Market Commentary

March 2020

Peak Investment Partners

EXECUTIVE SUMMARY

- **As coronavirus extended beyond China and economies have been shut down, equity markets have seen falls of near 40% from mid-February highs. From the lows of March 23rd, most have seen 20%+ rallies.**
- **Strong action by Central Banks and Governments are designed to reduce interest rates, increase liquidity and reduce the impact of a sharp recession, rising unemployment and increased business failures.**
- **Valuations have improved significantly from mid-February. However earnings are set to fall significantly in the months ahead, before a recovery later in 2020.**
- **We are unclear whether we have seen the lows. Regardless, investors are being better compensated for the risk of holding or buying equities**
- **Investment strategy remains defensive through exposure to healthcare, food, consumer staples, utilities & infrastructure.**

The first quarter of the New Decade will be etched into memories as one of the most extraordinary periods in modern history. From terrifying bushfires, widespread drought, a global pandemic, the onslaught of a global recession leading to a financial market crisis necessitating extraordinary actions by central banks and governments. The consequences of these events during the opening quarter may be felt for years to come.

The speed with which equity markets have fallen is without precedent. From February 20th to late March the S&P500 declined 35%, Stoxx600 40% and the ASX200 fell 38% to their low points. Since then, there have been varying degrees of recovery with most markets rising around 20% from those lows. There is much debate over whether the March 23rd levels were the lows and a new market cycle has commenced. History suggests markets generally re-test lows before entering a new cycle, though not always (ie 1982). It would be a first however to have a bear market with a duration of just a month-though these are exceptional times.

Where to from Here?

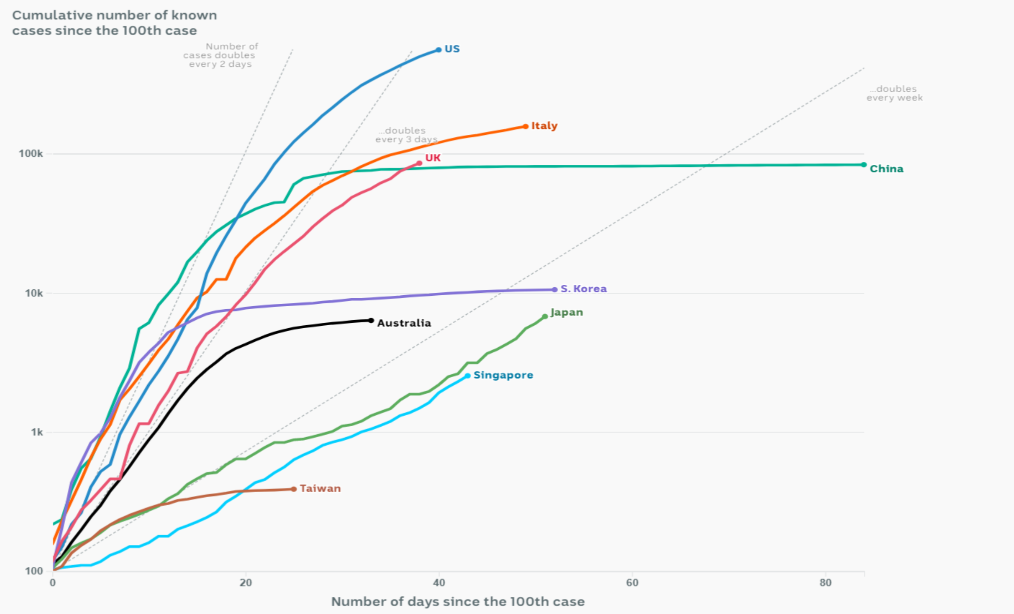
Our initial assessment of how the pandemic would evolve was based on the Asian experience (see the chart below). China, South Korea and Taiwan moved quite quickly to lock down economic activity, restrict people movement and close borders. This resulted in a month or so of disruption followed by a gradual return to business as usual. From the initial shutdown to a return to normal was a 3 to 4-month timeline.

