Investment Update – June 2020

Shifting Focus to Economic Effects

Investors in recent months have been confronted by unprecedented events. The emergence of the COVID 19 virus and the subsequent response of governments to the management of the virus has been a 'Black Swan' event that is a disruptive circumstance that could not be foreseen or an event the probability of which was considered to be so remote that the cost of taking precautionary measures was unwarranted. The initial uncertainties were the extent to which the virus would take human life, the rapidity of the virus' spread and the extent to which the virus would spread between countries. Although the population health effects of COVID 19 persist the focus of analysis is now shifting to the economic impact of the virus as countries emerge from lockdown. The economic urgency to exit lockdown conditions is illustrated by the Reserve Bank of New Zealand (RBNZ) estimates of the economic destruction under differing levels of lockdown. The RBNZ estimated that GDP was 37% lower under level 4, 19% lower under level3, 9% lower under level 2 and 4% lower under level 1.

Markets Awash With Cash

These events have been reflected in the performance of investment markets. Initially risk assets (shares) were sold off and investors retreated to the relative safety of investment grade bonds. The falls in interest rates were accentuated by central banks' policy which have universally expanded the money supply in a "whatever it takes" mindset. In conjunction with the flood of liquidity governments have also engaged in fiscal support- in New Zealand primarily in the form of employee subsidisation and various loan schemes. Share markets have shifted from extreme pessimism to optimism, with equity indices bouncing despite the economic impact of the shutdowns and subsequent effect on consumer behaviour remaining unknown. Forecaster's projected outlook for companies remains the key consideration and the expected returns from asset types are murky. Economist John Kenneth Galbraith stated, "We have two classes of forecasters: Those who don't know and those who don't know they don't know".

Investment Return Drivers

The rapid recovery in share prices can be supported on the grounds that the effects of COVID 19 will eventually dissipate, be that 12 to 18 months or longer and consequently company earnings will return to levels preCOVID. Scientific research has prioritised the development of COVID 19 treatments and vaccines with over 180 scientific programmes directed at the virus. Relief rallies (the markets move higher) have been evident when progress is announced on various research projects. On this thesis share prices in April represented a value opportunity which built momentum through May. The quantitative easing has driven down interest rates. The lower interest rates should increase demand for companies with sustainable reliable dividends as investors seek to replace low yielding fixed income with higher yield dividend income. Also, the amount of liquidity that has been injected into economies inevitably finds its way into the equity markets. The significance of the monetary stimulation entered into by central banks cannot be understated. Thus far all of the bond issuance by the New Zealand Debt Management Office has been absorbed by the RBNZ as they have purchased bonds faster than the Crown has issued.

Fiscal stimulus has also been meaningful with other countries spending at a higher rate than New Zealand. To date the New Zealand Government has undertaken additional spending equivalent to around 5% of GDP. In contrast the United States has increased fiscal expenditure by 12% of GDP and Australia by over 10% of GDP. The US Treasury borrowed a record US$3 trillion in the first quarter and US Government debt is near US$25 trillion. The current pre-occupation is with raising activity levels to mitigate economic hardship, but this will have future ramifications in terms of financing the additional spend. This may take the form of additional taxation, future austerity or eventually eroding the debt's significance through inflation. In this context New Zealand is fortunate that the prevailing debt to GDP ratio is below that of other countries and is likely to remain so post COVID stimulus. This however may also have implications in respect to relative credit worthiness and exchange rate strength. One positive attribute of the increased debt levels is the relative affordability as debt servicing at current low interest rates is more manageable. This in itself also represents a future challenge if interest rates rise and will act as a constraint on policy making. It has been estimated that every basis point 0.01% increase in US interest rates adds a quarter billion to the US deficit.

Negative Interest Rates Still a Possibility

Central banks have flirted further with the prospect of negative interest rates in the last month. The RBNZ has requested that trading banks ensure systems are able to function under negative rate conditions. This scenario would further diminish the income of bond holders and term deposit holders on maturity. Resident New Zealand term deposits totalled NZ$186 billion as of April 2020 and a proportion of this will seek a better return upon maturity. In comparison the New Zealand stock markets total capitalisation is approximately NZ$170 billion. Although New Zealand, Australian and United Kingdom central banks have floated the possibility of negative rates at this point it appears to be a case of keeping all options open and there has been some retreat from the possibility in subsequent statements by Reserve Bankers.

Mainstreet Impacts

The buoyancy within equity markets contradicts conditions being experienced on 'Mainstreet'. In New Zealand the number of unemployed has increased by 39,000 in April alone with announcements of further job losses an almost daily occurrence. Although lockdown restrictions have been loosened benefitting hospitality, retail and other sectors the current numbers seeking jobseeker benefits are likely to increase further. This in turn will have a negative impact on consumer demand until economic equilibrium is re-established. Tourism in New Zealand is the largest contributor to GDP. The external component of tourism demand remains effectively zero as borders remain closed. While a recommencement of domestic travel will be welcomed by tourism related businesses, sector participants remain in very straitened circumstances. For tourism to return to 'normality' it will require not only the reopening of travel channels but also the confidence of consumers to explore beyond local boundaries. Other sectors of the domestic economy are also feeling the effects of economic disruption, sales of new cars dived 90% and used cars sold in April totalled only 622.

Bank economists are forecasting a fall in house prices and residential construction despite New Zealand's population topping 5 million for the first time in May. Several factors contribute to this view. Population growth from immigration has dwindled to zero, soaring unemployment will limit the pool of prospective house buyers and with zero to very little international tourism Airbnb properties are likely to be returned to full time residential occupation. In contrast a supporting factor will be low mortgage interest rates. There is likely to be lower demand despite the ability of production capacity to restore itself relatively rapidly. Economic recession appears to be an almost inevitable consequence of the disruption experienced within the economy and as a result company earnings in the current reporting periods will likely decline. However, many analysts are looking through these immediate impacts to company earnings and towards what 2021 and beyond may look like. The impacts of the recession will be uneven with the more discretionary elements of the economy worse affected.

Trade Tensions Continue to Simmer

Heightened economic uncertainty is further compounded by the prospect of trade tensions reigniting. The China-US economic relationship remains tense despite the progress made pre-COVID 19, with the US Senate passing initial legislation which may ultimately result in Chinese companies (Alibaba being the most prominent) delisting from US exchanges. This tension has also been echoed in the China-Australia economic relationship with China imposing restrictions on the export of Australian meat and barley and the raising of possible non-tariff barriers on iron ore. New Zealand exports NZ$17 billion to China each year or 28% of all exports. Maintenance of the trade relationship is critical to the New Zealand economy and will require trade representatives to walk a delicate path. It would not be surprising to see a further ramp up in political rhetoric as the US election approaches.

Summary

A high degree of uncertainty prevails in the macro economy as to the extent and magnitude of the economic effects of COVID 19. This uncertainty is reinforced by further conjecture as to the future prospects of individual businesses. In an environment where forecasting is subject to even greater difficulty than normal, benchmark portfolio positioning is the default asset allocation. Adopting this position retains market participation at a level consistent with the investors risk tolerance. Growth orientated investors should continue to allocate to equities consistent with longer term return expectations whereas defensively minded investors retain the capital preservation characteristics of bonds albeit at a lower level of income.