MARKET PERFORMANCE AND ECONOMIC COMMENTARY – MARCH 2020

MARKET PERFORMANCE

Financial market behaviour over the past year is summarised in the table below:

Index	1 Month %	3 Months %	1 Year %
Global Equities			
MSCI Emerging Markets	-13.0	-19.1	-13.0
S&P 500 (US)	-12.5	-20.0	-8.8
Nikkei 225 (Japan)	-10.5	-20.0	-10.8
FTSE 100 (UK)	-13.8	-24.8	-22.1
DAX (Germany)	-16.4	-25.0	-13.8
CAC 40 (France)	-17.2	-26.5	-17.8
Trans-Tasman Equities			
S&P/NZX 50	-13.0	-14.8	-0.5
S&P/ASX 300	-20.8	-23.4	-14.5
Bonds			
S&P/NZX NZ Government Stock	-0.1	3.5	5.3
S&P/NZX A Grade Corporate Bonds	-0.7	1.3	4.2
Barclays Global Aggregate Bonds (Hedged to NZD)	-1.7	1.4	6.0
FTSE World Government Bonds (Hedged to NZD)	0.0	4.0	8.5
Oil			
West Texas Intermediate Crude Oil	-54.2	-66.5	-65.9
Brent Crude Oil	-57.1	-67.7	-68.2
NZD Foreign Exchange			
AUD	0.7	0.9	0.9
EUR	-4.3	-10.1	-11.0
GBP	-1.5	-6.1	-8.6
JPY	-4.3	-12.7	-15.2
CNY	-3.1	-10.6	-8.3
USD	-4.4	-12.1	-13.1

Source: Nikko Asset Management

We make the following key observations:

- Red ink across the board for equity markets, though notably the NZ market was only down 0.5% over the year ending 31 March.
- No escape from the sell-off, bond markets saw negative returns as investors rushed for cash liquidity.
- Immense fall in oil prices through February and March, down to 18-year lows.
- A rise of the NZD against the AUD due to the lower oil price having a more detrimental impact on Australia's economy via the energy sector.

