Strategic Wealth Market Update

strategicwealth

1st May 2020

COVID-19 Outbreak Update
Strategic Wealth Investment Committee

Market Update & Webinar Reminder: May 5th 2020

The Strategic Wealth Investment Committee met earlier this week to discuss the current market environment and the implications for the Strategic Wealth Lifestage Portfolios. The committee which is advised by one of Australia's leading investment consultancy group (JANA Investment Advisers), noted that the outlook for the markets and the economy remains highly uncertain. Despite the recent recovery of the sharemarket, the committee remains of the view that the economic news and company earnings outlook over the coming months are likely to be disappointing.

In the absence of a breakthrough on the medical front, the market may react negatively to news and we may see a further downturn in markets over the short term. Further, the recovery, when it comes, is unlikely to be a sharp uplift or a V shape as often mentioned in the media – we expect that it will take time for the economy to get back to the pre-COVID -19 type levels.

Based on this assessment, we are maintaining our current moderate underweight position to growth assets such as shares in our Strategic Wealth Lifestage Portfolios. We are of the opinion that there will be opportunities to increase our exposure to growth assets over the coming months. Every client's situation is different and please call us if you would like to discuss the implications for your specific circumstances.

I have attached a detailed report on the current market situation for your reading. It is a technical document, but one which provides a comprehensive review of the important issues.

As previously advised, the second of our Investment Webinars will be held on Tuesday, May 5th, 2020 at 3.00pm (Melbourne time). Our guest speakers will be:

- Michael Karagianis: JANA Investment Advisers
- Simon Doyle: Schroders Investment Management (Australia)

Michael will provide us with an update on the current COVID-19 crisis including the impacts on the global economy and investment markets. Simon will focus on the key issue of where we are in the downturn and when may be the right time to increase exposure to growth assets including Australian and International equities. I highly recommend that you participate in the Webinar to gain a better understanding of the issues and challenges ahead of us.

Please do not hesitate to call us if you have any questions about the Webinar or about your personal circumstances.

Take care and stay well.

Kind regards,

Peter Wilson CFP®, Dip FP, B.Sc
CEO & Principal Adviser
Strategic Wealth Pty Ltd
Authorised Representatives
Oreana Financial Services
Australian Financial Services Licensee

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The COVID-19 Pandemic is first and foremost a human health crisis with tragic personal consequences. It also represents a massive exogenous shock which has dramatically transformed the near term global economic and market backdrop. The impact of COVID-19 across markets has been already been significant as investors anticipate a global recession.

This has resulted in a significant tightening of global financial conditions (lower equity prices, higher corporate borrowing costs, investor risk aversion) which presents an additional pressure on economic activity as the global economy enters a deep recession. The IMF projects that advanced economies will experience a dramatic 6% contraction in GDP in 2020. This would be the largest annual GDP contraction in developed economies since the 1930s depression.

Uncertainty about the path of the pandemic and the depth and duration of the growth shock looks likely to be sustained for some time. The most immediate uncertainty relates to the evolution of pandemic management approaches and the decisions of policymakers balancing complex health related risks against the financial cost of economic shutdowns.

Even if the pandemic risk does recede in the near term and notwithstanding the already immense policy response, we believe this economic downturn is unlikely to pass quickly and will be damaging for many businesses and households. Given the degree of short to medium term uncertainty and the unusually wide distribution of plausible medium term economic and market outcomes, investors face more difficult choices in balancing portfolio risk and return than was the case before COVID-19.

As an update to our earlier report dated February 25, 2020, the following report has been released today by the Strategic Wealth Investment Committee. We will continue to monitor the situation and keep you apprised of major developments.

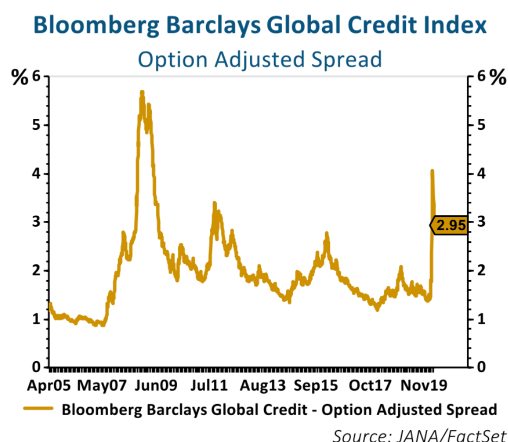
1. An exogenous shock and a rush for liquidity

The COVID-19 Pandemic is first and foremost a human health crisis with tragic personal consequences. It also represents a massive exogenous shock which has dramatically transformed the near term global economic and market backdrop.

