Dear Client,

QUARTERLY REVIEW – February 2020

The ASX 200 registered a rise of just over 20% for the 2019 calendar year, finishing on 31 December'19 at 6,684 – all sectors finished with double digit growth, except the financials. By any standard, this was a very good year (having finally taken-out the pre-GFC high) and similar performances were evident around the globe with the MSCI World Index (USD) rising by 27%. The key driver here was again the US, with the Dow Jones up almost 30%.

In Europe, the German bourse (DAX) maintained the rage posting +25% for the year, and even uncertainty over Brexit couldn't dampen the FTSE (UK) which registered a very respectable +17%. The unrest in Hong Kong saw the Hang Seng post sub-par returns finishing the year up "just" 12%, whilst the China A Shares Index was up 34%.

All this sounds very positive for share investors and the newspapers are trumpeting the tear away success of equities in 2019 – but this analysis fails to take account of the fact that during the latter part of 2018, the MSCI fell by over 12%, courtesy of the Federal Reserve's precipitous move on interest rates. In the case of the ASX 200, this fall into December 2018 was closer to 15%. This meant that **the 1 January 2019 starting point was artificially low**. If we smooth out the effect of the US Fed's equivocation on rates, the "normalised" rise in the ASX for the 15 months from Sept'18 to Dec'19 was around 5%.

As we entered 2020, the ASX rose further to an historic high of 7,163 earlier in February'20. In the latter part of February, however, concerns around the Coronavirus have panicked markets.

If the past few years have taught us nothing else about share markets, its that interest rates are king and that its their absolute level & likely direction that will determine the extent of future equity market movements. An interesting confluence has now developed – whilst there has been some debate about how long it will be before Central Banks (particularly the Federal Reserve) raise rate, the emergence of the Coronavirus will see increasing debate about the effectiveness of monetary policy (including QE measures) in stimulating growth (or inflation/ employment).

There is now a growing number of voices calling for fiscal policy to "step up to the plate". In this review we'll look at strange nexus that exists between the impact of Coronavirus and the stimulus of economic growth via monetary or fiscal policy.

The Coronavirus Correction

It's fair to say that the Coronavirus poses a serious threat to the global economy. The problem is that no one is presently able to even remotely estimate how big a problem it will be for countries around the globe – and its this uncertainty that equity markets despise with a passion and is at the centre of the recent share price volatility.

Initial estimates indicated that there would be limited impact and whilst equity markets were softening, it was assessed that any dip would be limited and quickly recovered (this on the assumption that we were witnessing simply a deferral of economic consumption that would be recovered in following weeks/months). Its safe to say we've moved beyond this proffered short "v-shaped" impact on markets.

What has prompted the recent dramatic fall in share markets has been the rise in infection rates outside China. As we type, the virus has now spread across Asia, Europe and the Middle East and we are playing in a different ball game. Granted, the virus itself is not a significant threat to human life (the death rate is short of previous infections such as SARS, MERS, Swine Flu, Avian Flu and EBOLA). However, the impact of Coronavirus (or its transmission effect on the real economy and financial markets) is via the closure of international boarders to trade (manufactured goods & services) and passenger movements. There are also knock-on effects for globally aligned supply chains as China shuts a raft of factories that produce (for example) componentry for smart phones, electrical appliances, cars & the like. It's the economic fall-out that is the main concern, not death rates from the virus per se (which are still quite low).

This time around, the economic significance of China is also an exacerbating factor – in 2003 when we encountered the SARS epidemic, China's economy represented around 8% of global GDP. In 2019, as China faces increasing trade & travel isolation, their share of global GDP has risen to 20% (Source IMF, Deutsche Bank).

The other unusual aspect to this virus is its "timing" relative to where we are in the equity cycle. The Coronavirus outbreak has occurred at a market top – ie **equity valuations are stretched**.

When the MSCI world index is plotted against major historic health outbreaks (as above) we do see some interesting trends. Historically, the impact of epidemics on share markets has not been significant (refer to inserted table) – they've largely been "noise". This has certainly not been the case with Coronavirus where increased globalization (trade interdependency) and elevated price earnings ratios, gave investors a sound reason to take profits. The thing about rising markets is that they **never just run out of steam – they correct for a reason** and the reason in February 2020 is the Coronavirus.