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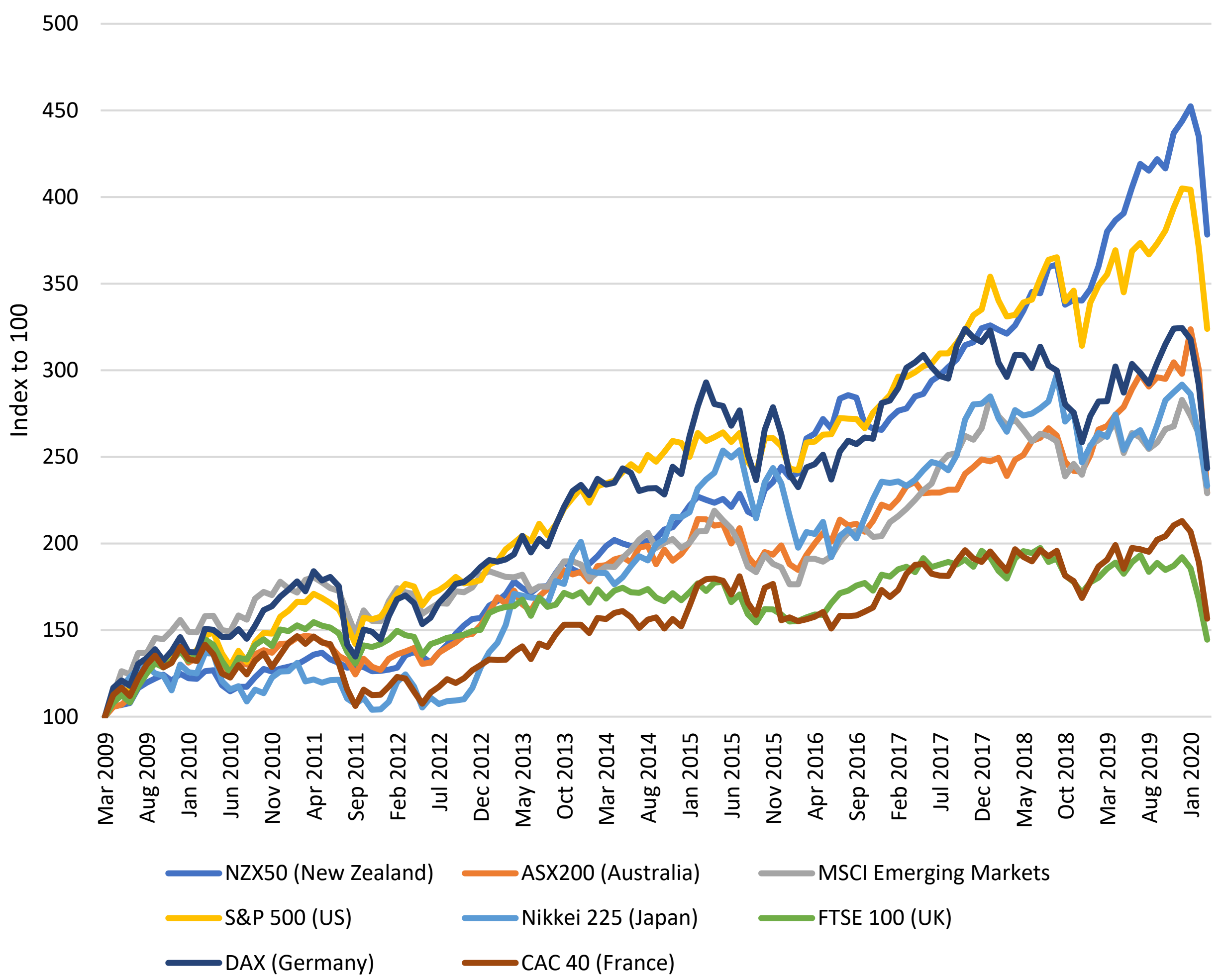
ECONOMIC COMMENTARY

What has happened so far?

The equity market bull run finally came to an end in February/March 2020. The run lasted almost eleven years, the longest in history (see Figure 1).

Figure 1: Equity Market Bull Run (March 2009 – March 2020)

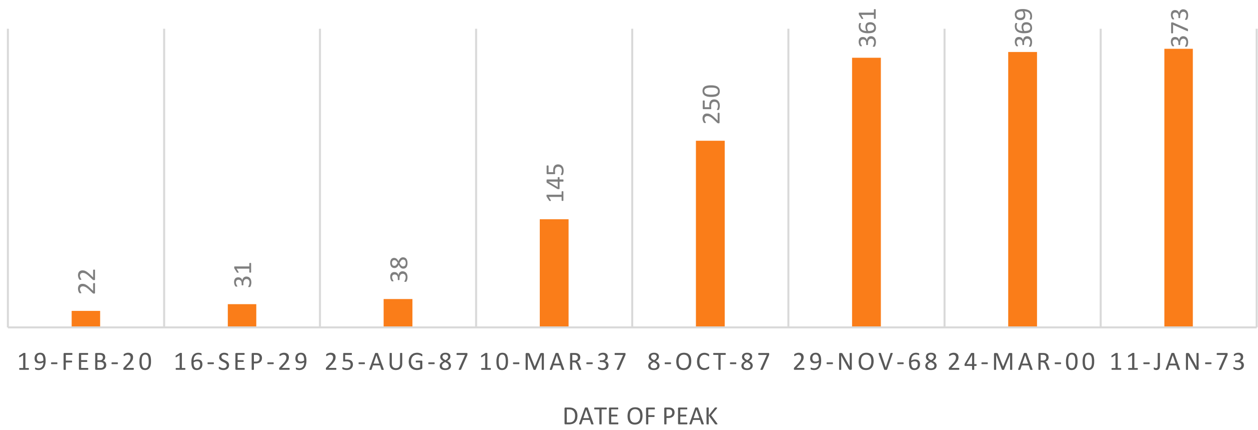


Through 2019 the market had become used to central banks suppressing any volatility in markets. Bad economic news was good news for markets as it meant central banks would reduce interest rates, thus providing valuation support to stocks. Markets continued to rise, though earnings were not able to keep up. The higher price-to-earnings multiples meant that equities naturally had further to fall and became more vulnerable to any kind of shock.