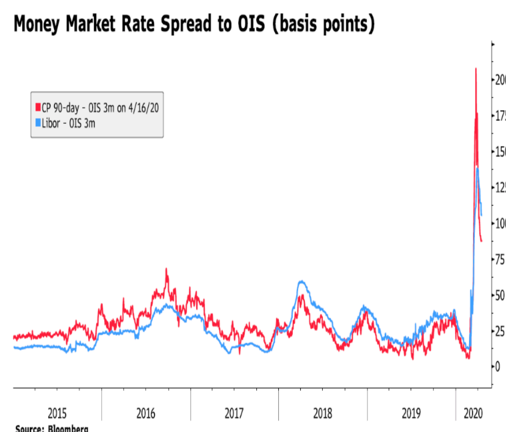
The economic shock is all the more unique because it is partly the result of government policy choices aimed at containing the pandemic spread.

The impact of COVID-19 across markets has already been significant as investors anticipate an imminent global recession. The sharp falls in risk asset prices during late February and March were amplified by significant stress in global funding markets as the demand for liquidity sharply increased while financial intermediaries reduced risk and the supply of liquidity needed to support the flow of funds across the global financial system dried up.

The chart on the right below shows the sharp spike in cost above the risk-free rate incurred by banks (Libor – OIS) and large corporates (CP – OIS) for short term borrowing during March. The liquidity strains quickly flowed through to the pricing of investment risk and led to forced selling by some investors to meet liquidity and margin collateral needs as markets fell. The quite extreme government bond rally, USD spike and equity and credit markets collapse were in part the result of a massive surge in investor demand for liquidity that markets were unable to deliver without a big shift in pricing.



Source: JANA/FactSet



Source: Bloomberg

The partial recovery in risk asset pricing over recent weeks is mostly due to the US Fed's easing of stress in key funding markets with targeted support programs and a liquidity injection that dwarfs what it delivered in the GFC. Investors have also been encouraged by decisive fiscal action which offers hope that the fallout from global economic shutdowns can be contained.

However, the threat to economic cashflows lies ahead. The early impact of COVID-19 on markets has resulted in a significant tightening of global financial conditions (lower equity prices, higher corporate borrowing costs, investor risk aversion) and represents an additional pressure on economic activity as the global economy enters a deep recession.

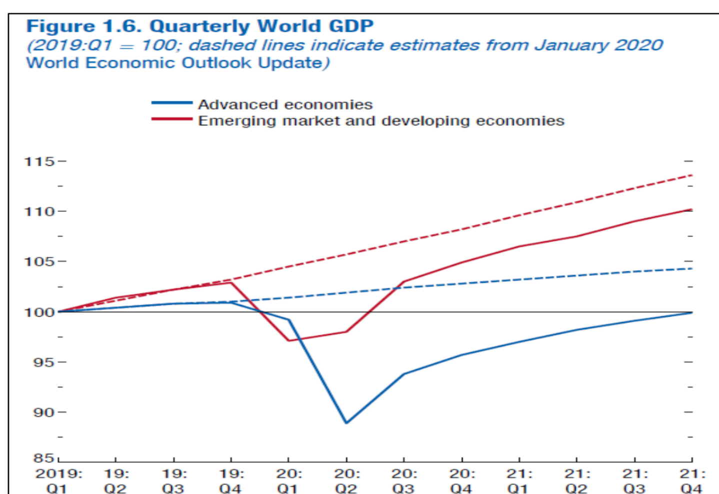
2. The policy response – plugging the gap in economic cashflows

Massive policy easing and direct intervention in markets by the Fed and other central banks has eased the immediate liquidity stress but the impact of an expected deep decline in global economic activity looks likely to overhang markets for the next year at least.

The biggest questions for medium term focussed investors are: ''How deep and how sustained will the economic downturn be? and what will be the impact on investment cashflows?" On both counts, the outlook is unusually uncertain.

Global policymakers are acting aggressively to limit the expected economic damage. Central banks are flooding the financial system with cheap liquidity via massive asset purchase programs and targeted support actions in critical areas such as corporate credit while fiscal caution has been cast aside with similarly massive government stimulus in many countries. Fiscal programs in major economies are especially targeted at businesses and households with cash transfers and loans aimed at dampening the shock to cashflows and providing a 'bridge' across the downturn. The scale of announced fiscal programs varies across economies, but in economies including Australia and the US the expected deficits are the biggest since World War 2.

