Axiome Autumn Update

January - March 2020

Covid-19 shut-down: empty streets in Devonport

IN THIS ISSUE

Investment Market Review

In our last report we highlighted the exceptionally strong returns in 2019, with markets registering gains of 25% or more. The good run continued into January 2020, but cracks started in February as concerns mounted that Covid-19 was spreading to other parts of the world.

Central banks started to cut interest rates, which initially supported markets rallying further. But from around the 20th February a very large and rapid sell-off began as the true scale of the global pandemic became apparent, and governments started to implement social distance measures and close borders.

Covid-19 became a global pandemic in February, plunging markets into bear territory

The sell-off from late February was also accompanied by extreme volatility and various stresses in financial market conditions (including reduced liquidity, longer trade settlement time frames, and increased credit spreads on bonds).

Policy measures and signs of reducing Covid-19 transmission has led to a large market bounce since late March

In response, central banks were quick to deploy the 'toolkit' they developed in the GFC in 2008/9. Interest rates were cut to zero in countries where they were still above this level (notably, the US, Australia and New Zealand). Quantitative easing programs were also re-started or kicked into life, including in New Zealand for the first time.

Central bank action, along with the unprecedented scale of fiscal support measures that governments have put in place, were successful in arresting the free

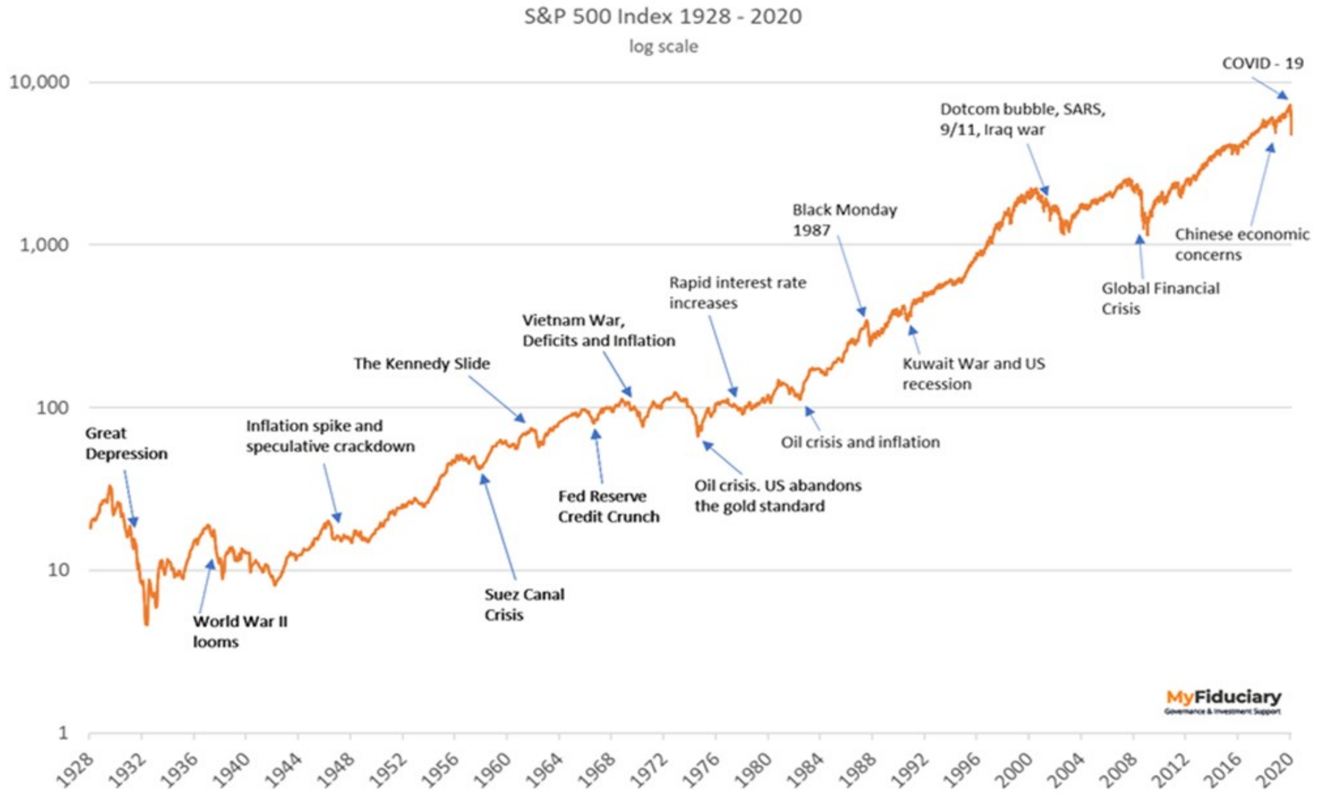


Figure. 1 Equity markets eventually recover from shocks *Source: Datastream, MyFiduciary*

fall in markets that began in late February. To provide some context, the US share market S&P500 index peaked at 3386 on 19th February. By March 23rd it had fallen around 33% to 2237 – it's fastest descent into "bear territory" (a decline of over 20%) ever. But since that point it has recovered around 25%, to a level of 2790 (as at the market close before the Easter break).

In our view the long-term reward for bearing risk remains intact

We don't know whether the lows reached in the 3rd week of March will prove to be the bottom, or if instead markets will suffer further large declines given the dire immediate economic situation. But we are confident that the long-term reward for bearing market risk remains intact, and that this "shock", like other large shocks markets have faced, will pass (see figure 1). As such sticking with long-term investment strategies, and re-balancing through the volatility as necessary, remains the best course in our view.

It appears increasingly unlikely that we are facing a GFC-styled financial crisis, or a Great Depression scenario, given:

1. The economic and financial market policy measures that have been put in place to tide banks, businesses and households over.
2. The increasing health successes in curtailing Covid-19 transmission, particularly in New Zealand, but also in US and European epicentres of the disease.
