Market Watch

First Sentier Investors

Coronavirus fears continue to dominate attention

End-February 2020

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Economics overview

- Investors reduced their exposure to risk assets, amid suggestions that the rapid spread of the coronavirus worldwide will result in a slowdown in economic growth.
- Global equity markets nosedived towards month end and government bond yields plummeted as 'safe haven' assets were favoured. This resulted in favourable returns from fixed income.
- At the end of the month the US Federal Reserve suggested it would step in to help support financial markets. Interest rates seem almost certain to be lowered worldwide – including in Australia – to provide support.

- **US**: US headline inflation rose to 2.5% in January, the fastest rate of increase since late-2018. Some observers suggested the improvement might prove temporary, with lower energy prices and US dollar appreciation likely to exert downward pressure on inflation in the next few months.
- Despite muted inflationary pressure, consensus forecasts suggest US interest rates could be cut twice in the near term.
- There was a rebound in the PMI manufacturing survey, which rose above 50 (indicating growth) for the first time in six months. The hope is that activity levels continue to recover as bilateral import tariffs between China and the US are wound back.
- Services sectors remain buoyant, thanks to the strong labour market. A further 225,000 jobs were created in the US in January, which was well ahead of consensus expectations. US workers are also enjoying average wage increases of more than 3%/year, well above the rate of earnings growth in Australia.
- In other news, campaigning is underway for the leadership of the Democratic Party. The successful candidate will run against Donald Trump in November's Presidential Election.

- **Australia**: Interest rates were unchanged at 0.75% following the Reserve Bank of Australia's first meeting of 2020.
- With the economy subdued, there have been calls for the government to loosen fiscal policy – increasing spending to help boost activity levels. The government seems reluctant to do so and appears committed to achieving a surplus.
- If this remains the case, there is an increasing probability that interest rates will be lowered again, following the three cuts in 2019. If the RBA does not move in March, consensus expectations suggest borrowing costs will be lowered by June.
- In other news, the recent pickup in house prices has prompted builders to accelerate plans for new developments. Building approvals in Australia have increased following more than a year in the doldrums.

- **New Zealand:** Interest rates were also unchanged in New Zealand, at 1.00%.
- New Zealand's trade deficit – the difference between imports and exports – is narrowing. In the year to the end of January, imports were nearly NS$4 billion above exports. The figure is moving in the right direction, however, and was better than expected. China remains the #1 export market for NZ produce.
- The labour market in New Zealand remains quite buoyant – unemployment fell to 4.0% in the December quarter, equalling its lowest rate since before the GFC in 2008.

- **Europe**: Industrial production in the Eurozone was weak throughout 2019, but conditions appeared to worsen as the year progressed. By year end, industrial output was -4.0% below December 2018 levels. This is affecting the growth outlook for the region and underlines why the European Central Bank deemed it necessary to recommence a Quantitative Easing program in November.
- In Germany, Europe's largest economy, factory orders are running nearly -9% below levels from a year ago. The statistics have not been this bad since 2009, in the aftermath of the GFC.
- Subdued activity levels are being reflected in overall growth. According to preliminary forecasts, the Germany economy did not grow at all in the December quarter. GDP growth slowed to an annual pace of 0.9% across the wider Eurozone area.
- In Great Britain, investors were shocked by the resignation of the Chancellor of the Exchequer. This came just weeks before the release of the UK's first budget since the UK withdrew from the European Union.
- Britain has rewritten fiscal rules to enable borrowing and government investment to be increased. As a result, investors will be interested to see details of spending plans in the budget and how they might stimulate activity levels in the UK economy.
- In economic news, UK inflation rose to an annual pace of 1.8% – the fastest in six months. This reduced the probability of the Bank of England lowering interest rates in the near term.

- **Asia/EM:** Virus-related news flow completely dominated the release of economic data. Encouragingly, the pace of new confirmed infections slowed in China during the month, suggesting government-imposed shutdowns might be having their desired impact.
- That said, factory output in China sank to the lowest level on record reflecting recent closures and supply disruptions.
- Various restrictions remain in place in Asia. Hong Kong partially closed its border with China, for example, directly impacting activity levels and productivity. Ships were also prevented from entering and leaving some Chinese ports, disrupting trade flows.
- Elsewhere in Asia, some firms enacted disaster recovery procedures and remain closed. This adversely affected services sectors in the region – significantly lower numbers of employees at work meant less customers, eroding profitability.
- Major airlines cancelled up to 40% of flights across the Asia Pacific region and various business, government and sporting events have been cancelled or postponed until later in the year.
- All of this is expected to have a meaningful impact on economic growth in the March quarter (at least) in Asia and elsewhere.

Australian dollar

- The beleaguered Australian dollar struggled again in February.
- The currency declined by 2.6% against the US dollar, closing the month at 65.2 US cents – the lowest level in more than 10 years. The 'Aussie' weakened against a trade weighted basket of international currencies too, depreciating by 1.9%.
- In time, this could benefit Australian exporters, whose goods and services become cheaper internationally. Other 'exports' including inbound tourism should also be supported.

Commodities

- Commodity prices continued to trend lower on fears the spread of coronavirus could impact global economic growth.
- Oil (Brent -12.0%) once again bore the brunt of negative sentiment.
- Industrial metals were mixed following sharp falls in January. Lead (+0.3%) and copper (+0.1%) finished slightly higher, while aluminium (-1.7%), nickel (-4.6%) and zinc (-9.1%) lost ground.
- Iron ore (-10.4%) fell on demand concerns, despite some disruption to supply.
- Gold (-0.2%) was little changed, underlining its defensive qualities during periods of market stress and uncertainty.

