1st March 2020

Woodhall's Wrap

Ron Bewley PhD, FASSA

Coronavirus and US elections disturb markets

Coronavirus causes disruptions to business and markets
Democratic primaries have yet no clear leader
US economy remains strong

The Big Picture

Only a couple of weeks after the US-China trade tensions settled down, coronavirus (COVID-19) spread across the globe from Wuhan, China.

While we are not experts in medical matters, we must still try and navigate the impact of this virus on economies and markets.

Despite China having seemingly acted swiftly in containing the virus, it has spread to many countries around the world. It has not (yet) been classified as a pandemic (a global epidemic) and various heads of health organisations have said that it is flu-like and would only have a mild impact on most people. However, as with regular flu, the very young and very old can have serious reactions and death may occur.

To put coronavirus in perspective, about 12,000 people died in the US from 'regular' flu in 2018 – the latest complete year of data. No vaccine yet exists to combat coronavirus and educated opinion seems to suggest a solution is at least several months away.

Some of the production lost in China might never be recovered but most expect Q1 to be impacted with a lesser impact on Q2. For example, the IMF shaved only 0.1% off its global growth forecast but cut China growth from 6.0% to 5.6%.

Besides China, Italy, South Korea, Japan and Iran have been particularly affected and even major sporting and cultural events have been cancelled or conducted without spectators.

So far, the direct impact on Australia has been limited but provisional plans are in place to shut down schools and similar centres if necessary.

While it is always difficult to ascribe precise causes to changes in stock market indexes, it seems reasonable to assume much of the sell-off in late February was due to the spread of the virus. Indeed, the strong changes in the direction of markets within a trading session (so-called intra-daily volatility) seems to be associated with news or rumours occurring in our 24 x 7 news world.

Had it not been for the coronavirus, the noise created in the US primaries (that Democrats use to choose their candidate to for president) would still have created some significant market volatility. There is still a large number of candidates including two on the extreme left of the party: Sanders and Warren. The larger number of more moderate candidates is splitting their share of the vote helping to make Sanders look like a leading contender – at least until the moderates consolidate their champions.

Although in his late seventies, Sanders is particularly popular with young voters. He is proposing free college education; wiping out existing student debt; decriminalisation of marihuana possession; and even the expunging of previous marihuana criminal charges! On top of that he wants free medical care for all and the outlawing of private health insurance. Of course, he has offered no reasonable costing of his plan nor the means by which he will raise money to pay for it all!

Many of the Democratic candidates are unusual in their ages compared to those of all past presidents. Not only would leading contender, Buttigieg, be the youngest ever elected president, he almost would be younger than Kennedy was even after completing a four-year term! Nixon, at just under 78, was the oldest sitting president after his two 4-year terms ended. Sanders, Biden and Bloomberg would be older than that before they even started their presidencies.

It is popularly suggested that the sitting president (in this case, Trump) is in the box seat if the economy is strong. With the official consumer confidence index read being over 30% higher than before Trump was elected in 2016 and the unemployment rate bouncing around the all-time low since man first walked on the moon, the US economy looks strong enough to be a positive for Trump.

While we do not want to predict who will be elected US president in November, we do believe it will be someone who keeps the economy on track. There are safeguards in place in the US system.

We do not know when the coronavirus issues will dissipate but we think markets will have recovered within a few months if not well before. With US 10-year and 30-year bond yields falling to record lows, growth assets continue to be a viable consideration in designing an investment strategy. We, and most other analysts, do not expect a global, US or Australian recession during 2020.

Asset Classes

Australian Equities

The ASX 200 reached an all-time closing high of 7,163 on February 20th 2020 and then fell sharply into the end of the month. The index was down -8.2% over the month. As we argued in our introduction, we believe the sell-off was largely due to news and rumours about coronavirus and the US election.

At the time of the peak we had the Australian market as only moderately over-priced. It is now very cheap by our metrics but heightened volatility means that it might be prudent to wait a little before entering or re-entering the market.

The February Australian company reporting season is all but over. It is hard to judge the full impact of reporting season owing to the heightened volatility. However, our analysis of broker-based forecasts of company dividends and earnings strongly suggests the market was in a stronger fundamental position at the end of February than it was at the beginning. Therefore, we believe the market will continue to improve once the coronavirus situation is resolved.

Foreign Equities

The S&P 500 reached an all-time closing high of 3,386 on February 19th 2020. At that time, we had that market significantly over-priced and in danger of a correction from any catalyst or a prolonged sideways movement. The market sold off sharply into the end of February. It was down -8.4% on the month. Unlike with the ASX 200, our analysis of broker-based forecasts did not strengthen much over February but they did stay solid and stronger than those for the ASX 200.

