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MARKET INSIGHT

Then out of left field along comes a virus

The coronavirus continues to dominate the headlines and news of the emergence of new clusters of infections outside China has caused jitters in global financial markets. Here's our assessment of what's happening and our investment view.

Taking stock

2019 was an unusually strong year for returns with risk assets such as equities and defensive assets such as government bonds both delivering returns of well above their long-run averages.

We began 2020 thinking an equity market correction was likely in the short term, but couldn't think of a catalyst. Central banks had been keeping interest rates low and the global economy seemed to be at a gentle turning point. Tension in geopolitical issues such as US Iran relations, Brexit and the US China trade war had all eased.

Then on 31 December 2019, China began reporting cases of a new COVID-19 virus (Coronavirus) that began in Wuhan, Hubei province. The equity market shrugged off these early reports and continued to rally during January and the first 3 weeks of February as the virus spread, making an already over-valued market even more over valued.

The world has seen many epidemics in the past and they tend to be short-lived, particularly those seen during this millennium (SARS, Swine Flu, MERS and Ebola) due to advances in treatment and vaccine development. These lessons learnt and the improving data probably goes some way to explain why equities rallied through January and into February as the virus spread.

Recently global markets have been more unsettled. We first noticed warning signs during the second week of Reporting Season in Australia when the number of management teams mentioning the risks from the virus outbreak rose.

Travel and tourism industries have been impacted, and with China being a manufacturing hub, the closure of cities and factories has hit global supply chains hard, restricting business activity.

Reaction by policymakers

Confidence is a vital component of economic behaviour that underpins financial markets and investor returns. It can be won over time, but it can also evaporate rapidly.

Confidence has not yet collapsed as it did in the 2008 global financial crisis and central banks have moved swiftly to restore confidence. In Australia, the Reserve Bank of Australia (RBA) reduced interest rates by 0.25% to provide support to economic activity. The US Fed decided to cut their main interest rate by 0.50%, reflecting their desire to reduce the economic disruption stemming from the virus.

The People's Bank of China (PBOC) has been relatively restrained to date but has provided $US174bn of liquidity to banks and $US4.4bn of special loans to affected firms. Additional government spending would be slower to roll-out but a useful tool if the economic consequences are likely to linger.

Where to from here?

News of a slowdown in the spread of the virus or the development of a vaccine would provide a timely shot in the arm for equity markets even though both of these developments don't seem likely in the near-term.

While our indicators continue to show that a recession isn't imminent, the risks have clearly risen as travel and crowd gatherings around the world are becoming more restricted. Supply chains have also been blocked affecting manufacturing of consumer and industrial goods and this could easily feed into rising unemployment. Another sign that global demand is weakening can be seen in the collapse of the oil price – since the start of the year the oil price has fallen by around 50%.

Effective diversification is important, particularly in this environment. While investments in one part of a portfolio may suffer losses, other investments may remain stable or even increase in value. Our portfolios use a mix of different asset classes and a range of fund managers with different investment styles to add layers of diversification.

Our investment team actively manage portfolios and are skilled to assess and position appropriately as the situation develops.

History has shown time and again that changing a long-term investment strategy during times of short-term volatility may not be a smart move. Staying the course means investors are more able to avoid crystallising losses during a falling market and can capitalise on gains once the market rallies again.

Speak to your adviser if you have concerns. They're well placed to understand your complete financial situation and assess whether any changes to your long-term strategy are needed to keep your goals on track.

Dan Farmer
Chief Investment Officer

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