The shock that triggered the fall in equity markets was partly a supply shock in the oil market. The disagreement between Russia and Saudi Arabia on how much oil to supply meant the price fell steeply in mid-February. This became a twin shock as continuing concerns over Covid-19 meant a global shutdown would reduce the demand for oil. Prices in March fell to $20 per barrel, an 18-year low. The break-even price for many producers in the US is around $40-50, so many are in danger of shutting down if the price stays around this level.

However, the key concerns for market participants through March were how severe the virus would be and how long it would last. Liquidity in markets became extremely tight and equity markets crashed as indiscriminate selling ensued due to investors demanding liquid cash. From the date of its peak in February, the S&P 500 equity market index fell 30% in just 22 days. The quickest fall in history.

Figure 2: S&P 500 – Number of days to fall 30% from Peak



Source: Schroders, Morgan Stanley

Indiscriminate selling in credit markets was also evident with spreads widening significantly as liquidity dried up. The market did not differentiate between issuers. The following graphs illustrate the stress on money markets (Figure 3) and investment grade debt (Figure 4) at present by showing a steep spike on the far right of the graphs. Though not as high as during GFC, the graphs show it is the most disruption credit markets have seen in the past ten years. A rise in the spread indicates that investors think there is a higher chance of default, so will demand a higher rate of return on the riskier asset (e.g. 3-month LIBOR in Figure 3), or alternatively accept a lower return on the safer asset (e.g. 3-month Treasury Bill in Figure 3).

Figure 3: TED Spread (3-Month LIBOR minus 3-Month Treasury Bill)

