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Podcast Transcript

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Nick Burgess, Research Analyst: Hello again, Nick Burgess with you. This is Update 7 on Navigating the bear market amid the COVID-19 crisis. With me here is EL&C Baillieu's Chief Investment Officer, Malcolm Wood, broadcasting from an undisclosed location. Mal, welcome.

Malcolm Wood, Chief Investment Officer: Thanks, Nick. Thank you very much.

Nick Burgess: Update 7. Mal we've got more sequels than the Police Academy movies, but way less entertaining.

Malcolm Wood: A few more to come.

Nick Burgess: Yes. Potentially. Way less entertaining, but much more serious.

So let's just set the scene for our listeners. We're speaking to you on Sunday night, the 29th of March. So a little bit of context. Last week, the global markets put together some gains. Three days of gains in particular. So the S&P 500 in the US was up about 17% last week in total, but remained down about 25% from its mid-February peak. The All Ordinaries in Australia is down a bit more than that, about 33%. Looks like this week may be a bit tougher, a slightly tougher one, although the situation is changing hourly and daily. So it's difficult to put a short term prediction on at this point. Mal, when we last spoke on this forum, you know, you did say that volatility was likely to continue and that appears to be the case.

Malcolm Wood: Absolutely. I think that whilst we get this to-and-fro, the news on the Coronavirus and progress against containing that. And then on the other side, the company news, which is probably going to be challenging. And then you get the policymakers chiming in with their responses to developments as well. So there's a lot of news. It's significant in impact on markets. So, yes, volatility is highly likely to continue.

Nick Burgess: Okay. So you've been saying, Mal, for a little while now the first step is containment. Signs that COVID-19 situation is stabilizing. Are there any signs of that at this stage in either Europe or the US?

Malcolm Wood: I think it's important, Nick, to also point out the progress that's been made in East Asia. So in answer to your question, it's pretty ambiguous in Europe and the US at this point in time. There may be a peak forming in Italy and in France. But it's sort of, you know, record numbers of new cases in Spain, UK, Switzerland. So I think it's pretty ambiguous at this point in time.

Nick Burgess: Okay. So last week, as I mentioned at the open, the US market in particular seem to like the stimulus package that's been unveiled there. At one point, I think Trump was talking about getting people back to work by Easter. Now he's talking about quarantining the entire state of New York. So some of the news flow comes and goes, but the stimulus package in the US. Explain that to us. And how important is that going to be?

Malcolm Wood: Yes. So we think that both monetary and fiscal support and stimulus are important to help us bridge the gap here between: when Coronavirus started to severely impact economic activity; and when things start to get back to normal. And really what the markets are debating is the adequacy of that policy, and the duration and depth of the economic disruption. And I think that the really good news last week, Nick, that drove the market bounce was the progress that we're seeing on the policy support and stimulus front. And that's pretty good. In the US, as you point out, the stimulus package at a headline level is about $2tn. When, I think, you strip out the loans and that sort of activity, that's included in that number. The real underlying spending and tax cuts is probably around $1.2tn. That's about 6% of US GDP. You know, we've been thinking that something in the range of 3-4% was probably what was needed for a three-month event. So this looks to us to be pretty good.

But it wasn't just the US. We had a massive package announced in Germany and they're pretty reluctant usually to do anything like fiscal stimulus. Headline there was 13% of GDP underlying I think was somewhere between 4-5% of GDP. We've had further rate cuts and QE unlimited from the Fed. So there's been a lot on both the fiscal and the monetary side last week that I think was pretty good. And that helped the rally.

Even in Australia, we had, of course, the $66bn package, the second package from the government with promises of more to come. I think the fiscal support and stimulus is somewhere around 3.5% Of GDP at this point time. So, you know, all those things have certainly helped markets.

Nick Burgess: So here's my question. You talked about, you know, the markets are debating whether all of this is going to be enough. I guess my personal reference point for a lot of this is the GFC. There were bailouts. And governments were bailing out, in the first instances, banks and other institutions. And when that was done, normally the dollar value of what was required was quantifiable to an extent. So, you know, what gives you comfort that the global stimulus is enough? How do we know what's needed and how do we reconcile with what's being offered?

Malcolm Wood: Yeah, I think that's a great question. And of course, the answer is we don't know the extent of the economic disruption. We can guess what that is. And of course, as lockdown gets more severe, the economic disruption intensifies. But my guess is the disruption in Australia is anywhere from 15-20% of GDP on an annual basis. Of course, both sort of on a month, 15-20% of what we produce on a monthly basis. But that's an educated guess. And I've seen estimates of the impact in the US up to like 25% or 30% of GDP. So, you know, that is an inexact science.