Notwithstanding its scale, the sum of this support is not expected to prevent a deep global recession during 2020. The chart below shows the IMF's most recent (early April) projections for global GDP over the next 2 years (solid lines) and highlights the precipitous deterioration in outlook since the pre-COVID-19 IMF projections were issued in January (dashed lines). The IMF projects that advanced economies will experience a dramatic 6% contraction in GDP in 2020. This would be the largest annual GDP contraction in developed economies since the 1930s depression (2020 projections see a 6.7% GDP contraction for Australia and a 1% contraction for the faster growing emerging economies). It is also notable that the IMF expects the global recovery to take some time with developed economy GDP not expected to return to pre-COVID levels before 2022.



Source: IMF

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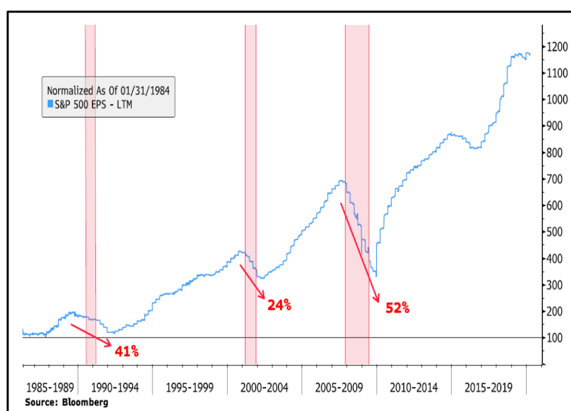
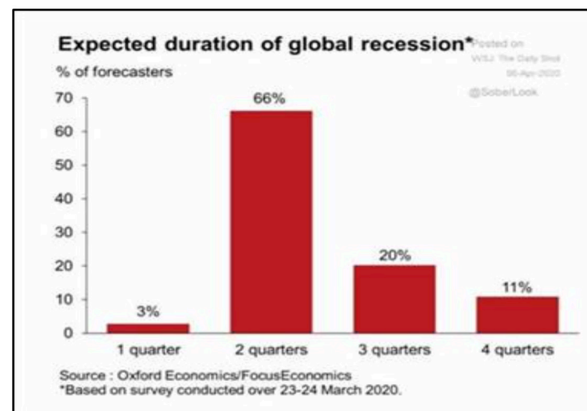
The projected deep recession represents a damaging threat to the cashflows of households and businesses. For businesses, the impact of the hit to headline cashflows on bottom line profits will be magnified by financial and operational leverage. As investors, we face a formidable challenge in assessing the potential impact of the COVID-19 pandemic and containment measures on investment cashflows and the extent to which the aggressive policy support can cushion that impact until global growth recovers.

With no modern precedent for a global pandemic accompanied by an immediate and deep global recession which is partly the result of global policy decisions of unknown duration, the challenge is readily apparent – we just need to work with what information and historical references we have.

Turning our attention to listed equities, market history tells us something about the sensitivity of corporate earnings to economic downturns. The chart on the left below highlights peak to trough earnings per share (EPS) declines for the S&P 500 co-incident with US recessions since the 1980s. These numbers and longer-term data for the US roughly point to EPS declines averaging around 20% - 25% in recessions with the EPS recovery to pre-recession levels taking around three years. For deeper and longer lasting recessions, the historical data shows EPS declines of 50% or more with recovery taking five years or longer.

Our challenge however, is that the COVID-19 recession will probably not look like any of these precedents – it is partly the result of policy choice, it is immediate and global, it is expected to be short and its economic impact is expected be cushioned by aggressive monetary and fiscal policy support which aims to provide a ‘bridge’ to the ‘other side’ when crisis policy settings can and will be wound back.