3. The accelerated timelines for the development of anti-viral treatments and vaccines, which ultimately means the life can "get back to normal".

Turning to the quarterly market results, fixed income returns were a bright spot, with international investment grade bonds returning around 1.5% over the quarter and 6% over the year.

NZ investment grade bond returns were also positive. But under the surface results were more disparate.

Government bond returns were much stronger as long-term rates fell over the quarter and investors "fled to safety".

Fixed income returns were a bright spot cushioning the decline of equity markets in portfolios

Investment grade corporate bonds returns were weaker, materially so until the central bank interventions started reducing credit spreads.

The NZ dollar decline also helped cushion the blow from declining global markets.

International shares fell around 10% in the quarter in NZD terms, whilst NZD hedged shares fell around 21% mirroring the decline in global market terms. The NZD tends to fall in time of stress, and this time was no different, which significantly helped cushion the blow from the global market decline.

Within global equities, higher risk sectors such as "small caps" and "value stocks" under-performed. In contrast, "growth stocks" performed relatively well, in part reflecting that this sector has a higher exposure to tech and the health care companies, which have been better able to continue business under the Covid-19 environment.

Emerging Market equities fell around 13% in the quarter, reducing the annual return to around -5%. While this is a poor absolute outcome, it is better than what we would normally expect in a market sell-off given emerging market stocks (like small cap and value stocks) are typically seen as more risky than large developed market stocks. The better performance likely reflects that key Asian emerging markets - China, South Korea and Taiwan - are further ahead in their management of the Covid-19 pandemic.

Emerging markets performed relatively well as did the NZ

Trans-Tasman equity markets had mixed fortunes. Australian shares fell around 23%, slightly larger than the international market decline. In contrast, the NZ market 'only' fell by around 15% over the quarter, and is still up around 12% over the past three years. The differences largely reflect the make-up of our markets. Amongst New Zealand's largest listed companies are Fisher & Paykel Healthcare, A2 Milk, Spark and Contact Energy, which are in sectors that are less impacted by Covid-19. In contrast, Australia's largest listed companies include banks and mining stocks, which are much more affected by the current economic conditions.

Australian equity markets and listed property returns were hit very hard

Finally, infrastructure and property stocks also had mixed fortunes. International property stocks fell by around 28% in the quarter (-39% on a hedged basis), reflecting large uncertainty around when commercial buildings can be re-occupied, and what tenant demand might be post-Covid. International infrastructure has been more resilient, returning around -10% over the year.