It's worth noting that it is far easier to enforce a strict lockdown in more authoritarian political structures. In advanced western democracies, this has been more difficult. With the core attributes of freedom, independence and civil liberties, lockdowns and social distancing have proved more challenging.

As a very infectious disease, once coronavirus gathers momentum, it has proved very challenging to bring it under control. Healthcare systems in many countries have been shown to be inadequate and incapable of dealing with the scale of the problem. Testing standards have been inadequate, as demonstrated by Italy, Spain, the UK and most significantly, the United States.

Importantly, as the chart highlights, it appears that most countries are now seeing a moderation in number of new infections. It gives some hope that we are near the worst of it, and that the measures in place seem to be working.

Pleasingly, Australia appears likely to follow the Asian model. By implementing a lockdown relatively early, enforcing social distancing and undertaking a comprehensive testing program the signs are that, within a month or so, the coronavirus can be brought under control. From there, things can begin to normalise.



`

What will the new normal look like?

The next 3 to 6 months will be an economic, social and emotional roller coaster. Substantial increases in unemployment, decreases in economic activity, implementation of the vast stimulation programs will continue to impact daily lives. Low oil prices will also contribute to the impact of the stimulation. Financial markets are likely to continue to reflect this volatility.

We would not expect the new "normal" to be the same as the old "normal". Some trends that have evolved during the lockdown phase could reasonably be expected to remain. Working from home, teams working together remotely, online education, online shopping are likely to remain in place. International travel, especially the cruise ship industry, will take time to recover with longer term consequences for the tourism industry. The retail sector faces structural change with consequences for the property sector. Changed work patterns may have consequences for the commercial property sector.

The winners will include parts of the technology sector and telecommunications. Growth in use of the cloud, datacentres, connectivity, movement of data are long term trends. Domestic tourism should rebound strongly, as will elective surgery. Healthcare, on a global basis, will likely see substantial attention and investment in the aftermath of the corona virus. For Australia, our economic linkage with Asia continues to underwrite the long-term success for our resources and food sectors.

Where to for the Market?

In the current environment, forecasting anything with accuracy is impossible. From a market perspective, we find Goldman Sachs framework helpful. How markets perform in the months ahead will be determined by:

- Control of Coronavirus
- Execution of the Fiscal and Central Bank stimulus plans
- Stability within market participants

With virtually all advanced economies forced into recession from March, corporate earnings trends will be decimated over the next few months. On the basis that the coronavirus is brought under control by mid-year (perhaps a big íf) corporate earnings should bottom out during H2, after a terrible Q2. On that basis equity markets have either seen the lows or may do so over the next month or two.

The massive stimulation packages announced by governments and central banks should start to have an impact through H2. Most have been designed to have maximum impact in the short term, through putting cash into people's hands, supporting businesses get back in production and hiring staff. Execution will be important. As our chart highlights, Central Banks are providing abundant liquidity to stabilise the system. These measures are very positive for markets.

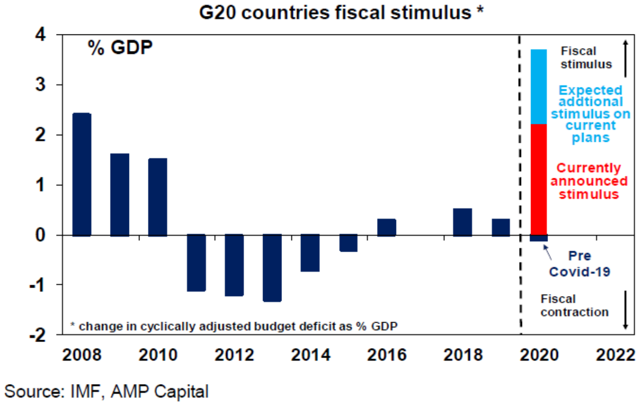
During March daily volume was more than double March 2019, according to ASX data. Volatility (often referred to as a measure of fear) increased fourfold in March compared to February. These trends suggest that many investors were forced or decided to sell at distressed price levels. The subsequent rally suggests that forced sellers have now largely exited the market. Share price trends will be more influenced by fundamentals.

