Investment Strategy Group
Updated thoughts on COVID-19

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With New Zealand having some clear success in its battle with COVID-19, and daily life now in the process of returning to some form of normality as a result (which we of course hope continues), it is perhaps a useful time to ask whether financial markets – after an incredibly volatile and dramatic past two months – are moving back towards more normality as well. In our update last month, we highlighted some of the reasons why global equity markets had bounced powerfully off their lows, despite being in the midst of one of the largest shocks in economic history. Since then, the magnitude of daily market moves has settled somewhat, and so one could argue that things are a little more "normal". Actions by the US Federal Reserve and other central banks to support market functioning has assisted with that. Yet with the S&P 500 in the US now just ~12% from its all-time high and the New Zealand equity market is just ~11% below its highs, despite numerous and significant uncertainties with the economic outlook remaining, our focus has not dimmed.

Right now, investors seem happy to look through much of the economic and corporate earnings pain that will be evident this year and instead focus on what the potential recovery could look like. We have stated previously that this COVID-19 crisis is a highly unusual shock for the global economy, and perhaps this investor behaviour of looking further into the future is another element that sets this crisis apart from others. In contrast to the GFC, when at the time it was quite difficult to determine how and when it would end (because the source of the pain was actually something internally 'wrong' with the economy itself), this crisis has a definitive ending – it is when the virus goes away (either by itself or because there is a medical solution). Of course, we don't know when that will be, but because policymaker action has been aggressive at providing support (reducing near-term corporate liquidity risk), and the rate of new global infections of the virus has slowed, investors seem comfortable not waiting around for confirmation of a resolution to this medical problem expecting that it is inevitable.

In this regard, we believe we have shifted into a new phase in the COVID-19 crisis, or at least a new phase in how we are interpreting financial markets. That is; assessing what type of recovery scenario markets have now priced and whether that is realistic or not. As we mentioned in our update last month, given where equity markets have risen to and where market valuations now reside, it is our belief that they are priced for a reasonably speedy recovery in economic activity and earnings over the next 12 to 18 months. It is this judgement, and our assessment of the likelihood of alternative scenarios around that, that helps inform our decisions on how the MAS Funds should be positioned going forward, both in a near-term context (i.e. the next few months), but also longer-term.

The speedy recovery scenario that we feel markets have priced is one that is possible. Certainly, if there was a medical breakthrough that enabled authorities to continue to ease lockdown restrictions without the fear of new infections overwhelming health systems, that would significantly increase the likelihood of economic activity returning to normal reasonably quickly. Indeed, the amount of work being done by the global scientific community offers faith that a breakthrough will eventually be made. According to the Milken Institute, there are currently 216 treatments in consideration and 133 vaccine candidates in development for COVID-19, and there have been some encouraging early results. Research on serology testing and the use of technology for contact tracing has also been impressive. It is possible that this 'breakthrough' (perhaps more than one) is only a few months away.

Yet there are also plausible scenarios where the economic recovery proves disappointing. One major risk, without an effective and scalable medical treatment yet, would be the emergence of second waves of the virus as lockdown measures are eased. Not only would that likely force authorities to respond by reintroducing containment measures, therefore delaying the economic recovery, but it could also have a detrimental, and perhaps more permanent, impact on consumer behaviour. Certainly, there have been recent flare-ups of the virus in places like Singapore, China, South Korea and Germany, although admittedly small, and thankfully strong contract tracing frameworks have allowed authorities to get on top of these outbreaks relatively easily. However, that may not be the case in other parts of the world.

Another risk we are increasingly mindful of is the global political backdrop. Whether it is increasing tensions between China and a number of western nations (the US especially), the fact that the Brexit process is becoming complicated again by some fast-approaching timelines, or the upcoming US elections, where the odds of the Democrats sweeping the three levels of government have increased given the damage evident in the US labour market (and therefore bringing things like higher corporate taxes back on the agenda), there are some clear market-relevant risks evident.

Ultimately, given that there remain several plausible scenarios for how the next 12 months could play out, we don't feel that it is a backdrop to make dramatic asset allocation decisions right now. Certainly, what the powerful rally in equities over late March and April reminds investors is that in this type of unusual and fast-moving crisis, with the amount of policy stimulus provided by governments and central banks, and prospects for a medical breakthrough, moving to the side-lines in an attempt to time markets is a very risky strategy.

Admittedly, we have maintained an equity exposure in the MAS Funds that is modestly below where our strategic target asset allocation would imply, and we are comfortable with that position. While the recovery scenario that we believe markets have now priced in is a plausible one, and we are very mindful of the upside potential of a clear medical breakthrough, with equity valuations back at elevated levels, there is less room for error. And with setbacks on the path to recovery quite possible, we feel that equity market volatility is likely to persist. Our intention is to use that volatility, and more attractive entry points specifically, to increase equity exposures back to target in time.

That said, within portfolios, and as mentioned last month, our overall cautious stance has not stopped us from actively seeking out strong opportunities when they have presented themselves. Over recent weeks we have continued to build larger positions in solid companies that we believe will benefit once the economic recovery does take hold. This disciplined approach is something we will continue to take over the coming weeks and months.

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