Current economic readings are dire. Various measures of activity and employment are showing the largest declines on record. Pre-Covid global growth was slightly below trend. Now there is no-doubt most economies are in recession, and the debate is over the recovery picture and whether some impacts (e.g. to tourism and commercial property) will be permanent.

Markets have been quick to price in recovery notwithstanding the restricted global economic activity projected for the next few months. Consensus forecasts have the economy starting to bounce back from the September quarter (Figure 2).

The current global slump in activity is the largest on record, with recovery timeframes uncertain

Economic forecasts should be taken with an even larger pinch of salt than normal given a lot depends upon public health risks.

Given the uncertainty, markets may see further bouts of volatility. But ultimately, as vaccines and better treatment protocols are developed, the pandemic will pass.

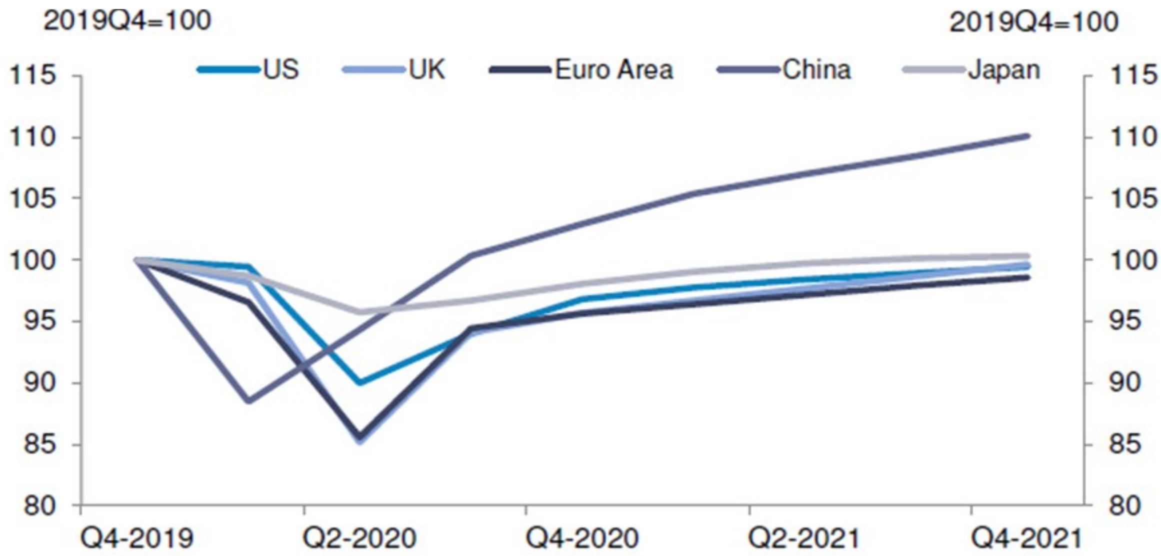


Figure 2: Economies will recover too, despite the uncertainty

Source: Deutsch Bank Research, April 2020 Forecasts

Key Market Movements for the Quarter

Quarter	Past year	
-14.5%	**+0.5%**	**New Zealand Shares** *New Zealand shares returned -14.5% in the quarter and around 0.5% over the year to March 2020. The decline in NZ equities in response to the Covid-19 pandemic, while large, was still smaller than many other markets. Over the past 3-years performance remains strong at around 12% per annum.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
+1.2%	**+4.2%**	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds returned 1.2% for the quarter and around 4.2% for the year. This return is both comfortably higher than 90-day NZ bank bill and term deposit rates, showing that NZ corporate bonds have delivered a premium over the year, and through the Covid-19 sell-off.* *Source of Figures: S&P/NZX A Grade Corporate Bond Index*
-23.7%	**-14.5%**	**Australian Shares** *Australian shares returned -23.7% in the quarter in NZD terms, reducing the annual return to around -14.5%. Within Australian equities, small cap stocks and value stocks under-performed returning around -27% and -30% for the quarter respectively. The large decline in Australian equities reflects their large exposure to the energy and commodities sectors, which have been particularly hard hit both by Covid-19 and an oil-price war between Russia and Saudi Arabia.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
-10.2% (-21.1% hedged)	**+3.1% (-11.1% hedged)**	**International Shares** *International shares fell around 10% in the quarter in NZD terms, whilst NZD hedged shares fell around 21% - mirroring the decline in global market terms. The NZD tends to fall in time of stress, and this time was no different, which significantly helped cushion the blow from the global market decline. Within global equities, small caps returned around -20% in the quarter while value stocks returned around -17%.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value, MSCI World Small Cap.*
-13.1%	**-5.3%**	**Emerging Markets** *Emerging Market equities fell around -13% in the quarter, reducing the annual return to around -5%. While this is a poor absolute outcome, it is better than what we would normally expect in a market sell-off given emerging market stocks (like small cap and value stocks) are more risky than large developed market stocks. The better performance likely reflects that key Asian emerging markets are further ahead in their management of the Covid-19 pandemic.* *Source of Figures: MSCI Emerging Markets Index*
+1.4%	**+6.0%**	**International Fixed Interest** *Global bonds returned 1.4% in the quarter and 6.0% for the year. The annual return remains strong given their low income yields, and reflects bonds being re-priced higher as longer-term interest rates fell on the back of global growth concerns.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
