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CORONAVIRUS (COVID-19) – WHAT IT MEANS FOR INVESTORS

PERPETUAL PRIVATE INSIGHTS

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Kyle Lidbury, Head of Investment Research at Perpetual Private addresses the economic and investment market implications associated with the coronavirus (COVID-19) outbreak.

Market fear over escalating global spread of coronavirus has seen a sell-off across many asset classes.

US and global markets took another tumble recently for three key reasons:

- On Wednesday 11 March 2020, the World Health Organisation (WHO) officially declared the coronavirus (COVID-19) outbreak a pandemic;
- The Trump administration banned all flights from Europe entering the US; and
- European and US governments failed to give confidence to the markets that business would be adequately supported during the economic downturn, caused by increased containment measures.

Global shares

The S&P500 was down 9.51% and the Russell 2000, an index that tracks small-to-medium (measured by capitalisation) companies in the US was down 11.2% as at 12 March 2020. European markets were sold off heavily in response to a perceived lack of action from the European Central Bank (ECB) and insufficient coordination between governments on fiscal stimulus packages, with French and German exchanges down by more than 12%. Italy has effectively shut down business and Denmark has also followed suit in an attempt to contain the disease. While the UK was a rare bright spot in terms of fiscal and monetary coordination, the FTSE100 still dropped 10.9% in line with global markets.[1]

Australian shares

The Australian market moved ahead of overseas markets in response to the outbreak. Despite the announcement of a A$17bn fiscal stimulus package by the government, the S&P/ASX 200 closed down by 7.4% on Thursday 12 March 2020 has been experiencing significant volatility on Friday 13th March 2020.

At a sector level, energy stocks have been hardest hit as oil prices move around the low $30 mark, a result of 'OPEC+' maintaining and even increasing production in an environment of steeply declining demand. At a more granular level, travel-related and airline stocks have been hit hardest with the share price of companies exposed to the tourism segment continuing to fall. Although other sectors had exhibited resilience during this downturn, we are now seeing the sell-off becoming broad-based in nature over recent days.