We believe the market will continue to improve once the coronavirus situation is resolved. The US election issues could mask market movements up until the Democrats have a clear leader to challenge Trump in the November election.

Bonds and Interest Rates

The Reserve Bank of Australia (RBA) was on hold in February but flagged that they were ready to act if necessary. The Bank of Korea, at their end-of-February meeting, kept rates on hold at 1.25% despite there having been strong market predictions that rates would be cut.

The US Federal Reserve (the "Fed") appeared to be settled at the current rate until the last day of February when the chairman, Jay Powell, came out in a speech to settle down markets. The market has been expecting cuts this year.

Until the stock market sell-off, a standard measure for estimating the chance of rate cuts (known as the CME Fedwatch tool) had priced in only a slim chance of their being a 25bps cut on March 19 at its next meeting. That has now moved to a 0% chance of the Fed staying on hold and more than a 90% chance of there being a double cut of 50bps on March 19th.

However, 50 out of 70 economists polled by Refinitiv (formerly Thompson Reuters) just before the market sell-off did not think there will be a US rate cut in 2020. Sentiment is changing on a daily basis.

The US 10-year and 30-year Treasury-note yields reached all-time lows at the end of February. However, the standard 2-10-year spread is not inverted that some would use as an indicator of a possible recession.

Other Assets

The prices of oil and iron ore fell over February largely over the China-coronavirus situation. The price of gold rose held steady reflecting its safe-haven status. The Australian dollar reached an 11-year low in February after falling -3% over February.

Regional Analysis

Australia

The Labour Market Survey for January reported in February showed an increase in the unemployment rate from 5.1% to 5.3%. We reported last month that we thought that the drop to 5.1% was likely to have been a statistical aberration. There were 13,500 jobs added in January with a very strong increase in full-time jobs. The Australian job market continues to be solid.

The Westpac consumer sentiment index rose back to 95.5 from 93.4 in February. The index has not been above the 100 level that separates optimism from pessimism during the current financial year. The Australian consumer is not optimistic but they are still spending.

The RBA is forecasting economic growth to be 2.75% this year followed by 3.0% in the next. We think those forecasts are optimistic but immigration will most probably help keep us well out of recession territory.

China

The coronavirus outbreak has caused major shut-downs in China. There will undoubtedly be a permanent component to the lost production and sales. Importantly, the supply chain for global manufacturing has also been affected.

The China manufacturing Purchasing Manager's Index ("PMI") fell to an all-time low of 35.7 (from 50.0) at the end of February. The services PMI also fell sharply from 54.1 to 29.6.

Sharp falls in the China PMIs were largely anticipated and may not further impact on stock markets going forward.

There was a report on CNBC that the supply chain for certain retail goods was already starting to recover. When there are so many products in so many regions of China, there may be conflicting reports for some time to come.

We understand that China has been collaborating with other countries in the search for medical solutions. Although the quarantining has been disruptive it may well be shortening the length and severity of the problem.

US

The US labour data remain strong. The number of new jobs came in at 225,000 against an expected 158,000 but the unemployment rate came in a notch higher at 3.6%. The change in wage rate returned to 3.1% from 2.9%.

The manufacturing recession in the US has now officially ended.

Europe

Italy has so far suffered the most of all European countries from coronavirus. Sporting fixtures and cultural events have been affected.

There appears to be little news on the Brexit front. Perhaps public servants are diligently and quietly working towards new trade deals. We are certainly not learning of any major disruptions to the UK or EU economies as were foreshadowed during the run-up to the start of the Brexit process.

Rest of the World

Japan's Q4 growth came in at -1.6% for the quarter while Singapore beat expectations with a growth rate of +1.0%.

Surprisingly Japan's industrial output and retail sales for January were both big beats over expectations. With coronavirus looming large in February and beyond, at least this good start to the pre-virus situation is a much needed positive.

Hong Kong will likely go into recession from the combined impact of the protests and coronavirus. In response, the Hong Kong government is reportedly going to gift about $A2,000 to each adult permanent resident (about 7 million). However, many of these people are not currently living in Hong Kong but are located in such countries as the US and Canada! Therefore, this stimulus measure does not seem properly targeted to kick-start the Hong Kong economy.

The holding of the Olympic games in Tokyo this year has been questioned. Apparently, there are nearly three months left in which to make a decision. Naturally there would be dire economic and social consequences of not holding the Olympics as planned. We are not yet aware of any contingency plans for an alternative date or location.