-28.0%	**-24.5%**	**International Property and Infrastructure** *International property stocks fell by around 28% in the quarter (-39% on a hedged basis) and 24.5% over the year. This asset class has been hit hard by Covid-19, reflecting large uncertainty around when commercial buildings can be re-occupied, and what tenant demand might be post-Covid-19. International infrastructure has been a more resilient asset class, returning around -10% over the year.* *Source of Figures: FTSE EPRA NAREIT, S&P REIT indexes*

Volatility and market stress

In recent weeks, investors could be forgiven for feeling like they had lined up for the wrong roller-coaster ride at the fair, that they were on the 'Adrenaline Peak' rather than the 'Little Dipper'. Volatility levels spiked to highs not seen since the Global Financial Crisis (GFC)

A measure of volatility used amongst investors is the VIX Index, which is sometimes called the 'fear index' (Figure 3).

The VIX is an up-to-the-minute market estimate of implied volatility of the S&P 500 Index, which is calculated by taking the mid-points of the bid/ask quotes of real-time S&P 500 options.

During the GFC the VIX spiked into the 80s, whereas it more usually sits between 10 and 30, perhaps moving into the 40s in more volatile periods, such as during the tech crisis in the early 2000s and the Asian debt crisis in the late 1990s. On the 16th of March this year, the VIX hit 80, so although it is not unprecedented, we were certainly at the extreme end.

When volatility goes up so sharply, history shows us it tends to take some time to come back down again. The VIX currently sits around 40.

The heightened volatility is a sign that the markets continue to function as they should. The news cycle is accelerated at times like these and prices seesaw as the new information is priced in.

In volatile markets the cost of trading is higher as the spread between buy and sell prices widens out. For the S&P500 index, representing the 500 largest companies in the US, the difference between bid and offer prices is usually very narrow because these stocks are highly liquid and traded in volume. A five to eight fold increase in volatility for the S&P500 says a lot about what is happening in the broader market.

Volatility from market stress is more pronounced in small cap stocks. Prices will tend to move further with each trade as liquidity is lower and there are fewer stocks traded at any given price.

Forced sellers in this environment will pay a high price to re-set their positions. There is a definite advantage in being a disciplined patient investor, which is accentuated in volatile periods.

Without volatility, however, there would essentially be very little risk in the market. Risk and return are related so in order to access the higher returns that equities generate over time, relative to less risky investments such as bonds and cash, risk is an essential part of the investment process.

Sharp spikes in volatility are tricky on an emotional level and may cause us to pose the question, "Is there something different this time?" However, the market is actually just re-pricing risk in a fast moving environment.

Whilst it may be uncomfortable, staying in your seat is important – you don't get out of the roller-coaster until it stops. Then, if you decide the peaks and troughs of the big rollercoaster are not for you, a reassessment of your risk profile can be made with a view to adjusting your portfolio asset allocation.

Recalculating whether this will work for your financial goals and re-thinking your overall investment plan is a critical aspect of making such decisions without emotion.

