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March 2020

MONTHLY AGENDA: SCHUMPETER RISING

Chief Investment Office

Long live Schumpeter

There is a lot of negative news, views and opinions in financial markets right now. This negativity is rightly occurring on a number of fronts – disrupted supply chains that cannot be fixed necessarily by fiscal or monetary policy; the coronavirus not being as contained as previously thought; and the impact on underlying economic fundamentals possibly being deeper and more permanent than expected.

It is hard to argue against any of this in the absence of good quality data. As the Chief Economist from Deutsche Bank Torsten Slok notes, there are three things investors need to know in order to make a fair assessment of the impact of the coronavirus:

1. Morbidity rate (share of population infected)
2. Mortality rate (share of infected cases resulting in death)
3. Number of work weeks lost

Torsten notes that we only have a reasonable understanding of point number two. Points one and three and known unknowns.

One possible outcome

Taking a step back, one of the issues the world has been struggling with since the global financial crisis is the absence of Schumpeter's creative destruction. This is the theory that economies need destruction for renewal and growth to occur. An economy that is flexible enough to allow inefficient or unproductive businesses to be replaced by thriving ones is said to be a healthy one.

The extraordinarily accommodative monetary policies implemented by central banks in the wake of the 2008 financial crisis meant that we had plenty of creative, but very little destruction. Otherwise unprofitable businesses were put on government-sponsored life support.

It is very hard to go bankrupt when the central bank is your underwriter.

The IMF recognised this when it highlighted the large number of what it called "zombie" firms. These are businesses that are solvent only because of the availability of cheap debt in the form of record low interest rates. If interest rates were to rise, these businesses would cease to exist. They are literally living hand to mouth.

The issue with having the "creative" without the "destruction" is that capacity in the economy doesn't deplete. It becomes so large that it prevents inflation from rising. Think about the number of coffee shops in your neighborhood. There is one on just about every other corner (the boom in highrise residential apartment building has festered this trend providing a ready supply of street level retail space). Prices are prevented from rising because there is just too much competition.

The cycle of extremely accommodative monetary policy can become self-fulfilling. Low inflation keeps central banks on the sideline which in turn keeps zombies alive, keeping capacity high, keeping inflation low and central banks on the sideline. And so it goes until something causes a destructive break in the cycle.

Is it possible that the coronavirus is the catalyst that will cause Schumpeter's destruction to finally emerge?

The idea that a negative supply shock cannot be fixed with monetary or fiscal policy has some merit. A direct injection of cash into the pockets of consumers is useless if the consumer is either prevented from leaving home to consume or can't consume because the supply of goods is not there. The stimulus will have a confidence effect but that would be short-lived if consumer activity doesn't follow through.

So what would happen to the zombie firms living hand to mouth if the quarantine measures as a result of the coronavirus continue for much longer? In short, they can no longer exist. In our view, this is the weakest link in the chain. This is where the supply-side shock begins to morph into a demand-side shock. If we do start to get business closures, unemployment will begin to rise. Higher unemployment will weigh on consumer spending which will weigh on overall economic growth.

This is bad for the economy in the near term. In the medium term, however, if enough capacity is destroyed, inflation pressures have the potential to rise to the surface. Take away that second coffee shop and the first has a chance of raising prices without risking a decline in business. This then encourages business investment and innovation, something that has been badly lacking in our economy for some time.

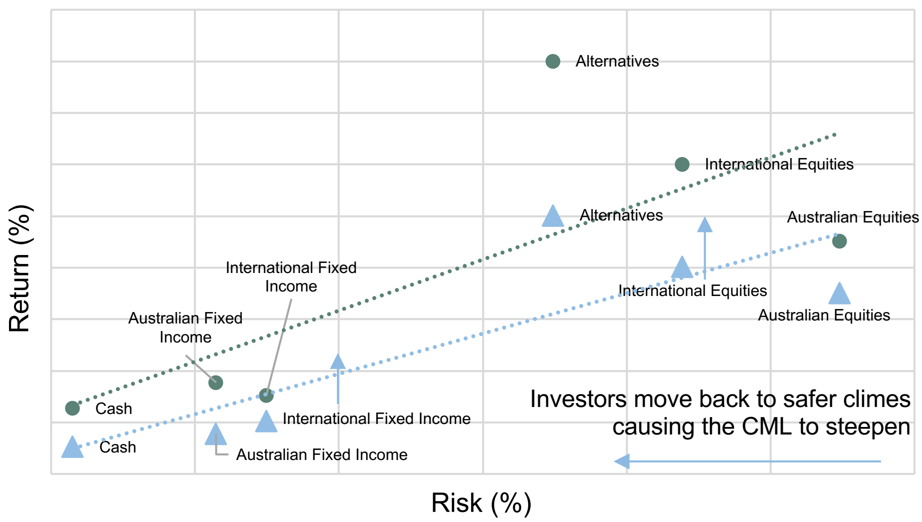
Short-term pain, long-term gain?