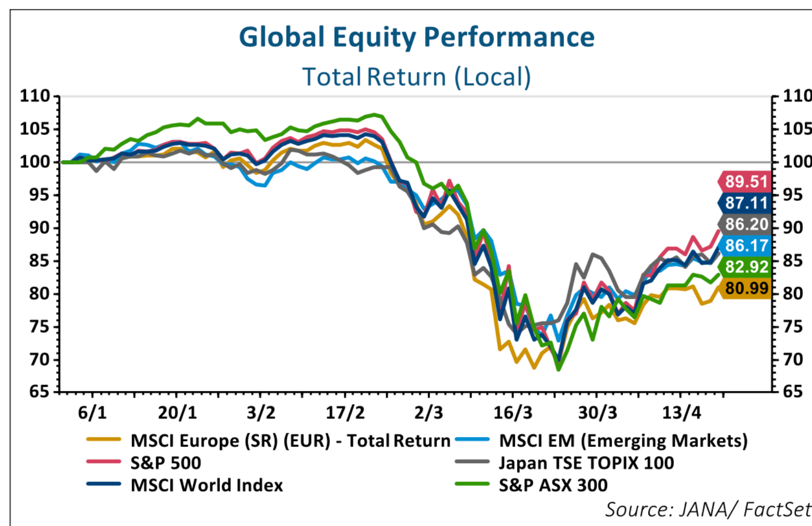




Forward- looking global EPS estimates for 2020 we see from market strategists currently fall in a very wide range from around minus 20% to minus 50%. There does however appear to be greater consensus when it comes to expectations of the duration of the economic and earnings downturn which an overwhelming majority of economic forecasters recently surveyed by Oxford Economics/ Focus Economics expect to have passed by the end of 2020, as shown in the right chart above.

These ranges are confirmation of what we know, which is that the world is experiencing a unique exogenous shock and with no precedent to guide reasonable expectations and for those reasons, ‘risk’ is harder to measure and ‘uncertainty’ about the range of possible outcomes is greater.

Over recent weeks, investors appear to have taken heart from the easing in global funding market stress, the aggressive monetary response including unlimited QE from the US Fed and the scale of fiscal support in key economies including the US, the most comprehensive and farsighted of which look out around six months. With returns across major listed equity markets down between 10% and 20% year to date (chart below), investors currently appear to be discounting a relatively shorter term hit to corporate cashflows which is towards the lower end of the range discussed above.



3. Uncertainty is high and likely to remain there

There is significant uncertainty about the depth and duration of the nascent global growth shock which in turn will depend on the trajectory of the pandemic, the efficacy of containment measures and the success of policy in sustaining the potential for economies to rebound.

The most immediate uncertainty relates to the evolution of pandemic management approaches and the decisions of policymakers balancing complex health related risks against the financial cost of economic shutdowns. An Imperial College London study titled 'Impact of non-pharmaceutical interventions (NPIs) to reduce COVID-19 mortality and healthcare demand' has been particularly influential on the adoption of virus suppression and economic shutdown measures in the UK and several other countries.

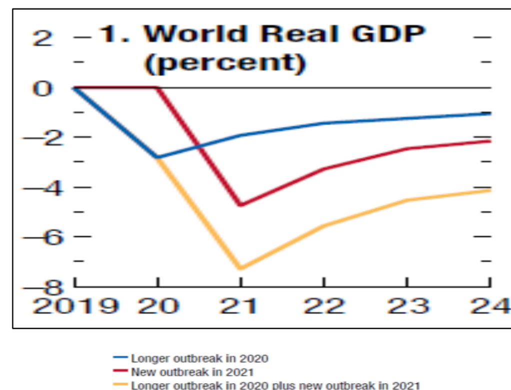
Crucially, that study also notes that suppression measures effectively limit the acquisition of 'herd immunity' and to keep death rates low suppression measures would "need to be maintained until a vaccine becomes available (potentially 18 months or more) – given that we predict transmission will quickly rebound if interventions are relaxed".

We note that tensions related to these policy trade-offs are already visible in many countries including the US and are likely to grow. Long term suppression will not be viewed as a feasible policy option in many countries and so we are likely to see virus containment measures diverge and evolve in different economies over time. For example, as infection numbers fall it may become more feasible to adopt intensive testing, contact tracing and quarantine measures similar to the strategies being employed in South Korea today.

The bottom line is that we cannot know how the trajectory of the pandemic will evolve, although there already appears to be a solid basis for caution about the prospects for an early return to 'normal' for the global economy.

The IMF notes the extent of uncertainty and downside risks for the global growth outlook associated with alternative paths for the pandemic and policy choices. The chart below compares projected global growth outcomes for alternative/longer pandemic scenarios relative to the IMF's baseline projection for the dramatic expected contraction in GDP in 2020 shown in section 1 above.

These scenarios highlight the risk of a more extreme, and long lasting global economic downturn if the impact of the COVID -19 pandemic is more enduring than assumed in the baseline IMF forecast. (The IMF's baseline scenario assumes that the pandemic will fade in the second half of 2020, allowing for a gradual lifting of containment measures and gradual normalisation in economic activity. The first alternative scenario shown below estimates pandemic containment taking roughly 50 percent longer than assumed in the baseline. The second alternative considers the impact of a second, but milder, outbreak occurring in 2021. The third alternative estimates the potential impact of both the outbreak taking longer to contain in 2020 and a second outbreak occurring in 2021.)