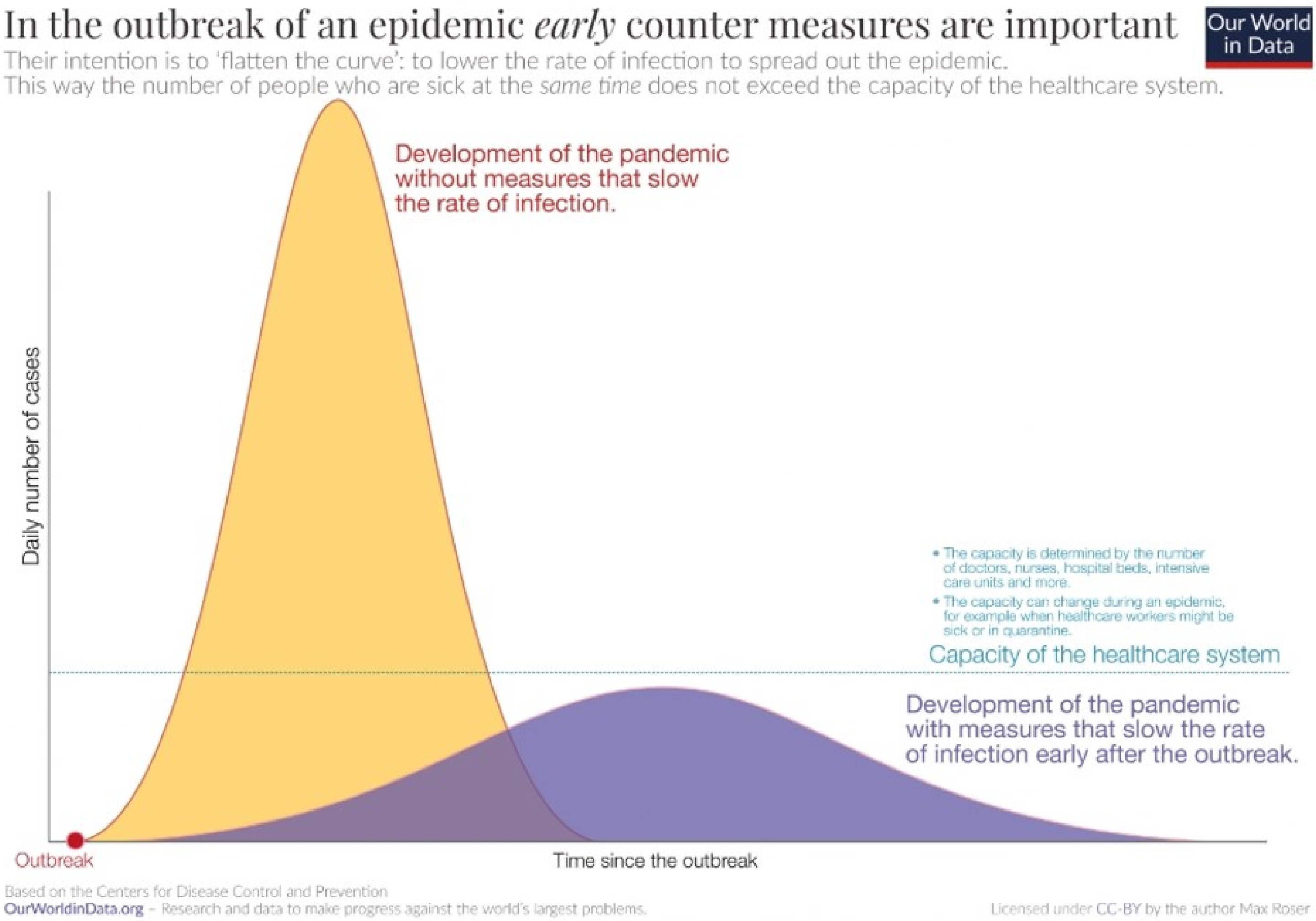
Bonds and commodities

Normally defensive assets, such as Fixed Income markets and even Gold have seen sell-offs as investors hunt for liquidity. We have seen an increase in credit spreads, driven by fear in markets as well as certain sectors such as US shale producers experiencing significant credit pressures. Despite this, credit markets seem to be holding up relatively well and we have not seen the market crisis translate into systemic issues for the financial system.

Governments now focusing on slowing the spread and rate of infection

COVID-19 continues to spread outside of China, with an acceleration in confirmed infection rates in many mainland European countries and now the US. The market is reacting to the potential economic cost of containment measures, at these levels factoring a possibility of technical recession in the March and June quarters, although the current market sell-off has arguably not priced in a protracted global recession.

Many clients have asked why such drastic measures are being taken at the risk of longer-term economic damage, given the uncertainty as to whether this virus can be effectively contained. Governments are not necessarily looking to completely contain the virus, they are really focusing on slowing the spread and rate of infection. A chart that demonstrates this well is from Max Roser, an economist at the University of Oxford.



Containment measures are essential to ensure that healthcare systems can remain within capacity in order to deal with patients. Left uncontained, healthcare systems would quickly become overrun and unable to deal with the number of new infections. By managing the rate of infection, healthcare systems can operate within capacity (even though the total number of infections may be unaffected over the longer run). It also gives time for preventative drugs or vaccines to be developed to more effectively treat and curb infection rates on an ongoing basis.

From a health and society perspective, containment is absolutely necessary to ensure a health crisis is avoided and deaths as a result of the pandemic can be minimised.

Supporting business through this crisis

China, as the epicentre of the virus, is now seeing a slowing of new confirmed COVID-19 cases and other countries are looking to China as a model in terms of how to deal with the pandemic. To that end, the fact that China seems to have managed this effectively is promising, however there is an acknowledgement the speed and extent of measures China took to contain the outbreak may not be possible in many western democracies.

The reality is the extent of the pandemic crisis is still unknown, with many variables determining what the ultimate effect will be on the broader global economy. The more drastic the containment measure, the greater the economic effect. This is evident in the strong market reactions we've seen to the stricter measures that are being implemented. We've said numerous times now that, historically, markets will not stabilise until some sort of turning point in infection rates is seen.