It could be a painful journey near-term, but we may be on the road to central banks moving back to a normal operation of monetary policy. Higher inflation from the destruction of capacity results in higher official interest rates.

What this means for investors can be illustrated using the capital markets line (CML). This line is simply the relationship between risk and return for different asset classes. The riskier the asset class, like equities, the higher your return should be so the line is necessarily upward sloping.

For too long, the low interest rate environment has been encouraging investors to chase returns, taking on more and more risk like equities. Higher interest rates would reverse that by making safer assets like bonds and term deposits more attractive. In the diagram, this relocation of investors causes a steepening of the capital markets line.

Capital Markets Line (CML)



Source: Escala Partners, for illustrative purposes only

Ultimately, risk premiums would adjust higher which means instead of constantly revising down our long-term capital markets assumptions, we can begin to revise them up. Expected returns rise.

Savers no longer punished

In this scenario, savers are no longer penalized by lower interest rates supporting the zombie companies. Take the zombies out of the equation, bring back creative destruction, some inflation returns and a normal operation of monetary policy can ensue.

Ultimately, however, the extent to which zombies will fall, and excess capacity is reduced, still depends on Torsten's point number three – how long will this last. On that, we don't know but having "air bags" in a balanced portfolio, such as fixed income and infrastructure (defensive assets), will provide a cushion of support in the event it lasts longer than expected. Hope is no substitute for good risk management.

The role of asset allocation

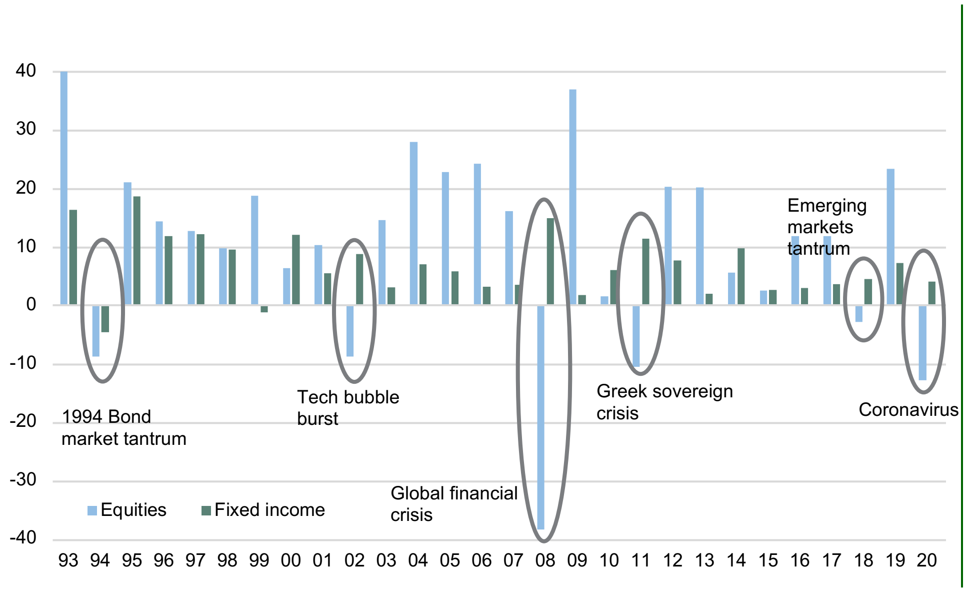
In times such as now, we maintain our belief that asset allocation is the most important portfolio management decision an investor can make.

