precisely where we see the role of government intervention occurring. We would be surprised if we didn't see governments attempt to ease cash flow strains if those pressures were to eventuate (just like we do in New Zealand when farmers receive government support during droughts).

This unfortunate event has come at a time when we were otherwise reasonably positive on the outlook for economies and markets this year. We will attempt to keep you updated on our thinking as this highly fluid situation evolves.

General Disclaimer

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