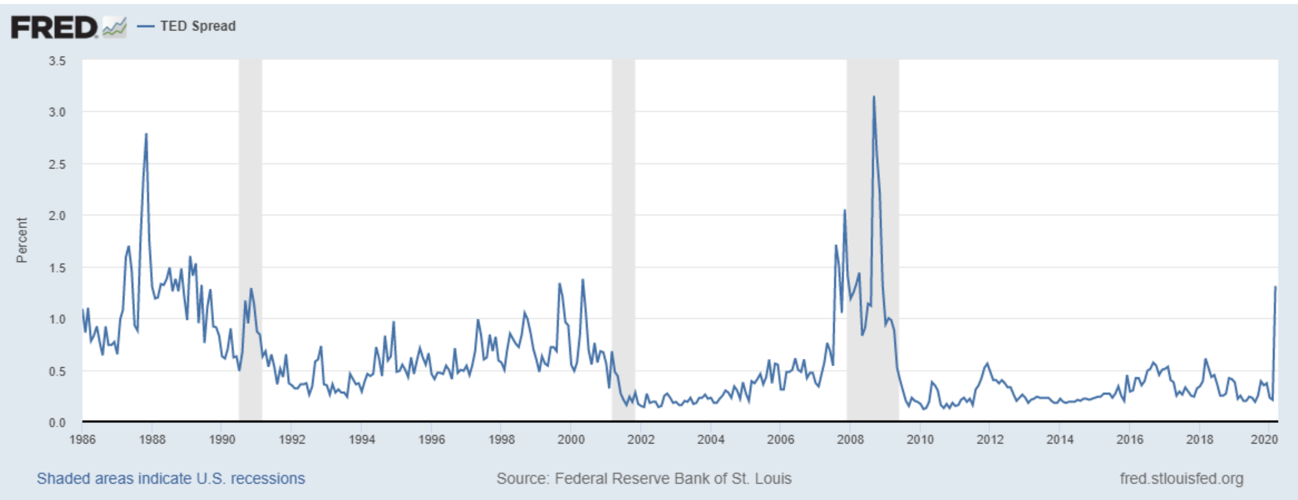
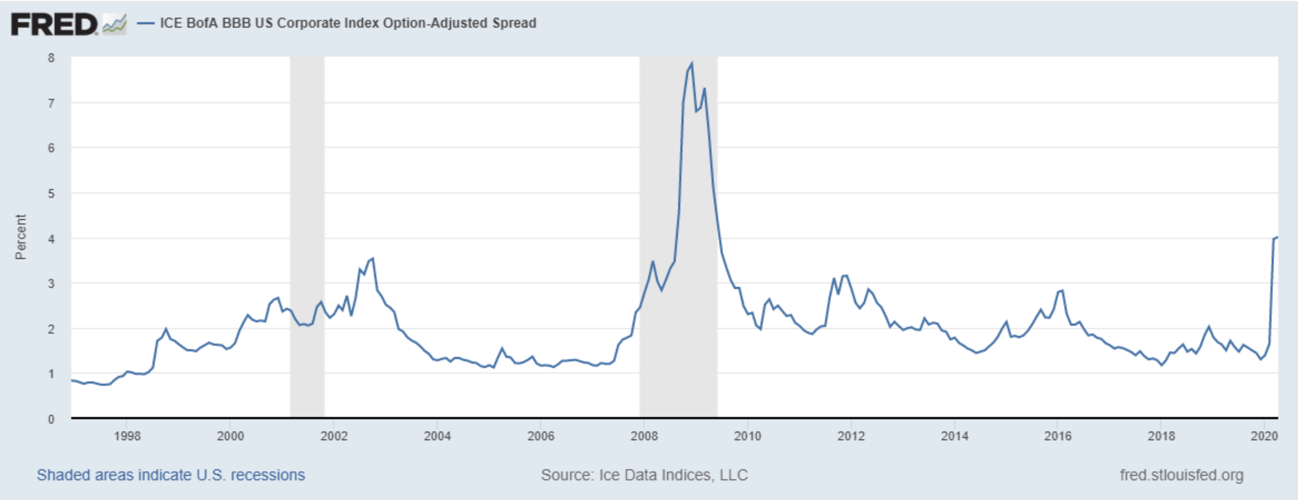


Figure 4: Option-Adjusted Spread of the ICE BofAML US Corporate BBB Index



Of some comfort should be the relatively well capitalised banks this time around. Banks should be part of the solution rather than the problem. Action taken by central banks around the world to inject liquidity helped reduce friction in markets through March. The actions taken to-date have been unprecedented in many economies. For example, in the US the QE asset purchases in late March were up to US$75 billion per day. Rewind back to 2013 and the amount of purchases were US$85 per month. Though, how effective monetary stimulus is to the real economy with interest rates already at low levels has been a risk for some time; so there is a greater need for extraordinary levels of fiscal stimulus to bridge the 'gap' and keep the economy going.

A summary of cash rate cuts and fiscal stimulus as a percentage of GDP is shown in Figures 5 and 6.

