Investment Update – August 2020

Competing Investment Views Shaping Market Conditions

The month of July was subject to tensions between optimists and pessimists. This has been reflected in market performance. The divergence in opinion between fixed income and equity investors remains stark. Fixed income investors remain pessimistic as to the outlook and interest rates have fallen modestly in the month as bonds continue to be bought as investors strive to preserve capital. In contrast equity investors drove up the value of growth stocks in anticipation of increased future profitability and embraced additional risk as these equities' valuations climbed to new highs.

Market Breadth has Diminished

Within the sharemarket clear division exists between investors willing to accept the risk associated with growth companies whose pricing has lifted to quite high levels given headwinds to current profitability and value companies whose price fundamentals are more modest. The prevailing preference for growth is expressed in narrow markets where the majority of gains has been concentrated in a small number of stocks that represent a disproportionate weight in mainstream indices. In the S&P 500 the FAANG (Facebook, Amazon, Apple, Netflix, Google) stocks now represent 22% of the index. In New Zealand Fisher & Paykel Healthcare (FPH) and A2 Milk equate to approximately 30% of the S&P/NZX50 Gross index. FPH trades at a price more than 50 times forward earnings. Australia is less subject to this lack of breadth with the S&P/ASX 200 having a lower concentration. Nevertheless, Australia has experienced pricing where growth companies (for example the Buy Now Pay Later companies) are trading at levels twice their pre-COVID 19 levels.

Identifiable Negative Factors

The more pessimistic outlook of some investors is based on a number of factors. This outlook is centred on the worsening impact of the COVID 19 virus as the total number of infections continues to rise worldwide. Based on this headline number the economic impact of COVID 19 may intensify and the duration of its impact extend further into the future. Investors within this camp are already concerned at the level of official unemployment and expect unemployment to worsen as support schemes begin to expire. Consequently, further impact will be felt as consumer demand remains weak or deteriorates with additional business closures a consequence.

The constraints placed on international travel have impacted a significant proportion of the tourism, accommodation, hospitality and education sectors of the economy. Investors with a pessimistic disposition assess this gap in GDP as persisting for longer with no line of sight as to when constraints may be lifted. The pessimistic view anticipates that the upcoming round of corporate earnings will be poor as impact of societal lockdowns on company profitability is reported. Share values may weaken as these effects are manifested.

The pessimistic camp anticipates that further business recapitalisations may prove necessary and that equity dilution associated with capital raisings will result in shareholder value diminution. In previous years share buybacks have been a contributing factor to market buoyancy. Stretched balance sheets or prudence in response to uncertainty will crimp the extent of buybacks going forward.

Political considerations also form part of the negative investor's thesis. Geopolitical tensions are continuing in the South China Sea and on the Himalayan border. Tit for tat consulate closures have occurred between the US and China. These incidents are exacerbating the hurdles to improving trade relations. Overlaying these cross-border issues are electoral cycles. The United States presidential election could result in a White House hostile to shareholder capitalism and intent on reinstating corporate taxation at pre-Trump levels. In New Zealand the rapidly approaching election may result in a different composition of parliament with less constraint placed on the governing party and potentially more radical policy implementation, less friendly to business and investors.

Bearish investors acknowledge the monetary and fiscal stimulus being undertaken and recognise the supportive nature of these actions for markets. However, the monetary and fiscal programmes in themselves also represent a source of anxiety for bears. If the fiscal issuance and bond acquisition become untethered from each other then this could be disruptive for fixed interest markets potentially with unintended results.

Bullish View is Winning at the Moment

In contrast, the more bullish scenario currently has the upper hand in sharemarkets. The more optimistic investors expect a COVID 19 vaccine to be successfully developed under an accelerated process that will be followed by a large-scale distribution within key markets. The more optimistic assessment of the pandemic considers infection rates to be peaking and to have flattened in geographies that were earlier exposed to the virus and that this foreshadows outcomes in other countries

Some herd immunity has been built in these areas under this scenario and any consequent second wave effects in geographies already impacted will be less severe depending on administrative response and the severity of the initial outbreak. Under this scenario, the economic disruption is not as dire in reality and as against expectation. The more bullish investors identify the green shoots within forward looking economic indicators, e.g. performance and confidence indices and identify these as precursors to economic normalisation.

Optimistic investors consider that the volume of monetary stimulus is being effective and will support both actual economic activity and asset values. Any sign of economic weakness will bring forth further rounds of monetary stimulus underwriting company earnings.

Although certain sectors and companies values now exceed their pre-COVID levels, especially NASDAQ listed companies, bullish investors assess the markets to still be pregnant with opportunity as a core of companies remain below pre-COVID capitalisation. As markets are forward looking and are pricing expectations 9 months ahead and beyond this engenders further enthusiasm from investors as they look through the immediate landscape.

Effects Are Uneven

Previously we have identified that the impact of COVID 19 has been uneven in its effects. This contrasts with the Global Financial Crisis in 2008 where all sectors were equally impacted by systemic concern as to the financial stability of banks. This unevenness is apparent in terms of the impact on different countries. A number of Asian countries have been able to manage the infection rate and rebound quickly, most notably China. New Zealand's pandemic response has also been effective in preventing community transmission of the virus. Other countries have been slower to respond to COVID 19 or have adopted a less rigorous health solution that has not held the virus in check or delayed the normalisation process. The United States appears to be one of the worst affected nations on the basis of reported data although many emerging countries may have been worse affected than official data indicates. In many instances, for the reasons identified above, this has not restrained headline market returns.

The headline results reflect uneven impacts, with internally focused businesses or businesses advantaged by COVID 19 able to recover quickly or increase revenues. Particularly notable have been the latest quarterly reports from the large US technology companies like Apple, Facebook and Microsoft. In contrast more discretionary activities and those with cross-border features have been negatively impacted.

Summary

In New Zealand to date the negative economic effects have been more limited than economists originally projected. The better outcome is encouraging in that it provides a stronger foundation to continue to rebuild economic activity and investor wealth. Offshore the setbacks experienced from premature removal of social distancing have resulted in a slower recovery than anticipated. The differing outcomes are demonstrative of the inherent uncertainty currently existing. Prospectively this represents opportunity, but investors need to be prepared for ongoing volatility in returns, focus on quality and be patient.