At a micro level, businesses in Australia and abroad are now enacting contingency plans, putting workforces on shifts, mandating working-from-home or moving operations to alternative sites. Even outside of formal government bans, many businesses have effectively stopped all corporate travel, cancelled conferences and events; putting downward pressure on economic activity. It is generally seen that the March 2020 quarter will show a large contraction in business activity and the market is now looking ahead at the possible length and depth of the slowdown.

It is fundamentally a question of whether businesses will have enough resilience to operate through the slowdown. As long as business owners believe that this crisis will be relatively short lived, then they will hold-off from having to make meaningful cutbacks in order to address falling revenues, such as cutting back on workforces, reducing overheads and holding off on investment. Should businesses feel compelled to cut back due to the crisis being drawn-out, the potential for a deeper and more damaging recession increases.

As such, fiscal measures will necessarily focus on supporting business through this crisis. The extent to which government measures are successful will be seen in labour market indicators (unemployment) and credit measures (number of defaults or loan distress) as to whether the crisis is deepening or stabilising.

What this means for investment portfolios

Given the uncertainty of the COVID-19 pandemic, many investors feel the need to head for the exits and 'cash out', however over the long-term on average, this is ultimately a losing strategy.

This can be seen in the chart below. Using a variety of different systematic 'signals' in terms of when to sell shares for cash and when to buy shares, based on actual data from the Australian stock market back to 1993, you can see that on every measure this strategy ends up costing investors, particularly when factoring in execution costs. This track record includes other market events, such as the Asian debt crisis, the tech-wreck, SARS, the GFC, and the European debt crisis.

Market timing challenges

Attempting to time markets can lead to long term underperformance

Strategy		Annualised returns			
Selling after a % fall from the peak	Buying after a % rise from the bottom	Buy & hold	Market timing	Outperformance of buy & hold	# buy/sell transactions
10%	10%	9.70%	7.77%	1.93%	18
15%	5%	9.70%	7.87%	1.83%	12
5%	15%	9.70%	4.15%	5.55%	27
10%	5%	9.70%	7.68%	2.02%	24
5%	10%	9.70%	4.81%	4.89%	39
5%	5%	9.70%	2.85%	6.85%	74

As at 31 March 2019.

Source: Factset. Data details performance of the ASX300 accumulation index from March 1993 and assumes 0.5% transaction costs and no tax in periods where the portfolio was sold, it was then invested in cash – represented by the Bloomberg AusBond Bank Bill index

The other thing to note from this table is that the more active an investor (that is, the tighter the band and the higher number of transactions), the worse off they would have been. While some investors may have fortuitously moved to cash ahead of this crisis, this is only half the challenge because they need to time when to put their cash back into the market. In essence, you need to get lucky twice, and the odds are arguably against tactical investors being able to do this successfully.

Our approach has always been that portfolios need to be well-positioned ahead of time, and a focus on quality investments, active management and diversification across a broad range of asset classes has always been to provide our clients with many layers of defence to navigate these sorts of market events in the best possible way.

Our advice to investors

While we can point to facts and figures and tables, we all know that people aren't 'systematic' in nature. We acknowledge when markets fall as steeply and precipitously as we've seen, there is a very real sense of dread as investors see the decline in value of their portfolios. This is where advice becomes invaluable to ensure an objective and long-term focus in investment portfolios. Our investment philosophy is to protect and grow our clients' wealth. As a firm founded in 1886, Perpetual has survived world wars, recessions and depressions, stock market booms and busts. We still manage money today that was placed with us over a century ago and we help keep clients and co-trustees focused on their long-term performance goals, financial plans and help them understand the short-term noise and nature of markets.

Good advice is always needed, but absolutely essential during these types of market events. We encourage all clients to remain in contact with their advisers as this latest crisis plays out through markets and economies.

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1. As at 12 March 2020

› FURTHER READING - COVID-19

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

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