THE WEEK THAT WAS - AUSTRALIAN EQUITIES INSIGHTS

PERPETUAL INVESTMENTS
Paul Skamvougeras, Head of Equities, Portfolio Manager
19/03/2020

Australian Equities – Weekly update

With markets again falling over the course of the week, and economic uncertainty mounting, the Australian government has flagged that a second round of stimulus will be delivered. This included $15 billion in support of SME lending to complement announcements by the Reserve Bank on Thursday. The RBA itself announced a much-anticipated cut in official interest rates from 0.50% to 0.25%. Even more importantly it has announced further easing measures; it would also be targeting a 0.25% rate on the 3-year bond yield as well as launching a 3 year funding facility of $90 billion to ease lending to business, especially to small and medium-sized enterprises.

Trump's $1 trillion stimulus is underway, and the Fed stepped up its bond purchase program, helping the US rally on Thursday. It is still too early to tell exactly where markets will land in the weeks and months ahead. Whilst we have to go back to 1918 to find a similar global pandemic, the markets have so far behaved more akin to the events of 1987. Much focus is on whether the world is entering a major recession or if, like 1987, a sharp crash is followed by a V shape recovery. Whilst the latter might seem unlikely at the moment, the world's second biggest economy appears to be showing signs of some recovery. Whether this is the exception, or the rule remains to be seen. In the meantime, we continue to work to protect and grow your investments and thank you for your ongoing support.

One important change we have made in response to markets is the way we work and interact as a team. Normally as an equity investment team we meet once a day, however for the past week - and for the indefinite future - we are holding meetings three times a day via video link. This is working well and ensures we continue to remain well connected as a team.

Key focus areas

Sudden reach for liquidity

The equity market on Thursday 19 March was hit by a dash for liquidity. It started on Wall St on Wednesday. Although the US equity market recovered from its lows (the Dow was down -2,300 points at one stage) the desire for liquidity pounded all asset classes with the US 10-year bond yield spiking sharply. In Australia this spike in bond yields seemed to have the biggest impact on REITs with stocks like Stockland, GPT and Vicinity Centre hit hard. Many retailers also felt the pressure, closing down sharply.

Portfolios: We maintain an underweight to REITs and other leveraged positions.

How safe are the banks?

It has been a big question for investors this week. Make no mistake the banks and the RBA are in constant communication and the banks will be crucial intermediaries in ensuring credit markets function. The banking system remains liquid and well capitalised. The big banks have evolved over many years to become oligopolistic utilities that enjoy some “exorbitant privileges” in pricing, guarantees and limited competition not available to other businesses. Much has been learnt from the Global Financial Crisis about the how the financial system behaves in a crisis and we think investors must be wary of “fighting the last war”, assuming this will be a repeat of 2008. There is a long way to go but, unless we have a full-blown credit crisis, this may not be where the main dangers lie, despite sharp downward movements in bank share prices so far.

Portfolios: We maintain a modest net underweight but have been selectively adding.

Guidance abandoned

Many companies are now “withdrawing guidance” - not merely downgrading guidance - which says a lot about the state of the markets and the current lack of earnings visibility. We have never seen a crisis quite like this so it’s going to be hard for investors to forecast company profits when even companies themselves don’t know where their profits will land. Whilst the market has little visibility over earnings, the same can’t be said for balance sheets. Companies either have the strong balance sheets or they don’t. They are in plain sight and will be a crucial dividing line for how equities perform in the period ahead.

Portfolios: We are still focused on quality balance sheets first where we continue to increase positions in companies with the best positions, such as Crown Resorts, Orora, Event Hospitality and Premier Investments which have little or no debt or sometimes net cash at their disposal.

How bad is China?

This is an important question for a variety of reasons; they were the first to experience pandemic and economic dislocation, however it also looks as though large parts of the economy are returning to growth. As we look for corroborating evidence, we note first that the iron ore price remains remarkably strong, hovering near US$85-90 per tonne several weeks after coronavirus started roiling global markets. China's rapid recovery from the GFC was crucial to saving Australia in 2009. Despite the focus on poor headline data from China in recent weeks (PMIs and retail sales), the strength in iron ore may be signalling a different story. In fact quite a few companies are telling us this week that China demand is "back to full strength ". Australia will produce around 1 billion tonnes of iron ore this year, equivalent to several government stimuli at current spot prices. We also note anecdotal evidence that more than 20,000 Chinese students have returned to Australia in recent weeks via third countries. University classes have moved online. There may be teething issues but much of the tertiary learning has been online for years. Overall though, maybe China is an early indicator that things are not as bad as the bears fear.

Portfolios: Adding to BHP and Iluka Resources.

Equity issuance

We are also looking ahead to which companies may need to raise capital. Wherever possible we don't want to own them ahead of a capital raising, but if an otherwise good company with a bad balance sheet can be fixed up by a capital raising, then this can be a great opportunity for our investors to acquire a position at steep discounts. This is where our size as one of the biggest Australian equity firms is a clear advantage, capable of putting our clients' money to work on a meaningful scale.

Portfolios: We are keeping our powder dry for now.

Find out more about Perpetuals range of Australian Share Funds.