The US market is currently down around 12% since the Coronavirus outbreak and it may well fall further in the short term (markets will also invariably "over-shoot" at the bottom). Historically, we would observe that after an almost uninterrupted run from early 2016, the US market corrected by over 16% in the latter part of 2018 after the Federal Reserve precipitously increased interest rates, causing the yield curve to invert. Corrections do happen in equity markets when they are over-heated, and everyone can point to the reason why after the event.

The one thing that we can say at this point is that the Coronavirus problem will be solved – the question is though, with what level of economic and financial fallout.

The Death of Monetary Policy as we Know It

For some time now the global economy has been drifting in a malaise of low growth, low inflation – this despite interest rates being at historic low levels. This situation is no more apparent than here in Australia where the cash rate sits at 0.75% and growth is struggling at 1.7% pa (the latter being driven largely by public sector spending). We would argue that in these circumstances, conventional monetary policy has likely reached the end of its useful life.

Banks are at the point where they are simply not able to sensibly pass-on any further official rate cuts initiated by the RBA. Their retail funding base (ie deposits) already sit on, or close to, an effective interest rate of zero percent. So in the absence of being able to re-price their liabilities (lower), they will be in no hurry to pass on any rate reduction to their existing loan customers.

Our view is that any further reduction in official rates would potentially do more harm than good. The only real option might be for some form of targeted QE that could see the RBA offer loans to banks (secured by existing collateral) at concessional or below market rates.

Keynesian theory is now back in the spotlight – that is fiscal policy (or how the Government spends, taxes & borrows) potentially offers a more effective mechanism for managing economic demand at this point in the cycle.

A holy trinity of unforeseeable factors (ie drought, bushfire & Coronavirus) has now all but wiped out any chance the Morrison Government had of delivering its much vaunted budget surplus. As noted above, the RBA is effectively out of ammunition so it will fall to the Federal Government to offer an appropriate suite of measures to steer the economy through any period of future economic uncertainty.

As part of the May Federal Budget, or as a mini-budget in the short term designed to address any looming economic impacts from the "holy trinity", the Morrison government will need to consider the following policies:

- Cuts to personal tax rates (**not** tax rebates). Consumers need an on-going increase in their take-home pays, not a one-off, annual refund
- Reductions to corporate tax rates. Whilst this measure was previously taken off the agenda after sustained resistance from many quarters within the community, the economic circumstances might allow a bring forward of slated cuts together with an additional pared back version of the original plan (likely targeting small and medium sized business)
- Accelerated asset write-off provisions for business & rural producers.
- One-off payments or subsidies to welfare recipients (probably not favoured but the Government, but they will need a quid pro quo for concessions to business, farmers & wage earners)

There may also be some limited scope to bring forward Government spending on infrastructure, however, the pipeline here is already congested (there are finite resources for large scale projects) and the economic impact is likely to be longer term.

Given that the Government will now likely be handed a "get of jail free card" on the budget surplus, the Prime Minister has an opportunity to wrestle back the political agenda and lay down a blueprint for economic growth based on the prudent deployment of additional fiscal measures.

OUTLOOK

The fear around the Coronavirus is certainly unsettling markets and it may well have some time to run as countries take disruptive action to stem its spread. However, the virus will be brought under control at some point and attention will then switch back to macroeconomic & company fundamentals. The global economy is in a healthy underlying position and we expect **interest rates to remain very low** and for Central Banks & Governments to provide whatever support is necessary to maintain their economies.

What the last few years has highlighted about markets is that the equity risk premium is king. People talk about "FOMO" (fear of missing out) driving investor behavior, but we have now moved beyond this paradigm. Around one third of global bonds now yield negative returns – in other words, the safest bet in the market (holding a bond to maturity) actually costs you money. Accordingly, equities are now "the only game in town" (TOGIT) when it comes to long term investing.

At the end of the day, only one thing matters - its **all about interest rates**. Whilst interest rates remain at historic lows, and provided authorities don't drop the ball on monetary or fiscal policy, equities will continue to deliver solid financial returns over the foreseeable future.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** With the impact of the Coronavirus on markets and the resultant impact on valuations, we are now more comfortable to maintain a neutral position to equities.
- **Global Equities (Slightly Underweight):** The US market is now off more than 12% since early February and, whilst still somewhat over-valued, looks better value at current levels. Asian and European markets appear to have more headroom for growth.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro tailwinds have now abated.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little more in fixed interest instruments relative to cash.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, our net cash position is slightly overweight.

Regards

Andrew & Stephen
27 February 2020