Figure 5: Covid-19 Cash Rate Cuts

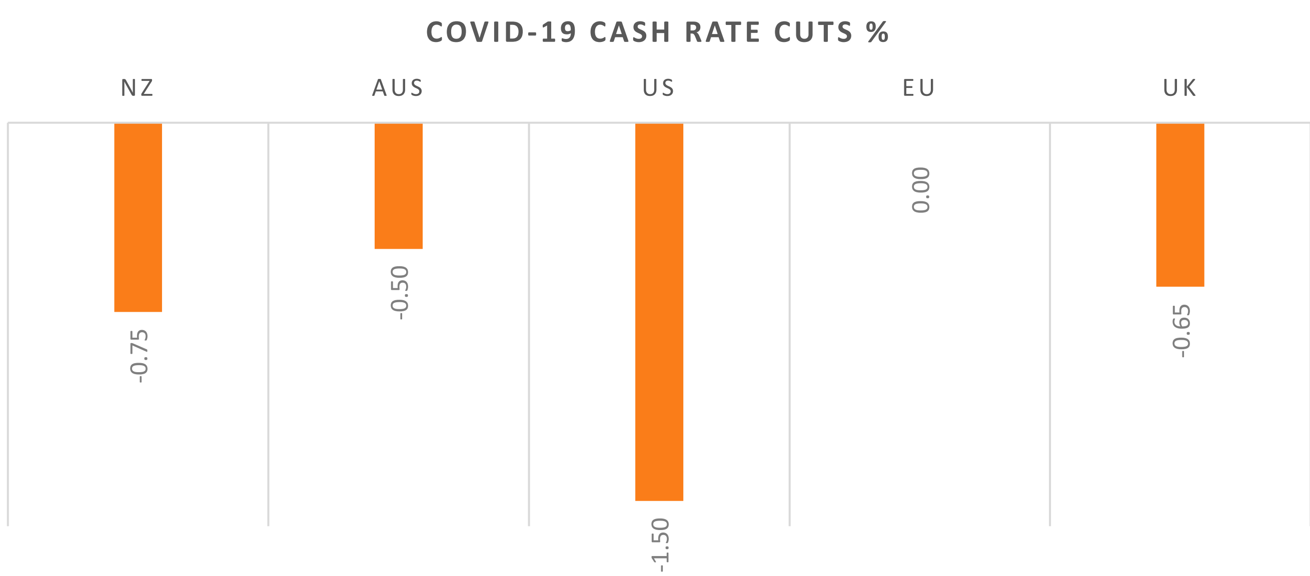