Figure. 3 CBOE Volatility Index (VIX)

Final thoughts...

The VIX index aptly demonstrates how the volatility peak towards the end of March (when 'fear' was most accentuated) was in line with the bottom of the market falls as far as we have seen to date. This is not to say there may not be other dips in markets ahead. But we did not foresee the extent of what has just transpired and neither will we accurately forecast what is presently unknown about the future.

The speed and extent of the bounce in share markets to the date of publication (mid–April) has also surprised.

Past performance does not dictate future outcomes, but it does provide valuable experience about how to manage our finances with discipline in an unpredictable world. The chart below provides insight on the value of staying the course through previous times of market crisis.

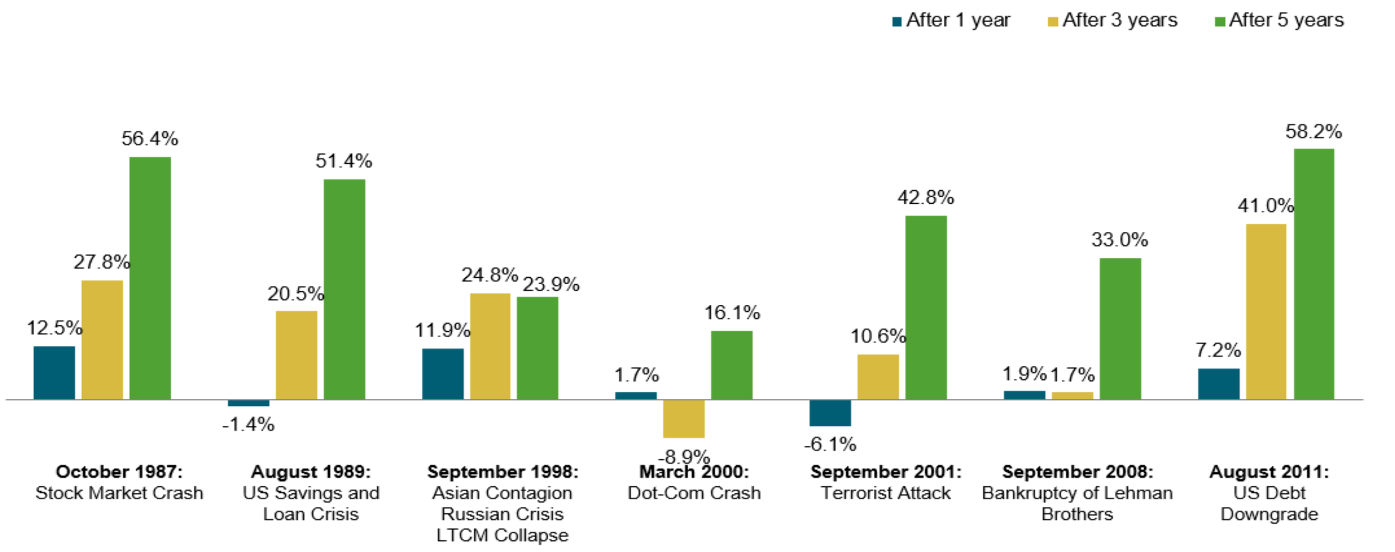
Personal application:

If you haven't learnt something unexpectedly new about your personal risk aversion, or discovered a need for greater liquidity, then the asset allocation previously designed for your long term objectives is most likely best maintained.

Mistakes during a period of high volatility are invariably costly.

The Market's Response to Crisis

Performance of a Normal Balanced Strategy: 60% Stocks, 40% Bonds
Cumulative Total Return



In AUD.
Balanced Strategy: 30% S&P/ASX 300 Index (total return), 30% MSCI World ex Australia Index (AUD, net div.), 20% Bloomberg AusBond Bank Bill Index and 20% FTSE World Government Bond Index 1-3 Years (hedged to AUD); rebalanced semiannual. S&P/ASX data copyright 2020 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. MSCI data copyright MSCI 2020, all rights reserved. Data provided by Bloomberg. FTSE fixed income indices © 2020 FTSE Fixed Income LLC. All rights reserved. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance. Returns taken one month after specified crisis date.

3

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