The Global Economy, Financial Markets and COVID-19

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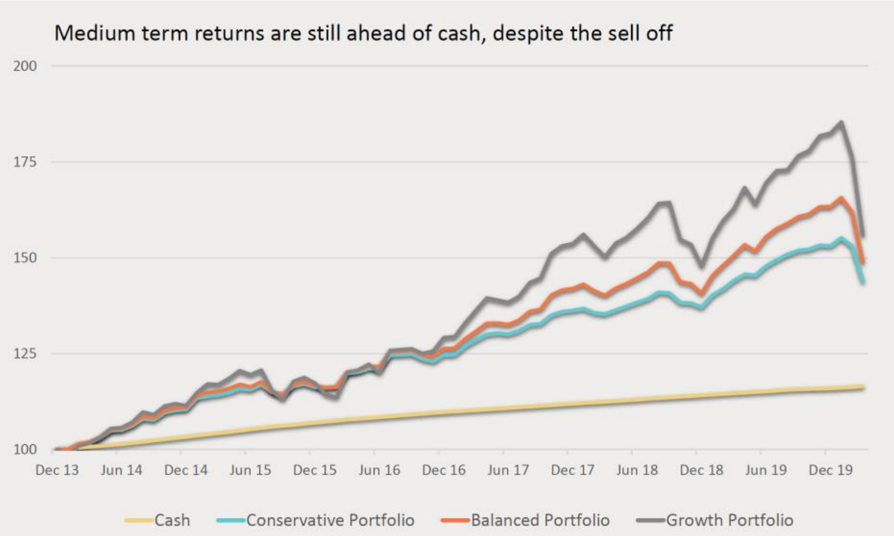
New Zealand's wealth advisers

Current situation

What a start to 2020. Optimism in the global economy was high and many major share markets were at an all-time record level in mid-February. Then the transmission of COVID-19 migrated out of China to the rest of the world and the seriousness of the virus became a reality. Share markets plunged 34% within 6 weeks (MSCI All Country index). Central banks around the world dramatically cut their cash rate and embarked on bond purchase programmes to provide liquidity in the financial system and keep interest rates low. Governments introduced various levels of lockdown measures which had the immediate impact of contracting economic activity. This was supplemented by an unimaginable level of cash injection into the economy to minimise growth in unemployment, support household and business during the lockdown and assist the recovery.

At the time of writing, the reported global infection level from COVID-19 has reached 2.2 million and deaths are approaching 150,000. These numbers are likely to be understated and will, unfortunately, get worse. New Zealand has fared better with its early adoption of strict lockdown measures but as the PM said, "we're over the worst but not out of the woods".

Economically, New Zealand has followed the global trend with the RBNZ cutting the official cash rate from 1% to 0.25% and are purchasing government and local authority bonds. The Government has introduced policies to minimise the adverse impact on the economy from the lockdown.



Where to from here

In all honesty, no one knows.

Until there is a vaccine for human use to combat COVID-19, governments will face the decision on what level of economic revival it is prepared to take against how many deaths it is prepared to endure. Unfortunately, governments are adopting a different stance which in itself is a global health and economic risk.

New Zealand has adopted a 'humane' position and appears to be successful in containing the virus and limiting deaths. Should that success continue, we will see some relaxation of lockdown measures but will need to ensure strict border control to minimise the risk of a further wave of contamination coming from offshore.

Economic activity is contracting, and a global recession is inevitable. Governments' response has to be to support household and businesses to minimise the economic damage and avoid civil unrest. Austerity measures in Europe in recent years has seen the rise of extremist parties and the current economic condition is conducive to its growth. The European Union is itself in danger of a breakup unless united policies are implemented.

Most governments are highly indebted but will have no option to take on further debt as they will have to spend while at the same time, their tax revenues are collapsing. New Zealand is in a favourable position with its relatively low level of debt (around 20% of GDP against over 100% for the United States and over 200% for Japan). Further government support is inevitable.