What we've seen so far, on that score, is China's Purchasing Managers Indicators for February were worse than the GFC. The economic data for January-February was double digit declines in those. So pretty consistent with a pretty nasty picture. In the developed economies, we haven't had as much economic data. But the jobless claims number in the US last week jumped from 3 million people to 3.3m. To put that in context in a normal economic recession, that number peaks in the 600k-700k range. So we're just talking about something that's extremely unusual at this juncture and we're just trying to get our hands around it. So the short answer to your question is, it's highly uncertain and it's going to be difficult to know. What we do know, though, is that policy makers support pulling out all stops. Or, as they say, whatever it takes to respond to that, which should give us some comfort that if more is required, we'll get it.

Nick Burgess: What about the concept of dry powder? Do governments need to leave themselves a little bit of room to move, to see how further or much deterioration we do say from here?

Malcolm Wood: Yes. So I'd say it's the $64 question, isn't it? I think on the monetary side, you basically say they've spent the stimulus. Interest rates in the G7 with Canada cutting to 0.25% on Friday have basically gone to at or below GFC or post GFC lows. So the cash rate in the G7 is 0.7%. And we've got most of those central banks, everybody except Canada in fact, doing Quantitative Easing. Our own central bank of course has gone to levels we've never seen before. And while it doesn't call it Quantitative Easing, it did $18bn of buying of bonds in the first five days. That's almost 1% GDP here. So that's pretty impressive. So they've sort of done that already.

On the fiscal side, of course, what we're looking at here is record packages. You know, the $2tn package in the US dwarfs the $800bn from the GFC, just to put that in some context. The big country that we have not seen a stimulus package from today is China. So maybe there's something there to come that could help shape the outcomes over the next few weeks. But we haven't seen that from China yet. So I think that the point I want to make about the dry powder, though, is that I think governments are going to leave the payment side of that issue 'til after this. So some of our listeners are probably going to be concerned about who pays for this. I suspect that the leaders aren't too worried about that at this point in time. So we'll just do whatever it takes and worry about that down the track.

Nick Burgess: Okay. And just from an Australian perspective, by your analysis, Australia seems to be doing a little bit less in terms of stimulus as a proportion of GDP. Somewhere between 3-4%, you said. So in your opinion, is Australia doing enough?

Malcolm Wood: I was actually pretty impressed with the two packages that the governments brought out. Certainly this has helped to break that sort of "we want to focus on the return to surplus". That's sort of been thrown out. And I think that gives them flexibility now to respond as appropriate. You know, I my first numbers were, if we can contain this to a three, 2-3 month event, 3-4% of GDP should be around about right. So maybe they want to take out a bit of insurance and do more to that. So I think we're around about right. Of course, the Reserve Bank, as I said, has already spent its bullets. So we really can't ask for much or expect much more from them, except to print more money. So it's really, I think, leaving it up to the fiscal side there. And, you know, we'll have to wait and see what the next steps are from the government. But I don't think we should have much doubt that if more is required, they'll do it.

Nick Burgess: Okay. So I want to ask you two things about the Australian economy: the Banks and then the Construction Sector. So in Australia, some of that government help, some of that stimulus is coming to people and to small businesses in the form of loan repayment holidays, wage subsidies. Certainly the press is starting to talk about rent holidays, particularly for the retail sector. So they're all other things that are happening or being considered. I wanted to read you this quote, Mal. So this week, the CEO of the ANZ Bank, Shane Elliott, was quoted as saying this and I quote:

"We can't oversimplify this and say the banks can save everyone. We don't have endless resources either. We have highly leveraged balance sheets because that's the nature of what we do and we have depositors to look after as well. So we have masses of capacity, but it's not limitless."

When you hear that here that does that, does that concern you?

Malcolm Wood: Now, I think that's I think that's absolutely right. And another strong reason why Australia should be taking the tough measures now to get on top of this. Put it another way. Nick, you know, if you miss one month's loan repayment, that's an inconvenience. But if you're getting up to three, four, five, six, well, where's the bank's cash flow? There isn't one. That's the problem we're going to get into. So that's why we need to be acting on this quickly to sort of minimise those sort of nasty choices, which would which would really start to mount as this drags on.

Nick Burgess: Okay. And speaking of it dragging on, you know, the Building and Construction industry in Australia is the backbone of our economy, really. So far they are, from what I can tell, continuing to work. But further lockdowns, I guess, might bring that into doubt. So is that the real downside for the Australian economy, if we were to get a significant interruption into the construction economy?

Malcolm Wood: I think that, you know, we've got many sectors of our economy which are at threat here. You know, I've assumed, for example, that our Farming Sector is unaffected; that our Mining Sector is largely unaffected. I'm assuming that Construction is down 20-25%. So if it were to be a significant lockdown, that would be a that would be a big negative. Because the Construction Industry's about 7% of GDP and I think our largest employer of any private sector. So yes, the short answer to your question, Nick, if the lockdown means the ending of work on a lot of projects, that would intensify the problem.

