Economic Commentary

17 March 2020

After a benign start to the quarter in December and January, the global economy and financial markets have been derailed over the past month by the sudden emergence and spread of the novel coronavirus (Covid-19). Initially, markets were optimistic that the virus could be contained, but since the final week of February we have seen significant falls in international sharemarkets as the spread outside China has accelerated. Although we did not anticipate a virus as the cause, we have been expecting a market correction for some time due to the high valuations and length of the economic cycle. Portfolios are therefore positioned to mitigate the worst of these declines. However, there will certainly be a significant impact and the volatility will likely continue. In time, we will be looking to take advantage of the lower prices for good quality long-term assets.

Media reports on movements in the financial markets tend to focus on changes in the level of the sharemarket indices, which provide an indication of how the market as a whole has performed over a short period. For example, in New Zealand the largest index is the NZX 50, and this comprises the largest 50 companies on the NZ sharemarket. Since the 20th February, the NZX50 is down by around 22%, less than the main indices in Australia, the United States, Japan, and the UK, which are all down between 27% and 29%. We have seen some of the largest one-day falls in these markets since 1987. Interest rates in wholesale markets fell as investors moved from shares to 'safe havens' such as government bonds. Amid all this virus-related market turmoil, some of the biggest moves have been seen in oil prices. These initially declined due to the potential for reduced demand from a slower global economy. To stabilise prices, the OPEC group of oil-exporting countries met on 6th March to discuss a cut in production to reduce supply. However, talks failed after Russia rejected the plan and this triggered a price fall of 25%, the largest one-day fall since the first Gulf War in 1990. The declines have been significant and the speed with which events have unfolded has been particularly notable. It has been a dramatic month and one that will go down in the history books!

Already we have seen action from governments and central banks around the world to provide support and cushion the economic effects of the virus. In emergency meetings, the Federal Reserve reduced official interest rates in the United States to zero, the Reserve Bank of Australia reduced their rates to 0.50%, and our own Reserve Bank cut to their lowest ever level of 0.25% on 16th March. With interest rates now at all-time lows, there is also an important role for governments to play in increasing fiscal spending to stimulate activity. The NZ government today announced their largest ever fiscal spending package, putting $12 billion (4% of GDP) into the economy through a mixture of wage subsidies, increased benefits, changes to tax rules, and cash injections to the health sector. This is sorely needed given the massive hit to the economy from the self-quarantine requirements (especially the travel and tourism industries).

What does all this mean for your investments? If you had 100% of your money invested in a passive index-tracking fund designed to follow the S&P500, your investment value would be down by 29% (plus fund manager fees) since 20th February. However, we manage diversified portfolios which contain a mixture of assets from the four asset classes - cash, fixed interest, property and shares. *This means that portfolios will not feel the full effect of the sharemarket correction as only a part of the portfolio is allocated to shares and listed property*. A conservative portfolio will have a greater proportion of the total capital position in the defensive assets of cash and fixed interest, and a smaller proportion in property and shares (The opposite is true for a growth portfolio, although there will still be a significant weighting to defensive assets). Furthermore, we have been anticipating some level of market downturn due to the strong performance over recent years. As a result, we have for some time been positioning portfolios to be more defensive than normal, holding a greater proportion of cash and fixed interest than would usually be the case.

Within the share portion of portfolios, we use (almost exclusively) active fund managers rather than following a passive strategy. As mentioned, if you invest in a passive fund which is designed to track an index, you will always receive the return that the index produces less the manager's fee. If the index goes up, you'll get the return. If it goes down, you'll suffer the loss. An active fund manager conducts their own research on the various companies in the sharemarket and picks those that it believes will perform over the medium to long-term. If the manager feels that economic conditions are unfavourable, they can take actions to protect the value of the investments from any downside risk. These actions include holding a higher level of cash in the fund, selecting defensive companies with businesses which are resilient in a downturn, and even using hedging strategies which actually increase in value when the market falls. When selecting fund managers, we place an equal importance on their ability to mitigate market downturns as their track record in outperforming in a rising market. To date, the managers we employ have generally been doing a good job and funds are down less than the overall market indices.

We anticipate that the market turmoil will continue in the short-term and that there is likely further downside to come. At this point, investor panic and "herd behaviour" is driving the markets, but this will subside in time and a more rational focus will return. Portfolios are well positioned to offset the worst of the volatility. *However, there has been and will continue to be an impact on asset prices, leading to a fall in portfolio valuations*. Rather than selling out of the market and crystallising these losses, it is important that we hold and continue to look to the medium to long-term. History shows that markets recover from shocks, and when the time is right we will be looking to use cash from portfolio call accounts to take advantage of the opportunities that have opened up.