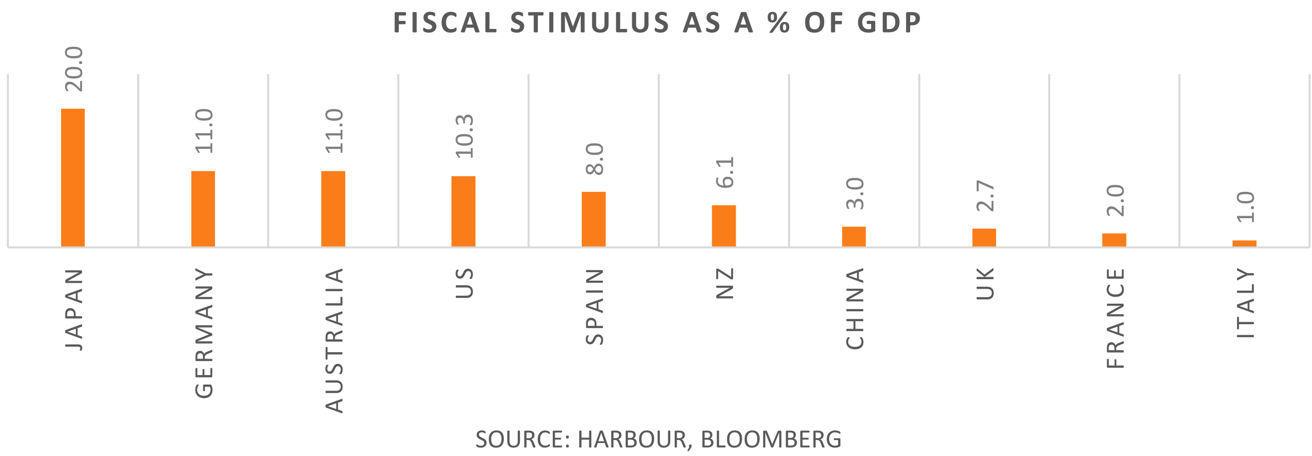
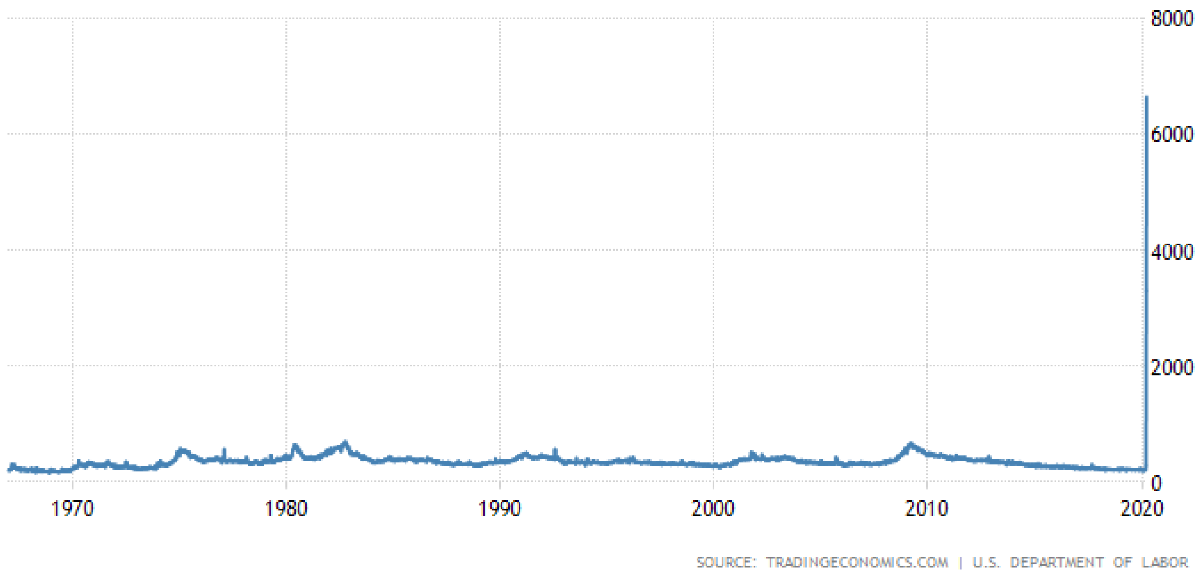


