DOES A RELIEF IN FINANCIAL MARKETS SIGNAL AN OPPORTUNITY FOR INVESTORS?

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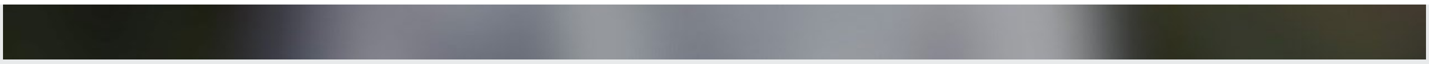
Massive central bank stimulus sparked a strong second-quarter rebound in global financial markets, bringing relief to anxious investors. Despite uncertainty caused by the economic fallout from the pandemic, the market dislocation may deliver solid investment opportunities.

Unprecedented central bank stimulus and hopes for economic revival sparked a strong second-quarter rebound in global financial markets. Following the rapid and severe collapse across financial markets in February and March, the June quarter has been one of relief.

Following the fastest sell-off across global markets in history, assets buoyed by fiscal and monetary easing regained lost ground. The previous quarter was stressful and the wild market swings had made investors fearful. But as policymakers stepped in to combat the shock caused by the virus, that initial panic subsided, and investors grew more confident as they saw steady gains.

The strong rally saw Australian equities surge 16.5 per cent, while international equities soared 18.5 per cent. Credit markets also recovered as spreads narrowed in the face of greater liquidity and the emergency stimulus.

See more detailed analysis of the performance in the June 2020: Quarterly Market Update.



Economies torpedoed

Still, while investors may feel as though they have weathered a market shock, a recent rise in coronavirus cases shows they are not out of the woods just yet.

We are facing an economic crisis that was born from the health crisis lockdown. On the economic front, the global outlook remains uncertain, as governments try to balance the winding back of restrictions against the threat of a re-emergence of the virus.

Ultimately, every lockdown will damage the economy. Anything that slows the recovery risks further damage. And, we are expecting to see more ‘waves’ until a vaccine is available. One thing is clear, however. Economies will only rebound if the connections between companies, workers, and suppliers are protected.

The Australian Government’s JobKeeper program was designed for just that purpose – but support programs cannot run indefinitely and consumer behaviour changes over time and exposure. Timing is everything. Continuing stimulus for too long could lead to the formation of price bubbles, competitive distortions and drive public debt even higher. While withdrawing and reversing stimulus too soon could prompt an economic relapse.

Keeping rates positive

The good news is that the Reserve Bank of Australia (RBA) is paying close attention to the economy. Having cut the cash rate target twice in March to encourage a recovery, the RBA held its cash target rate at an all-time low of 0.25 per cent.

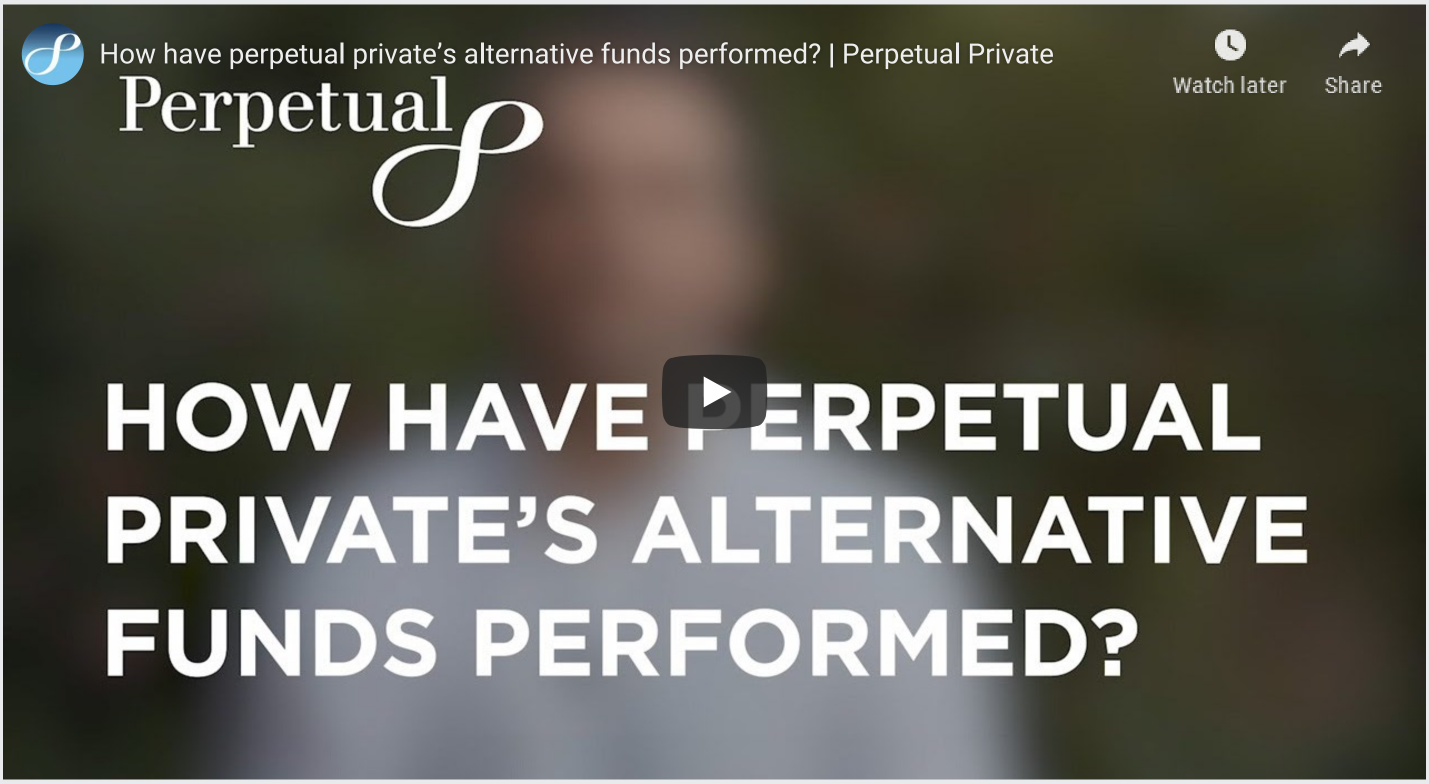
In line with its global peers, the RBA stands ready to do ‘whatever it takes’ to support the financial system; rates are at the“lowest bound” possible before falling to zero or going negative. While the RBA is unlikely to follow Europe and cut cash rates to below zero, Australia's central bank is using newer, unconventional tools to monitor and manage yield curves.

