25 March 2020

Market update: impact of COVID-19

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The past three weeks has brought unprecedented turmoil and volatility to global equity markets. Investors are gripped with rapidly shrinking wealth combined with fear for their health and safety. The velocity and speed of the market crash exceeded that of the Global Financial Crisis and have now been compared to the 1987 and 1929 market collapses.

As such, I'd like to spend some time at this juncture to share my thoughts with investors on where we are at in this market cycle, and how we take advantage of the dynamic market environment while navigating and controlling unforeseen risks.

Where we are at in the market cycle?

There is no doubt we are now in a bear market, and we got here with lightning speed – the fastest 30 percent fall in the history of the Australian equity market (only the 1987 crash comes close in terms of severity and it took a week longer to reach the 20 percent drawdown mark). The sharp correction was partly reflective of the increasingly complex and passive market structure today, with so many geared funds, ETFs and systematic funds all becoming indiscriminate sellers in a falling market.

Added to the pressure, large super funds were meaningful sellers of the market, accounting for large part of the local market, as their members moved allocation to cash in a panic.

Making matters worse, Saudi Arabia and Russia chose this time to have an oil price war, which has seen oil prices collapse. This has created enormous pressure on the high yield credit market, from which many of the oil and energy companies were borrowing. The crisis reached a peak when all asset classes, including bonds, collapsed together, crushed by investors' fear of recession and the possibility of increased bankruptcy. It is almost a case of what can go wrong, has gone wrong.

Mass liquidation of equities in the past ten days is something that we have never before seen on this magnitude. Volumes on the busiest day during the GFC were 20 percent lower than the past fortnight; a material disconnection between the fundamentals of the businesses and their price performance is now evident.

Some of the largest ASX-listed companies, including Commonwealth Bank of Australia, are experiencing double digit price swings in a day. In other words, the past two weeks have been truly unprecedented and extremely rare.

To assess where we are in this bear market, let's examine some of the economic realities. Firstly, investor fears are well-warranted. Western economies have responded to COVID-19 by shutting down social events, venues and other gatherings, which has resulted in significant numbers of casual staff being laid off. For most OECD countries, over 60 percent of GDP lies in consumer spending, and a consumption-led recession will unequivocally lead to a material rise in unemployment over the next three months.

On a positive note, equity markets have always been a forward-looking instrument. If authorities are able to control the COVID-19 outbreak quickly, it would see many companies' earnings bounce back reasonably quickly, particularly with the significant pending stimulus.

Trillions of dollars around the world is being deployed to stimulate economies, much of that yet to be spent. Central banks have learned that during times of stress, keeping money flowing in the economy is paramount.

Based on the action plan announced by the Reserve Bank of Australia, Federal Government and other regulatory bodies, we believe the stimulus plan is sufficient for the current environment. One key variable at this stage is how long we will be in lock down before consumers can be allowed to spend the stimulus provided?

How does Australia compare in containing Covid-19 outbreak?

Australia has two distinct advantages relative to other markets, due to a combination of good luck and sound preparation.

Firstly, we are fortunate to be a week or two behind the US and Europe in terms of outbreak, reflecting the actions of the government to close borders. Secondly, we have a world-class healthcare system and, very importantly, a well-equipped and resourced pathology sector, ensuring one of the highest rates of COVID-19 testing in the world.

Widespread testing allows rapid identification, treatment and quarantining, limiting the spread and reducing mortality. South Korea has been a leading example of this, with cases controlled and the economy allowed to remain relatively open.

Importantly, testing to date in Australia has revealed a very low level of positive results, suggesting community spread is low. This increases the likelihood that the government's mitigation strategies can also be effective. Overseas experience shows interventions (particularly social distancing, quarantining and border closures) applied early and with good compliance can slow the spread.

Portfolio positioning

We are tracking ahead of our benchmark and continue to steer the portfolio with caution, while actively taking advantage of price volatility to add to our high-quality portfolio of stocks. We have long held overweight in the healthcare sector which has helped us immensely during this volatility, and we believe some of our portfolio companies will deliver defensive earnings regardless of the economic outlook.

Our top ten holdings have delivered exceptional returns since the crises hit.

- Fisher and Paykel has upgraded earnings twice in the past two months as result of the surge in demand for its emergency room ventilators (>60 percent of the revenue).
- A2 milk has surprised the market with its resilience across its distribution platforms; mothers in China flocked online to stock up on quality-branded infant formula and, as a strong online player, A2 has been well placed to benefit from such a shift. This will likely cement its brand in the offline Chinese consumer segment.
- Coles Group is another top holding that has seen significant improvement in its sales as consumers move to stock up their pantries; it has also meaningfully outperformed its peers, including Woolworths, which we don't hold in our portfolio.

Of course, we do have a number of meaningful detractors we have long held in the portfolio, including AfterPay and Tyro, both of which have short-term earnings sensitivities to our economy. Our investment thesis for such growth businesses has always been premised upon their future growth opportunities, and the strength and longevity of their respective business models. One quarter of weak earnings does not change our view, although we are regularly testing our assumptions based on current economic conditions and the duration of the COVID-19 lockdown. We have little doubt that once the market stabilises, both of these businesses will meaningfully outperform.

We believe the mass selling observed in the market over the past ten days has now passed. The market's ability to move definitively higher in the short term is contingent upon confidence in the containment of the virus.

We always endeavour to shore up our portfolio, and strive to outperform the ASX200 irrespective of market conditions. The past three weeks have been testament to our prudent investment process and tight risk controls. Our portfolio is primed to deliver strong returns once market rationality returns.

Take care and stay safe.

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