"On average, 90 percent of the variability of returns and 100 percent of the absolute level of return is explained by asset allocation." Roger G. Ibbotson.

In other words, asset allocation is as much about risk management as it is about return management. Your allocation between different asset classes will help you achieve your target return while at the same time managing your risk through diversification.

The chart below shows annual returns for Australian bonds and Australian equities. In the past 28 years there have been six years where equities have generated a negative annual return for investors. On each occasion, an allocation to bonds would have cushioned the impact, even in 1994 when both bond and equity markets sold-off together.

Diversification in action (% annual change)



Source: Bloomberg

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Uncertainty is always and everywhere a market phenomenon

It may seem like we are deep in uncertain times right now but the reality is we are always in uncertain times. In the 1970s it was oil price shocks, Vietnam, and Watergate; in the 1980s it was the US savings and loan crisis, the ’87 stock market crash, Beirut, and Tiananmen Square; the 1990s saw the Asian financial crisis and the Russian debt default; and the 2000s saw the war in Iraq, the bursting of the tech bubble, the global financial crisis and the European and Greek sovereign crisis.

With uncertainty comes risk and the best risk management tool is diversification.

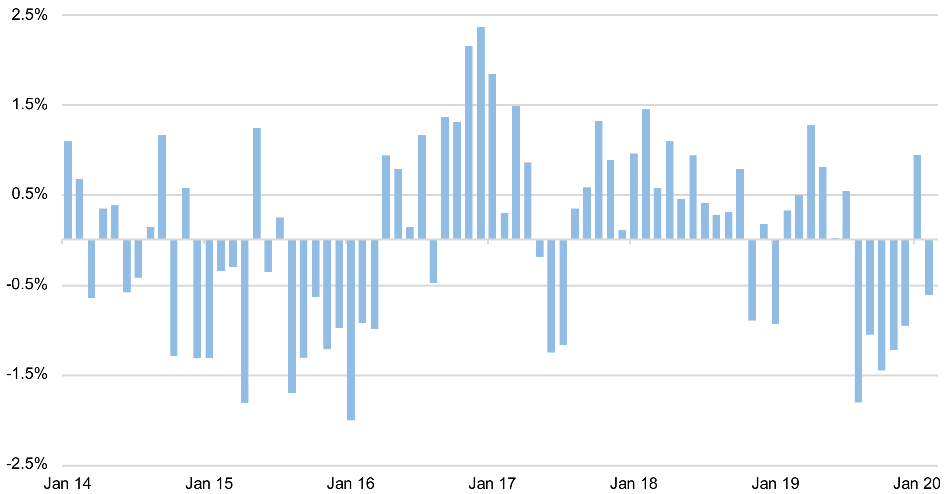
Australian equities

The Australian equity market’s performance in February was driven by two primary factors, being half year reporting season and escalating fears around the coronavirus, with the latter clearly the dominant driver. China’s initial virus containment measures were viewed favourably by investors as the rate of new infections slowed. However, a risk-off sentiment quickly swept through markets as the virus spread into Europe and various countries around the world, leading to a sharp drop of almost 10% in the final week of February. For the month, the ASX 200 Accumulation Index lost 7.7%, which was broadly in line with moves in offshore equity markets.

Results from half-year reporting season were still important in determining individual stock performance. At an aggregate level, earnings were softer than the low expectations leading into the month, while full year consensus forecasts were downgraded further, reinforcing the view of a low growth environment. At a sector level, cyclically exposed resources stocks suffered on commodity price weakness, with the energy sector losing 17% and materials 12%.

Information technology (-17%) succumbed to a potent mix of elevated valuations and earnings season disappointment. Defensive sectors typically outperformed, including utilities, health care and REITs, with all three supported by the ongoing decline in bond yields in anticipation of central bank support for markets.

