UNPACKING THE IMPACTS OF COVID-19

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Despite recent volatility, the market is beginning to feel a little more discerning. This is a welcome change from the last five years where the biggest driver of future share price performance was share price and earnings momentum.

While the COVID-19 pandemic is without precedent, we live and invest in a world where the future is always uncertain.

As a value investor we like a margin for error; after all, the past shows us that the future can always throw up unexpected challenges. Remember the Asian Crisis, Tech Bubble/Crash, September 11, Global Financial Crisis, Euro meltdown and Brexit, a range of unexpected events that demonstrate you cannot forecast the next year…let alone the next thirty years!

As we examine the current environment, we're not trying to predict market movements over the next day, week or month. Markets in the short term are volatile; predicting or investing based on these movements can distract you from the big picture.

We are, however, trying to answer two key questions: the political motivations underpinning government actions and how long the government is willing to keep the economy of life support.

Understanding the political motivations

Given the increased involvement of government within the corporate sector, understanding political motivations is important when analysing the impact across different industries.

Given that governments are driven by the election cycle, government policy tends to err on the side of short-termism. Success at suppressing the virus is easily measurable in the short term; if the news gets incrementally more positive, both state and federal politicians are likely to drag their feet a little longer than necessary to ease the current social distancing/isolation rules.

On the other hand, the full economic ramifications of policies designed to minimise the spread of the virus could be delayed through fiscal policy at least until after the next election.

Once Australia believes it has the virus under control domestically, our government may be extremely careful about opening our borders to international travellers, and the quarantining of Australians returning from overseas may remain vigilant. We don't expect international travel to return to normal for well over a year, which may have material impacts on our education and tourism sectors. It may also slow immigration, a key economic driver. One beneficiary could be our local tourism market which is able to cater for domestic travellers.

How long will the government keep the economy on life support?

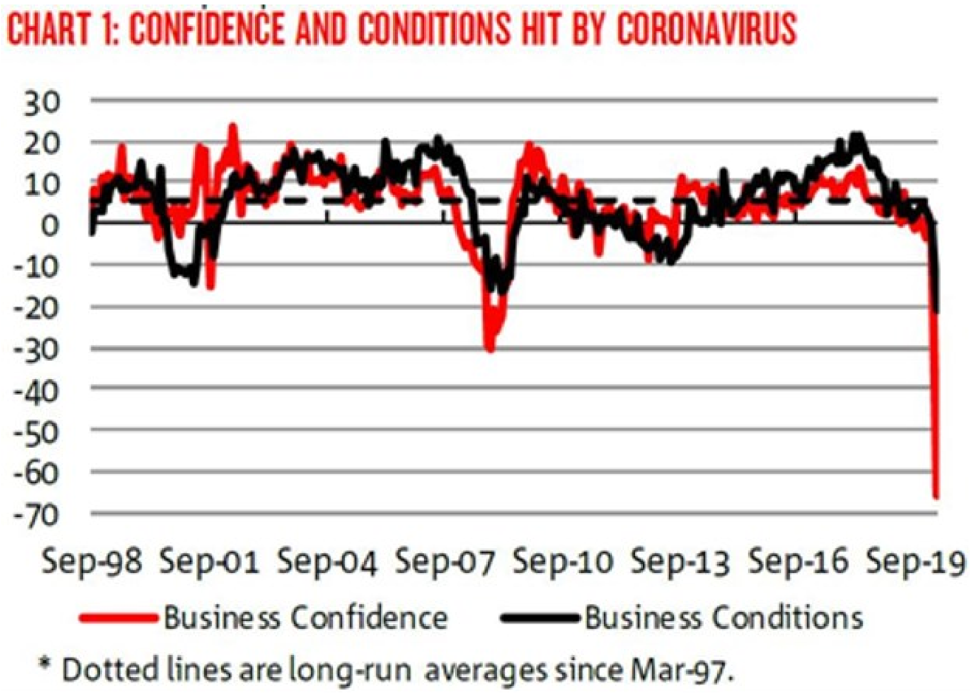
Any capitalist economy where people are forced to stay at home for an extended period is going to be extremely painful for most businesses, especially Small to Medium Enterprises (SMEs). SMEs employ around 70% of Australia's labour force and, given the speed at which the economy was forced to halt, SMEs around Australia have gone into survival mode.

To survive, SMEs had to minimise their two biggest fixed costs: labour and rent. This resulted in a sudden spike in companies firing or standing down their employees.

Given the massive spike in unemployment and pending mass insolvency event, the economy received some resuscitation from the federal government. The centrepiece of the government's fiscal response is JobKeeper, a wage subsidy available to businesses impacted by COVID-19. JobKeeper and eligibility for JobKeeper is the gateway for other schemes, including the landlord mandatory code of conduct, six-month moratorium on residential and commercial property evictions, and banks providing six-month loan holidays for households and SMEs under stress.

Just how temporary are these plans are and under what circumstances will any government start removing them?

In an extremely optimistic scenario, one where all restrictions were removed over the next six months and life returned to normal, the economy isn't likely to simply bounce back. It's likely that SMEs will employ a few less staff and households will squirrel a little more away for a rainy day. In aggregate, this may provide a headwind for the economy.



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What happens in six months if the economy is still struggling?

We think it's likely six months gets extended to 12 months, which could get further extended beyond the next election. Extricating from this scheme will be tricky. Given the government's strong fiscal position and the RBA's willingness to engage in quantitative easing, the ability to fund it will not be brought into question over the short term.

We have seen fantastic co-operation from the big end of town with banks, bank regulators, insurance companies and private hospitals doing what they can to help the Australian economy. This cannot last forever.

At what point do banks stop giving a holiday to SMEs and households under financial stress? At what point are landlords allowed to evict non-paying tenants? Will the private sector be able to start making decisions based on what is best for their shareholders when it differs from national interest? What are the unintended consequences of the fiscal and monetary policies? What will the 'new normal' look like in different industries?

These are the questions we're examining, looking forward across the next 12 months. We believe this is more important than trying to guess the direction of the market over the next week, month or year.

Find out more about the performance, strategy and holdings of the Perpetual Share-Plus Long-Short Fund.

› FURTHER READING - COVID-19

Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.