One key aspect of the COVID – 19 recession that is unique is that each of these more extreme pandemic related downside scenarios for global growth are plausible even though their probabilities are unknown. Any additional downside pressures on global growth would prove particularly difficult to manage given the already stretched position of policy.

Even if the pandemic risk does recede in the near term and notwithstanding the already immense policy response, we believe the downturn the global economy is just entering is unlikely to pass quickly or without residual damage.

- There will be gaps in cashflows in all global economies/sectors that will not/cannot be plugged by policy. We expect many businesses and households will come out the other side more indebted;
- The capacity of monetary and fiscal policy is constrained in some regions and could struggle to manage the extent of economic disruption (the Eurozone and in many emerging economies);
- The pandemic has the potential to overwhelm healthcare infrastructure and cause significant and extended economic disruption in some emerging regions;
- Some more leveraged and cyclically exposed industries and individual businesses (airlines, tourism, hospitality and energy, amongst others) will need to raise capital, cut dividends and implement spending cuts while many others may not survive an extended gap in cashflow.

Global economic cashflows look likely to be compromised for well beyond six months and a synchronised 'V'-shaped global recovery looks highly improbable. Such a dramatic downturn in global activity and economic cashflows will also have second order impacts that are impossible to predict but will begin to ripple through economies over the year ahead.

We expect investor uncertainty to remain elevated and potentially increase over the next 6 – 12 months unless the virus threat quickly burns out.

4. The 'other side' doesn't look the same

Just as personal crises often act as catalysts for change, there is no shortage of evidence in historical literature that economic crises and pandemics have been powerful in changing behaviours. The longer the COVID-19 crisis overhangs society and the global economy, the more enduring its impact is likely to be. From a behavioural perspective, the immediate and widespread threat to cashflows presented by shutdowns is likely to lead to lower confidence, safety preferences and more precautionary behaviour (such as higher savings) for both households and corporates.

Looking more broadly at longer term trends, the vulnerability of global supply chains has been laid bare by the COVID-19 shock and so deglobalisation pressures may well be reinforced. The economic impact of COVID – 19 will disproportionately impact the marginalised, the low paid and casualised workers and will reinforce inequality as a threat to the wellbeing of millions and the risk of populism as a threat to future political stability.

It is important to note that these are the same forces that have already proved disruptive to markets and have periodically raised investor risk aversion over recent years.

Finally, the potential longer term economic and market impact of the current crisis cannot be assessed independently of the global economic pre-conditions of low potential growth rates, low inflation, high global debt levels and interest rates at or close to zero across the developed world.

Looking forward we see:

- Developed world central banks that are 'all in' on sustaining the global expansion and now have very limited bandwidth to stimulate future growth;
- With monetary policy scope more limited, fiscal policy will become a more important moderator of economic cycles;
- Coordinated fiscal and monetary policy actions look more likely in the US and elsewhere as fiscal deficit spending needs to be maintained;
- Greater inflationary risks, caused for example by the disruptions to the supply of goods, or stronger wage growth and a rise in input prices, which could result during a post-COVID-19 rebound in economic activity.

In short, the economic backdrop looks different for the duration of the crisis and possibly longer.

Given the degree of short to medium term uncertainty and the unusually wide distribution of feasible medium and longer economic and market outcomes, we believe investors now face even more difficult choices in balancing portfolio risk and return than was the case before COVID-19.

5. Strategy

The COVID-19 pandemic has already delivered a health crisis, a sharp correction in markets and the prospect of a deep global economic downturn. We believe that economic and market risks will remain elevated over the short to medium term. At current prices we believe it remains appropriate to maintain a cautious stance in portfolios.

As outlined in this Note, we are particularly cautious about the fundamental outlook and believe there will be opportunity to reduce our recommended underweight listed equity position in the period ahead, but it might take time. Specifically, our preference is for a moderate underweight equity exposure to Australian equities.

Foreign currency has provided a valuable hedge for portfolios over the March quarter. We continue to see the potential for foreign currency to provide a risk hedge in portfolios and an overweight exposure is preferred at this time.

Finally, a well-diversified portfolio with a sufficient allocation to cash or other liquid assets is appropriate where the level of medium-term uncertainty is elevated.

General Advice Warning

This advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial and tax/or legal advice prior to acting on this information.