ASX 200: Monthly Earnings Per Share Revisions



Source: Bloomberg. Data as at 10/3/20

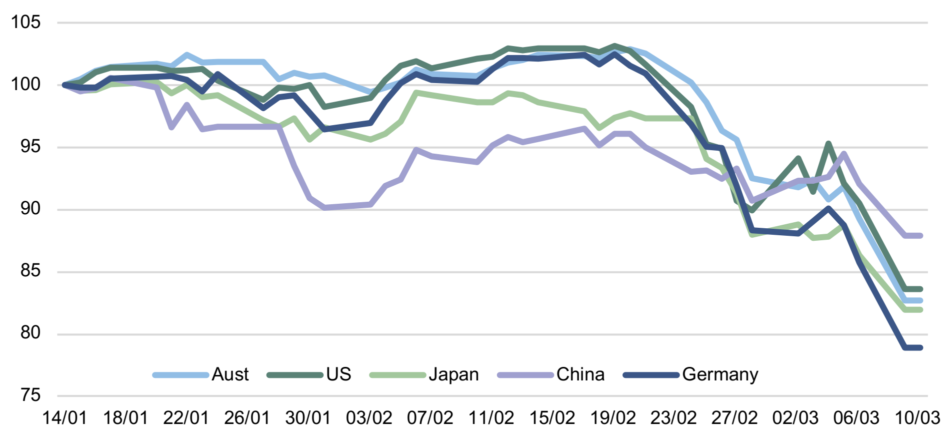
Global equities

Complacency around the coronavirus marked the first half of the month for global equities with most markets up by around 5% in the first two weeks. The peak was February 19 after which equities experienced their fastest 10% fall in recorded history. For the month, global equities were down by between 8-10%. Europe and the US were the hardest hit as the number of new virus cases escalated there. A general view that China had seen the worst of the virus, combined with the fiscal and monetary response by the government, meant China was one of the better performing markets in the month, up 0.6%.

Overall, developed markets underperformed emerging markets.

A 2.6% fall in the Australian dollar meant unhedged global equity positions did better than their hedged versions.

Equity markets from the outbreak of the virus (Index 14/1=100)



Source: Bloomberg. Data as at 10/3/20

Fixed income

Over the month of February bond yields fell across most markets. In Australia, 10-year yields finished down 13 basis points to a record low of just 0.82% while 3-year yields fell 12 basis points leaving the yield curve slightly flatter.

The move was even more stark in the US where expectations for interest rate cuts are higher. The US 10-year yield fell 36 basis points while the 2-year yield fell 40 basis points.

By the end of the month, the market had all but fully priced in another two interest rate cuts in Australia for this year (of which one was delivered on March 3) and four rate cuts in the US (of which two were delivered in one hit on March 4).

As the “diversification in action” chart above shows, there has been no better hedge against an equity market decline than bonds. The sharp drop in stocks and other risk assets in late February—fuelled by concerns about the spreading coronavirus—serves to remind us of that. It’s why we continue to believe that most investors should have an allocation, however modest, to high-quality bonds of intermediate or longer duration.

Yield on 10-year government bonds (%)

Source: Bloomberg. Data as at 10/3/20

Currencies and commodities

Oil prices fell by over 13% in a very volatile month for the commodity as the impact of prolonged business shutdowns and restriction on travel in China and neighbouring countries hit demand expectations. WTI closed the month at US$44.76 whilst Brent fell to US$50.52, both had begun the year trading above US$60.

As risk off sentiment spread through all asset classes gold continued its surge higher reaching US$1,659 on February 24, less than $100 from its all-time high of US$1,772 set in September 2012. During the month the safe-haven asset traded through a volatile range of $1,552 – $1,659 before settling around flat for the month at $1,585.69. Iron Ore and copper both had mixed months as demand issues, Chinese consumption, and potential supply disruption meant that both commodities traded through wide ranges. Iron ore declined by 7% early in the month before settling back for a 2.9% decline on the month.

The so-called fear gauge, the CBOE Volatility Index, surged to its highest level since the European debt crisis of 2011. Prior to this move the index had remained below the widely watched 20 level since August 2019 and began the month at just 18.

In currency, safe havens such as the US dollar and Japanese yen were the big winners while the Australian dollar and the British pound were the major losers during the month. The losses on the pound were widely seen as profit taking on what had been a strong gain for Sterling in recent months following the removal of the no deal Brexit threat in October and the landslide victory for the Conservative party in December. The Australian dollar hit its lowest level against the US dollar in over 10 years as it slid to $0.6515; fears of the economic impacts of the sever summer bushfire season and the slowing Chinese economy pushed the currency lower against most major currencies whilst traders also began to price in rate cuts from the RBA towards the end of the month.

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