JMI Wealth

Economic & Investment Market Review

March 2020

Investment Impact of Coronavirus

February investment returns have been dominated by the implications of Coronavirus. The number of virus infections rapidly increased in the city of Wuhan and despite quarantine restrictions spread to other regions of China and internationally, with non-China cases accelerating into the end of the month. Efforts to control the spread of the virus in China appear to be successful as the number of new cases being reported there has declined. The proportion of fatalities from the virus has remained more or less constant although more virulent than other forms of influenza.

While not to diminish the humanitarian aspects of the deaths resulting from the virus, the economic impact of the outbreak has primarily been expressed in interruption of production, disruption of supply chains and curtailing of travel. The current rate of recovery from the pathogen gives cause for optimism that impact on the human population will not be calamitous. If this scenario is valid then the economic effects of the Coronavirus are likely to be transitory and the investment decisions to be made in response to the virus revolve around how long it will take before conditions return to normal and which sectors will be most severely impacted. Investment markets will anticipate any normalisation prior to the effects of the virus fully dissipating. Investors should also recognise that markets tend to overshoot on both the downside and the upside.

To date the impact of Coronavirus has primarily been upon Chinese domestic demand and production within China. Western companies with manufacturing in China or using componentry sourced from China have in turn been affected by this disruption (e.g. Apple). Alibaba the China based equivalent of Amazon has warned that economic growth for the current year will be significantly diminished. The direct effects are being felt not only by users of Chinese sourced products but also by suppliers of raw materials into China. The cessation of log supply from New Zealand ports has been well publicised. Further reverberations are being felt in travel related sectors: - airlines, accommodation and tourism destination businesses.

Other Factors

Coronavirus is not the only factor to which the current weakness is attributable. The decline in the US equity market has also coincided with the success of Bernie Sanders in some of the Democratic primaries. There is a widespread view amongst US investors that the election of Sanders as President would be negative for equity values. US February equity performance may also have been affected by the performance surveys in manufacturing and services which were much lower than the prior month. In response to economic conditions the US yield curve has once again inverted (taken as a signal of potential recession) and this may also have shaken confidence. Economic data from Europe has deteriorated. Overall Eurozone fourth quarter GDP growth was only 0.1%. German, French and Italian industrial production declined in December. This economic weakness was also evident in Japan. A specific example of some of the economic pressure was exhibited in global Bank HSBC's result. HSBC intends to reduce its head count by 35,000 and assets are to be reduced by US$100 billion by the end of 2022. Symptoms of a less buoyant economy within Australia were seen in the Australian unemployment figure which lifted from 4.9% in December to 5.7% in January.

Chinese Response

The most commonly recommended treatment for influenza is to maintain a high level of fluids. The level of monetary stimulus in the market has continued and the Peoples Bank of China has announced a US$173 billion liquidity injection. Overall liquidity will be 900 billion yuan, approximately US$130 billion greater than last year. This adds to other monetary measures in China which have further reduced interest rates. China has also moved rapidly to implement the trade agreement with the United States, halving tariffs on US$75 billion of goods. Local governments in China have continued to announce further investment in infrastructure. The latest announcements amount to 11 trillion yuan. Hong Kong has been even more specific in its stimulatory measures implementing a form of helicopter money with Hong Kong citizens the recipients of a HK$10,000 handout.

US and Europe Market Reaction Disproportionate?

In the US the political drama surrounding the impeachment process has ended with President Trump acquitted. The political theatre now moves to the outcome of the Democratic party's presidential candidate selection. The main parties are already jockeying for elector's votes. The Republican party has floated the possibility incentivising retail investment by ring fencing a certain amount of investment from tax. The US economy has remained strong. 225,00 jobs were added in January exceeding the 158,000 estimate. The completion of the 4th quarter earnings season saw the S&P 500's earnings up 2%. The positive earnings momentum predominately arose from Facebook, Amazon, Apple, Microsoft and Google which grew their earnings by 16% year on year. Amazon's revenue grew by 21% in the 4th quarter of 2019.

The Europeans are also taking some measures to buoy their economies. Germany and the UK (GBP106 billion) have green lighted rail projects. Unemployment in the UK is at 3.8% and average earnings are growing at an annual rate of 2.9%. Although Greek government 10-year bonds are still rated at a non-investment grade level the yield has fallen below 1% for the first time.

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New Zealand Market

In New Zealand prior to the impact of Coronavirus the outlook had been more positive. Consumer confidence in January was 122.7. Unemployment fell to 4% and wages have risen by 2.6% in the last year, - the most since 2009. New Zealand house prices continue their upward march at an annual rate of 4.4% for January indicating increasing confidence. Overseas investment in New Zealand land and business continues with a 40% surge in 2019 to NZ$17.5 billion. Government spending continues to increase with the government 6-month accounts to December growing at 3x the rate of the rest of the economy. Although the rate of growth has slowed the rate of population increase is still strong with a 43,625 increase in 2019. New Zealand company reporting for the period ending 31 December was generally satisfactory. A2 Milk recorded strong revenue and profit growth up 31.2% and 21.1% respectively. Chorus similarly pleased investors with increased guidance.

How long might the Impact be felt

The fall in the S&P/NZX 50 Gross index in February and early March at just under 10% from peak is technically defined as a market correction. In the United States there has been 26 corrections since World War 2. These corrections have averaged a 13.7% decline over 4 months and have taken 4 months on average to recover. In order to be defined as a bear market the index would need to decline by 20%. If in the event the current downturn becomes a bear market, then it typically takes a longer time period to recover (US markets 14 months). The bear market of 2007-2009 was more prolonged and lasted approximately 17 months. The current correction has occurred over a much shorter period than the US examples suggesting that any bounce back may also be sharp.

Fixed Income Offset

The Coronavirus has catalysed a flight to safety with demand for fixed interest securities driving down interest rates. Fixed income values have benefited as the market prices of bonds have risen. The New Zealand 10-year government bond index returned a positive 1.5% in the month. Balanced and conservative portfolios have therefore been cushioned to a degree by the inclusion of fixed income securities or bond funds mitigating the larger negative price movements in equities.

Policy Response

Inevitably the Coronavirus will impact economic activity in terms of end demand, production and supply logistics. If the effects of Coronavirus are prolonged, then this impact may extend beyond 1 or 2 quarters. In this event the response of central banks and governments is likely to be further monetary and fiscal stimulation. The Chinese government's policies are indicative of the likely response from other governments. The ability of countries to respond effectively will vary with the extent of stimulus already applied and capacity. In the case of the United States and Australasia there is monetary and fiscal capacity available to mitigate the worst effects.

Outlook

The experience in China suggests that although disruptive, the effects of Coronavirus can be managed effectively. The effectiveness of counter-measures will be patchy between countries. Within investment markets some companies will be able to better navigate the effects. The recent fall in values may represent a better investment proposition for those investors able to take advantage of them. Once markets stabilise investors should seek companies with businesses with strong balance sheets, robust cash flow generation and sustainable dividend yields.

If you have any question, please contact us on +64 9 308 1450 or visit our website www.jmiwealth.co.nz