Nick Burgess: Okay. Let's start to think of the glass half full, I guess. On recovery, you've done some work on what a recovery might look like. So what are your thoughts on that?

Malcolm Wood: Yes, we've got these three scenarios that we've been running with. So the V-shaped scenario is one where this is a 2-3 month event. So we contain it effectively; and all these support and stimulus measures that we've referred to, minimise the second round effects so people get back to work quickly. The vast majority of businesses survive this and we're back at work and operating in, say, 3-4 months' time. There's going to be a lot of pent up demand at that point on. I think, you know Nick, you've been accused of a bit of cabin fever here. So in three months' time, I suspect you're going to go out and spend big, mate, when you get the chance. So that's the sort of thing we're looking for to propel a recovery. And that sort of scenario, I think, is one that we should still think is probable.

But equally, if we don't get on top of this, the cost of the support and stimulus is going to rise and keep on rising. And it's going to be a more sluggish recovery. That's what we call the U-shaped recovery.

The other scenario, the L-shape to us is unlikely. But it is possible that we won't have a solution to COVID-19 and it will just continue to wreak havoc on our society and on our economy.

I'm a bit more optimistic than that. I think there will be solutions. We're learning rapidly about this disease. And I think that the "V" or "U" are the more likely scenarios.

Nick Burgess: Okay. And on those two scenarios, Mal, you've also done some work on previous bear market events and comparing it to this one. And so what are your sort of key takeaways from that work as well?

Malcolm Wood: Yeah. So this has been a remarkably quick bear market. Now, maybe this is to do with news travelling very fast in today's globalised economy. But there's no doubt that the data shows this has been the fastest bear market on record. We fell 37% in 22 trading days, which is even faster than the '87 crash. In terms of size, we're talking about something quite similar to the average.

So the point of all that is, to say, that we've seen unusual stress in the markets. I think part of that could be a sense that people have gone, "oh no, it's another 2008, 2009". The last event can tend to shape our reaction. And of course, this is very, very different to the GFC, which was a global financial crisis. This is a health crisis. And so I think we've got to be careful about all jumping off the boat on the basis that it's 2008 all over again.

So one application of that work is to say, look, this has been an average sized bear market already, but it happened very quickly. There are signs of people really overreacting to this. And we should be careful we don't get caught up in that panic. If we can see signs of containment starting to happen, I think the market's given everything else that's in place there can rebound fairly quickly. We're looking for signs, of course, that that is in fact happening. That we are getting on top of this and the number of new cases are beginning to slow in the Western economies.

Nick Burgess: Okay. And wrapping all of that up, Mal, your suggested asset allocation at this time.

Malcolm Wood: Yes, so I think what we're going to see when we come out of this is Cash Rates at zero for an extended period. We're going to see Bond Yields that are probably kept low by central banks in an effort to help the recovery. So bonds earning you less than 1%. We don't think that that will change. And of course, if bond yields rise, you lose money. And so if we can if we can put together here a recovery, equities certainly become the asset class of choice, almost by necessity as much as anything.

We're looking at a dividend yield in Australia at face value at the moment of 5.6%. Globally, 3.5%. Even if you take 20% off that and assume that sort of level is sustainable, you're talking about a yield which would be better than you can get in other asset classes.

So on the assumption that we can see a gradual stabilisation and then recovery, you know, I think that you want to be overweight growth assets. And that's where we are. We think it's too late to sell your equities. It's probably time to look for the rebound.

Within your equity portfolios, what we're emphasizing is the resilient businesses. Again, probably a bit late to be loading up on food retailers. Everybody knows about purchases of toilet paper, pasta and rice. Instead, we want to be owning great businesses that have had their prices cut significantly through this bear market. That have the balance sheet and resilience to get through this and come out the other side. And some of the names that we were talking about recently on that include the likes of: Wesfarmers (WES); BHP (BHP); Woodside Petroleum (WPL); Telstra (TLS); Macquarie Group (MQG); Commonwealth Bank of Australia (CBA), if you want to own a bank, despite all we've been saying about concerns there. So these are the sort of securities that we think are resilient and should perform beyond this shock.

Nick Burgess: OK. Thanks, Mal.

As I said, this is Update 7. All our other updates are available on the EL&C Baillieu website, through your advisor, or on the EL&C Baillieu page on SoundCloud.

Mal's latest research piece is called: Anatomy of the COVID-19 Bear Market and it was published on Friday, the 27th of March.

We will no doubt be back shortly with further updates. But until then, please stay safe and well. And thank you for listening.

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