Figure 6: Fiscal Stimulus (as at early April)



Economic measures released so far show a severe drop off in jobs and economic activity already. For example, the Purchasing Managers' Index for the service sector in the US fell to 39.1 (a level above 50 indicates economic expansion), this was the steepest decline since October 2009. US initial jobless claims (a weekly measure) sky-rocketed to over 3 million in mid-March then 6 million at the end of March (Figure 7). The highest level seen up until this point was just under 700 thousand.

Figure 7: US Initial Jobless Claims



<u>Where to from here?</u>

There are three broad actions needed for people, the economy and the market to recover:

1. Beat the COVID-19 virus.
2. Effective monetary stimulus.
3. Effective fiscal stimulus.

First and foremost is focusing on people's health and the ability for different countries to fight off the bug.

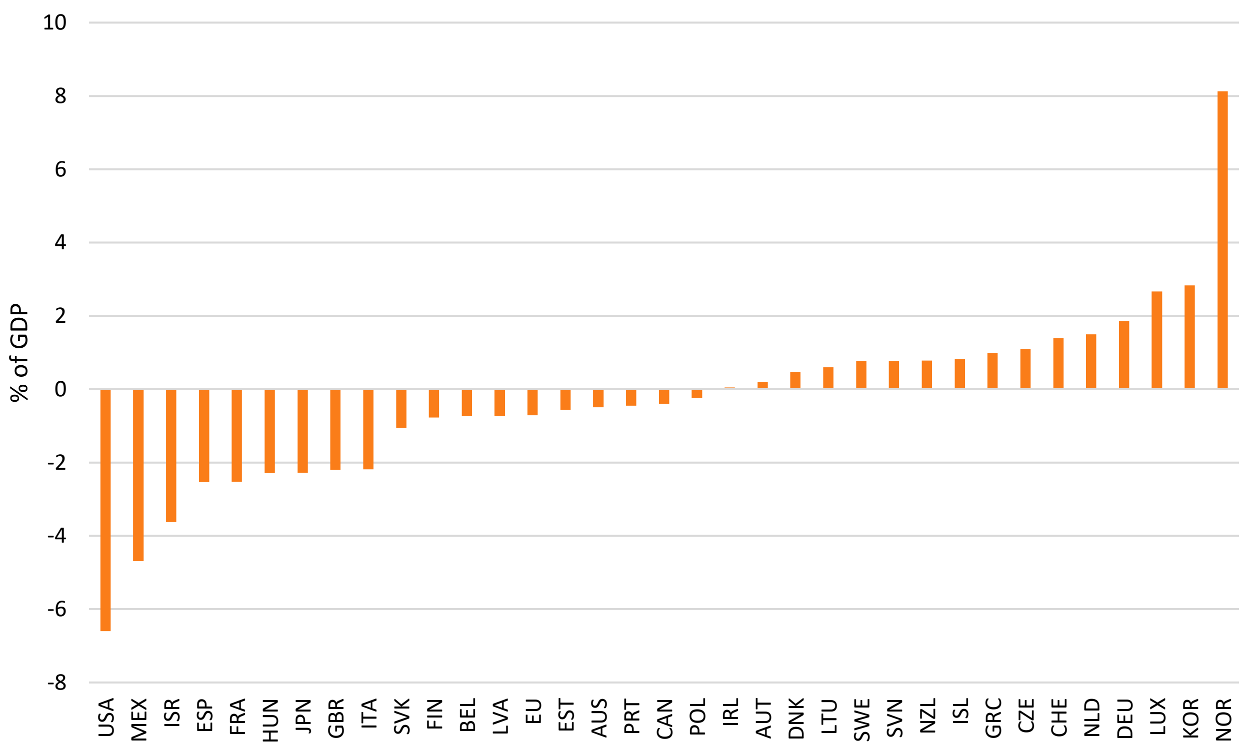
Countries which are isolated like Australia, New Zealand and Pacific Island nations, with wise government controls to prevent the spread and sound health care systems are well placed to recover quickly. In fact, these countries all have young healthy active populations for whom the mortality rate is very low. Less than one death per 1,000 people who catch COVID-19!

In Australia and New Zealand, we are blessed with dedicated, professional, well-trained and relatively well-resourced health workers including doctors, nurses and paramedics, not to mention the armies of support staff and volunteers. Our hospitals have cancelled elective surgery so are only half full to cope with the emergency cases. We also have supportive communities and neighbours.

Although winter is approaching, the climate is pretty mild so we should get through this pandemic in several months, not years. However, we should expect the levels of isolation to vary, depending on the spread and incidence of the outbreaks. Our sympathy goes out to any of our readers who have lost loved ones, friends or colleagues at this time.

