Investment Strategy Group
Updated thoughts on Covid-19

12 March 2020

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Earlier this month we outlined our preliminary thoughts on the outbreak of the Covid-19 coronavirus and what it could potentially mean for the global economy and financial markets. At the time, the situation in China was encouragingly looking under better control, in large part due to the unprecedented containment efforts put in place by officials. However, the unfortunate spread of the virus to other parts of the world was a development that was justifiably unnerving financial markets given its highly uncertain nature and the risks it presented to the global economic outlook, and hence corporate earnings. It left us with a cautious position towards markets overall, although our base case was that the most likely outcome would be a short, sharp shock to economic activity, before a relatively rapid recovery.

Since that time, there has unfortunately been a further escalation in the severity of the outbreak globally, with large increases in confirmed cases in Europe, the US and the Middle East. It has now got to the point where the WHO believe it has reached the threshold to be defined as a 'global pandemic'. While in itself that classification has no real significance, it does imply an acknowledgement from officials that containment of the virus has become extremely difficult, although that hasn't stopped some Western countries still putting in place some unprecedented containment measures of their own in an attempt to, at the very least, slow its spread, largely to relieve potential strain on health systems and the ability to treat severe virus symptoms on top of other hospital care requirements. Ultimately, it means that downside scenarios that we hoped wouldn't occur, are becoming more like the reality.

The path of the outbreak remains unclear. Uncertainty is extreme. However, what has become more obvious, even in the space of the past week, is that initial estimates for the disruption to global economic activity were too conservative. The negative shock to economic activity over at least the first part of the year will be considerable, and corporate earnings will naturally experience an unavoidably large hit too. The odds of a global recession have increased significantly.

Yet there are reasons for optimism. Policymakers are now aggressively responding to the crisis. Central banks have eased policy and further monetary policy stimulus is highly likely. Governments are also introducing targeted stimulus measures to assist businesses through the disruption and help avoid meaningful impacts on labour markets. We expect further stimulus measures to be announced in time. Furthermore, from a structural perspective, the global economy was in a reasonable position prior to this crisis, as it doesn't have the same degree of imbalances (whether economic or financial) that it had, say, in 2007/08 that exacerbated the economic downturn and slowed the recovery. This leaves us with the view that once the outbreak stabilises, the economic recovery is likely to be rapid, albeit from a lower activity level than we thought even a week or so ago.

After the sharp falls over recent weeks, global equity markets are now better reflecting the risks to the economic outlook and corporate earnings. As such, the risk-reward from here is far more balanced. Market valuations have arguably returned to levels where for those with a longer-term focus, buying in these markets is likely to generate a positive return over the medium term. That being said, risks are still elevated and skewed to the downside in the short-term, so we still feel it is prudent to tilt the MAS investment portfolios in a more conservative direction by modestly lowering the allocation to global equities and increasing the allocation to cash. We have also been doing this naturally through delaying portfolio rebalancing after recent market moves.

We would emphasise the need to stay invested though. Just as this correction in equity markets has been extremely rapid, it is quite likely that the recovery is equally as rapid once conditions stabilise. Picking the timing of that recovery is likely to be tricky, and there won't be a number of signals that all line up to provide a nice clear 'buy' signal. Instead, it is far more likely that our progress to shifting more confident in the outlook will be incremental. Judgement will still be required.

So, what are the signposts we are looking for to shift more positive?

Putting aside the scenario where the virus outbreak does somehow slow, either through natural means (perhaps warmer weather in the Northern Hemisphere) or successful containment or treatment efforts, we are focused on four broad signals:

1) Market positioning and sentiment: We actually think this can be ticked off already, as a number of technical gauges suggest markets have shifted from elevated levels of optimism in January following the nascent recovery in global growth and de-escalation in the US-China trade war, to one where there is now elevated levels of pessimism. As mentioned, for investors with a longer-term focus, and perhaps higher tolerance for risk, signals such as this suggest that buying in this

market will likely generate positive returns over the medium-term (although it doesn't rule out further falls in the near-term).

2) The policy response: How bold is it? Are stimulus measures going to be large enough and targeted enough to avoid meaningful impacts on labour markets? Can firms continue to retain staff through what will no doubt be a tough period for cash-flow? We think we are heading in the right direction. There have been some significant announcements in some parts of the world already. However, so far, the response from the US has been lacklustre and unclear. Broader Europe also raises some questions given the likely need to co-ordinate and an inherent bias towards fiscal discipline. It may ultimately take a shock and awe approach to finally appease markets in a kind of "we will do whatever it takes" type approach to break the negative feedback loop for markets, and we don't think we are there yet.

3) Limited signs of financial contagion: This relates to credit markets and whether the likely increase in corporate defaults (exacerbated by the plunge in oil prices for the oil and gas sector) results in a tightening in credit conditions even for credit-worthy firms. We don't expect this but will be watching survey data to confirm.

4) A less-bad economic situation: Markets do a good job at pre-empting economic recoveries. But before they can do that, they need comfort that things aren't getting worse. And unfortunately, the economic news will get worse over the coming months. PMI surveys in China have already fallen sharply, and data from other countries will follow suit. But once timely gauges of activity, like PMI surveys, stabilised during the GFC (i.e. stopped falling) this proved to be a great signal for a sustained rally in equity markets over 2009. It also worked incredibly well over 2019, when global PMIs troughed around August. They certainly don't have to rise into positive territory, just a stabilisation is typically a firm buy signal.

Clearly, recent developments are troublesome as downside risks to this outbreak that we hoped would not occur have started to come to fruition. However, we have little doubt that the crisis will come to an end at some point and while caution on the part of investors is still justified right now, we are looking at ways to position the MAS portfolios for the recovery in economic activity and markets when it does eventuate. Ultimately, in time this will present a strong opportunity to buy some quality investments that have stood the test of time at more attractive valuations.

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