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Update Markets & the Coronavirus

The dynamics of the coronavirus are fast moving as government and health officials respond in real time to the evolving situation. Measures taken a week ago are no longer appropriate as the measures of today may be in a week's time. Governments are focused of what is referred to as flattening the curve that is slowing the spread of the virus such that the peak infections is much lower than if left unabated. To do this governments are putting in place social distancing measures, banning tourists entering the country or enforcing self-isolation, banning events that involve large gatherings, with some going into a fuller quarantine of the populous.

The measures taken are having a significant economic impact with a slowdown in consumption and discretionary spending with the demand for many goods and services having fallen dramatically. In addition to this is the supply disruption following the shutdown of the Chinese economy and with many businesses having significant issues in relation to parts and materials used to manufacture their goods. In many ways this is an unprecedented simultaneous supply and demand shock.

The nature of this shock makes it difficult for policy makers to respond as the measure to counter the spread of disease are what is causing the economic weakness. Many commentators are indicating a largely fiscal response is what is required to bridge the gap, and we would tend to agree with this. Despite that we have seen action from the RBA, the Fed and other central banks cutting interest rates and restarting quantitative easing. We have also seen fiscal responses here in Australian as well as the US and elsewhere. History shows that policy action often requires a few attempts before the aggregate response is enough to settle markets and affect an economic turnaround. History also shows that markets are resilient, and the rebounds can be dramatic particularly in the first twelve months of recovery.

We would think several conditions (see table below) would be required for the market to bottom out. Many of these are not in place and therefore we would be some way off reaching the bottom. Based on expert commentary peak infection rate is likely to be at least six weeks away and therefore any reduction in social distancing measures that will allow demand to pick up is also probably some time off. Importantly for share markets an indication that a recovery in earnings is on the horizon will be what enables the start of a recovery.

Conditions already satisfied/partially
Panic selling with immune assets also being sold down
Equity Valuations back to fair value
Commodity prices begin to recover/gold weakens (partially)
Cyclicals no longer loss leaders (partially)
Concerted global policy action (monetary & fiscal) (partially)
Yield curves begins to steepen (partially)
Conditions required
Peak Infection reached and declining
Volatility stabilises at a lower level
Credit stabilisation and spreads cap out*

Source: Macquarie, AMP Research

*spreads are the difference between the yields of two bonds of similar maturity but different credit quality

Financial markets will be volatile for some time while uncertainty remains high and the virus has not peaked. However, we believe that policy makers have the desire and tools to act as a circuit breaker and provide the right stimulus to economies. Volatility will fall as risks decline and markets will settle when they consider the appropriate policy responses have been put in place. History shows that trying to predict or time markets is very difficult. We continue to support investors staying with their investment plan, continuing to hold quality assets. The current market volatility may present the opportunity to rebalance portfolios in the near future to take advantage of the lower share prices.

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