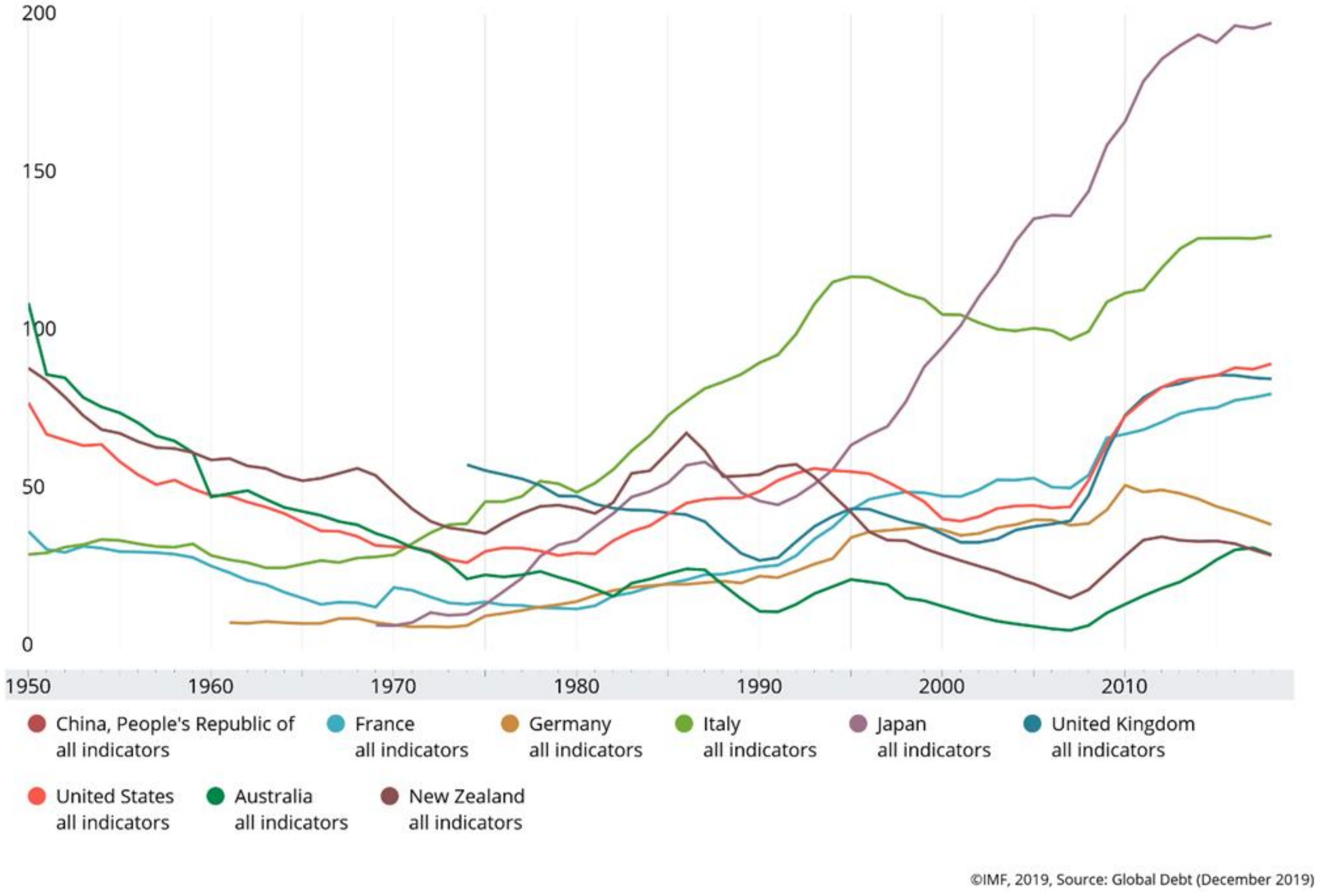
The other two broad actions for recovery are the effectiveness of monetary and fiscal packages. These are important for businesses to stay afloat and thus for people to keep their jobs. The money needs to get into the right hands as soon as possible. In saying this, a concern is that the stimulus measures are only a stop-gap until businesses and economies have to yet again face the real consequences of the ever-growing debt overhang. Figures 8 and 9 show the variance in debt levels across different economies.

Figure 8: Government Deficit (% of GDP, 2018)



Source: data.oecd.org

Figure 9: Central Government Debt (% of GDP)



Although it is early days, we are pleased to report that liquidity is being restored to bond markets through central bank interventions. Financial markets are working smoothly again with very low interest rates and flattish but positive yield curves. Businesses needing to raise capital are able to, but they have to pay an appropriate price for the risk. For example, Carnival Cruise Lines borrowed $6 billion but are paying an 11.5% p.a. yield.

The fiscal support from governments is also filtering through, with considerable funds rightly going towards health care.

We therefore expect an L-shaped recovery as some countries get back on their feet sooner than others. Prepare for a period where austerity, accepting and adapting to change becomes normal.

Life will never be the same again.