June highlights: A stronger Australian dollar

In addition to the sharp rally in equities and investment-grade bonds, the June quarter saw other highlights. The Australian dollar recovered its crisis-led falls over the June quarter, strengthening against all major currency pairs.

Generally, in tough times the Australian dollar weakens as the US dollar strengthens, which is what we saw in the first quarter of 2020. But this changed in the June quarter as the US dollar was no longer viewed as a safe haven and fears that the Australian dollar would slide further subsided.

Indeed, a combination of the RBA rejecting negative interest rate policy, some early success in virus containment and a restarting Chinese economy will help support the Australian dollar. If that’s the case then, with the currency (in US dollar terms) sitting just below long-term averages, the Australian dollar could move up in the coming months.



Hedge funds return value

Meanwhile, we are more positive about alternative investments. At first glance, alternatives had a difficult quarter. Some of the big names in the hedge fund world are shutting up shop or turning into family offices as investors continue to pull money out.

Yet Perpetual's Growth Opportunities Fund and Income Opportunities Fund delivered positive returns in the quarter thanks to its different approach. When it comes to growth opportunities, we are not looking for high-flying hedge funds that charge ridiculously high fees for few diversification benefits.

As well as the crazy fees, many of the big names have unusual strategies and that's not what we want. Simply put, we are looking for diversification of income streams within portfolios. Capturing investment returns that are uncorrelated with other asset classes ensures a smoothness to long-term returns.

Alternatives can include assets ranging from publicly-traded alternatives like absolute return funds (hedge funds), as well as unlisted private markets, infrastructure, and real estate. We continue to research private debt and diversified credit strategies which, in addition to syndicated bank loans, incorporate high-yield, and structured credit opportunities.

Lack of liquidity and fewer deals across private equity and debt markets led to a tough quarter as unlisted assets were revalued using public market valuations. Although this caused a fall in prices, it's a short-term impact. None of the underlying assets in our funds have been impaired, so we expect capital values to quickly return to previous levels.

The market dislocation caused by the crisis is a source of opportunity as many companies and sectors will be forced to restructure or consolidate.

Volatility is here to stay.

Market volatility will continue as investors weigh the economic damage being caused by the pandemic against the massive amount of monetary and fiscal support that is being put in place by policymakers.

Certainly, we expect volatility over the coming months as financial markets deal with real-world developments like the US election. With President Trump no longer being able to campaign on a strong economy, he is left with the ‘wartime leader’ strategy and that means aggressive geopolitics.

The sabre-rattling with China indicates that tensions between the US and China will escalate until the November election. Aside from the US-China skirmish, significant setbacks in virus containment, or policy error by governments or central banks could impact financial markets.

Nevertheless, despite the turmoil, our long-standing belief that long-term fundamentals drive returns remains intact. This period of uncertainty has brought this belief back into sharp focus as investors seek the security of companies with strong balance sheets and sustainable earnings.

Do nothing

The current market turbulence is a great reminder that markets are wildly unpredictable. It's important in times of crisis not to panic. Studies of investor behaviour show the biggest harm to long-term performance is overreacting. If your long-term strategy was correct before the market rout in March, it is likely still correct now. To change a well-known phrase: Don't do something. Stand there.

WEBINAR 13th AUGUST: PROTECTING YOUR INVESTMENT PORTFOLIO DURING A PANDEMIC

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return of an investor’s capital. Past performance is not indicative of future performance.