Until the availability of a vaccine to combat COVID-19, we expect:

- Governments to pursue various levels of lockdown measures; and
- Government to support household and businesses to minimise the level of economic contraction.

After the Vaccine

The vaccine is reportedly some 12 to 18 months away from human availability but thereafter lies the prospect of economic recovery. However, the pace of recovery is unknown. Commentators have spoken of various alphabets (V, W, U or L) and even a bathtub (an elongated U). This is where the commentators disagree.

The key will be the recovery of both consumer and business confidence and this indebtedness of governments.

V – Immediate recovery in economic activity.

This assumes that the pandemic fear has gone and that latent demand will lift the economy. However the risk is that demand could outstrip supply and inflationary pressure could arise and force interest rates up and lead indebted household, corporates and governments to further distress.

W – A hesitant recovery followed by another setback and then a more confident recovery. This will require a new world order whereby debt is forgiven, particularly for households and governments. The argument being no point chasing repayment from someone who cannot repay.

L – There is no recovery as we have seen in Japan over the past 30 years. Consumer and business caution and government indebtedness creating a headwind for the economy. A scenario whereby possible debt forgiveness may lead to recovery.

U or a bathtub – An economic recovery after some time whereby the excess debt level is reduced before an eventual recovery. This is similar to New Zealand after the 1987 October crash.

Which scenario evolves will depend on the time required for the implementation of global debt forgiveness or the gradual reduction in debt levels.

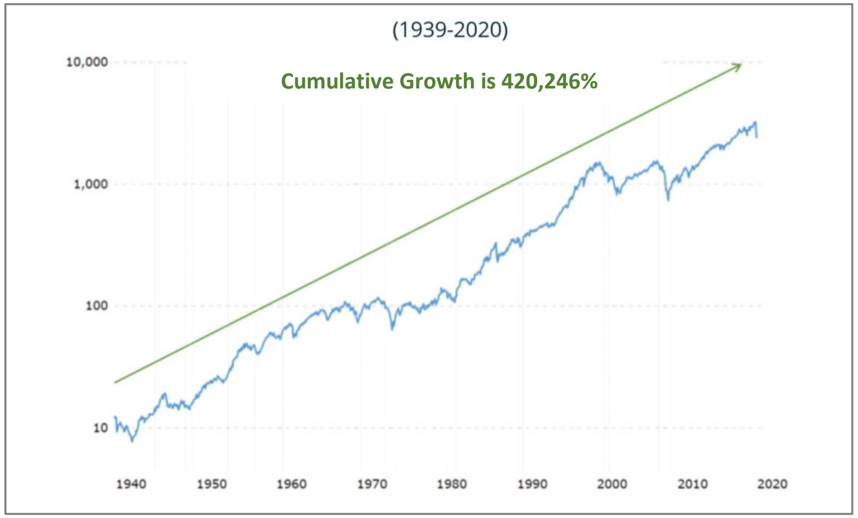
What are the prospects for listed financial assets

The term 'low-interest rates for longer' will remain, particularly while the household and government debt are at painful levels. Central banks are held hostage by this indebtedness.
The term 'the only game in town' for equities will remain as it is likely to be the only avenue for income-seeking investors, coupled with the prospects of some capital growth.
That is equities are likely to provide the return that fixed interest investors seek, exactly as we have had in recent years.

Your Portfolio

Your key consideration is what level of liquidity you require and secondly, if you are a long-term investor, the graph below should give you some comfort that all obstacles will be overcome in time.

The graph illustrates that since 1939, there have been 16 significant market falls, including this 2020 edition. While the timeline for recovery differs for each market fall, ranging from a few months to a few years, the one common feature is the stock market did recover in every instance, providing an annual return of 10.8% per year. There is no reason to expect anything different in 2020.



We know that market volatility can sometimes be unnerving. Irrespective of market conditions, we can control how and when to invest. That is why we believe that despite the market uncertainty, investors should remain invested and committed to their investment goals.

Therefore, sometimes the best approach for weathering the storm is a simple one.

<u>Remain invested and focused on your goal</u>