Markets and Valuations

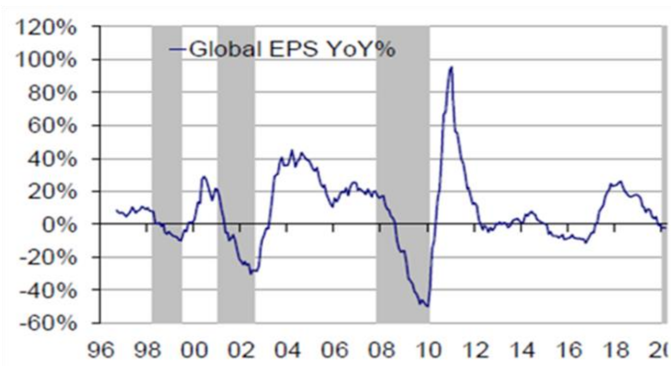
The market correction has seen a material improvement in stock valuations, based on current consensus forecasts. Sadly consensus forecast are cum substantial downgrades over the coming months, only to be followed by a meaningful improvement as things begin to normalise.

The Citi chart below (EPS Falls and recoveries) shows the historical pattern in earnings trends through recessions since 1996. Typically earnings fall 30-40%, followed by an equally sharp recovery. We would anticipate a similar pattern in the current downturn. The downturn may perhaps be sharper, given that economies have been forced into a deep recession quickly, although the rebound could also be sharp.

As described in our recent note, this is an event driven bear market rather than a structural one.



EPS Falls and Recoveries



Source: Citi

Investment Strategy

In the current uncertain and volatile time we find ourselves in, capital preservation is the main priority. From a stock perspective that involves investing in companies with reasonable earnings visibility and predictability, reasonable certainly around cashflows and solid financial structure.

In the short term, we have seen many companies withdraw earnings guidance. Many appear likely to cut dividends (including banks) to improve cashflows and balance sheets. Our focus is on ensuring companies we are invested in are sustainable under a worst-case scenario. While they may be impacted short term, we are confident they will be around for the recovery.

Sectors that have a relatively high degree of sustainability include healthcare, consumer staples, food and beverage, utilities, some infrastructure and technology.

There has been a sharp rise in capital raisings. Some relate to a dramatic change in business conditions i.e. Cochlear, Auckland Airport, Flight Centre and Webjet. Others are designed to capitalise on potential opportunities arising out of changing circumstances ie Nextdc, IDP, Megaport and Wesfarmers.

The present market volatility is also providing us with the opportunity to add to some of our core holdings at very attractive entry points. Some have traded 50% down on recent highs over the last month or so, including REA, Seek, James Hardie, Aristocrat, Qube, Macquarie Bank, Magellan.

As things stabilise, we are likely to reduce exposure to more defensive names that have performed well during the downturn (e.g. Resmed, A2 Milk, CSL, Coles, Woolworths) and recycle funds into stocks that have seen much larger falls.

The hybrid market has suffered more than we expected as stress in credit markets has forced up credit spreads, impacting negatively on hybrid prices. With central banks injecting substantial liquidity into markets along with a higher oil price, spreads should normalise in H2.

Our Small Companies portfolio has performed relatively well during the downturn. In times of market distress small companies inevitably are harder hit than larger ones. Many small cap stocks have fallen by 50 to 70%. Some of attractive opportunities include Altium, Appen, EML, Nanosonics, Costa, Freedom Foods and Jumbo Interactive.

Finally, we continue to like resources, including BHP, RIO, Fortescue and Northern Star. The combination of China in recovery mode, relatively high iron ore and gold prices and a low $A underpin corporate earnings.

We appreciate that this has been a very uncertain and difficult time for many. To you and your family please stay safe and well.

Thank you for your continued support.

Recent ASX200 Fall in Historical Context

Source: Bloomberg

Ian Wenham
Director

Richard Nicholas
Director

Andrew Martin
Director

Contact details
Level 11, 56 Pitt Street, Sydney NSW 2000 **Phone: (+61 2) 8274 5800**
Email: info@peakinvest.com.au **www.peakinvest.com.au**