Australian equities

- A relief rally drove markets for the majority of the month as a domestic reporting season, which wasn't as bad as initially feared, allayed investor concerns (see *Chart of the Month* overleaf). Leading into the last week of February, the broader equity market had rallied close to 2%.
- The final week saw the S&P/ASX 100 Accumulation Index drop over -9.5%, owing to worries over the resilience of the Chinese economy and a deteriorating outlook for global growth. The number of confirmed coronavirus cases was increasing rapidly across Europe, South Korea and Iran.
- As a result, the S&P/ASX 100 Accumulation Index ended February -7.7% lower, its worst month since August 2015 (also a result of Chinese growth fears).
- Declines were seen across the board, with all sectors closing the month lower. Those typically regarded as 'safer' – including Health Care (-3.4%), Utilities (-3.6%) and Real Estate (-5.1%) – generally outperformed. Financials (-4.7%) also fared relatively well, bolstered by a pleasing earnings update from CBA (-1.9%).
- The IT (-19.2%) and Energy (-17.6%) sectors saw the greatest falls. All constituents of the IT sector suffered double-digit declines as several companies downgraded earnings guidance to reflect coronavirus-related uncertainty.
- Energy stocks were hampered by lower oil prices and news that natural gas inventories are well above their five-year average.
- Australia's smaller companies had outperformed their large cap peers for the majority of the month. However, their relative performance turned negative in the final week with the S&P/ASX Small Ordinaries ending the month -8.7% lower. The increased volatility likely reflected a 'flight to safety', with investors preferring the perceived earnings resilience of more mature companies.

Listed property

- Global listed property sold off heavily with other risk assets as concerns mounted around the escalation of the virus outbreak. The FTSE EPRA/NAREIT Developed Index fell -7.4% in local currency terms and a less significant -4.7% in Australian dollar terms due to the weaker AUD.
- Every major developed listed property market posted negative returns during the month. The best performing regions included Canada (-3.3%), Hong Kong (-3.6%) and Singapore (-4.8%).
- Despite holding up well for most of the month, Japan (-10.7%) was the worst performing market in February. The market fell rapidly at the end of the month, including a decline of -5.6% on 28 February, which was its worst single day return since 2008.
- These moves were likely driven by global equity funds reducing their exposure to major non-US REIT markets in response to the weakness of US REITs and due to the acknowledged weakness of Japanese REITs in serious 'risk-off' phases.
- In Australia, A-REITs (-4.9%) outperformed the broader equity market. Following the December 2019 reporting season, the industrial sub-sector outperformed (+0.6%), driven by Goodman Group, while Retail (-8.1%) was the weakest sub-sector.

Global equities

- Having established new all-time highs on 19 February, global shares plunged. The MSCI World Index finished the month down -8.1%, its worst monthly result since the GFC. The Australian dollar's weakness meant returns were less bad in AUD terms (-4.9%).
- Concerns over the impact of the virus on the global economy, and particularly China's demand for commodities, saw the Energy and Materials sectors lead the downturn. These sectors fell -13.0% and -9.1% respectively in local currencies.
- Markets with the greatest exposure to China and resource stocks typically suffered the worst returns, e.g. the Japanese Nikkei 1000 (-10.0%) and the UK's FTSE 100 (-9.0%). This was also the case across emerging markets with Europe, Middle East & Africa the worst performing region, pulled down by both Russia (-10.5%) and South Africa (-8.7%) – all in local currency.
- Asia-Pacific markets fared a little better. Australia was one of the stronger performing developed markets for a second month in a row, with its relatively high exposure to Financials and Health Care helping offset weakness in the Resources sector.
- Asian bourses helped boost emerging markets to some rare recent outperformance against their developed counterparts. The MSCI Emerging Markets Index falling 'only' -1.6% in AUD.
- The outperformance of Asian stocks seemed counterintuitive, but was a result of both China and Taiwan posting the strongest returns (+1.2% and -1.7% respectively in local currencies).
- Both markets proved relatively resilient after being the two worst-performing emerging markets in January.

Global and Australian Fixed Income

- Lower bond yields supported returns from fixed income assets.
- In the US, 10-year Treasury yields closed the month 36 bps lower, at 1.15%. This was particularly significant, as the move saw yields decline to the lowest level on record. 30-year Treasury yields also fell to record lows.
- Yields fell elsewhere too, though not as significantly. Benchmark 10-year government bond yields declined by 17 and 8 bps in Europe and the UK, respectively, and by 9 bps in Japan.
- In Australia, 10-year government bond yields closed February 13 bps lower, at 0.82%.
- All of these moves reflected the probability that economic growth will be adversely impacted by virus-related disruption, in turn increasing the probability of monetary policy settings being eased by global central banks.

Global credit

- Corporate bond spreads widened, reflecting the sell-off in equities and the general 'risk off' tone across markets in general.
- The moves were most significant in the high yield space as investors favoured less risky exposures. Spreads in this part of the market widened significantly, to their highest level for more than a year, resulting in negative returns.
- Despite the sell-off late in the month, the past few months have been extraordinary for credit. In spite of recent spread widening, a combination of record low Treasury yields and spreads that remain quite tight relative to long-term averages means borrowing costs for investment grade corporates have never been lower. At around 2.4%, the overall yield on investment grade debt is less than half of the long-term average.
- With this in mind, it is unsurprising we have seen a large amount of issuance in the sector in the year to date as companies seek to take advantage of favourable financing costs.
- That said, new issuance dried up almost completely in the last week of the month as virus-related fears intensified.

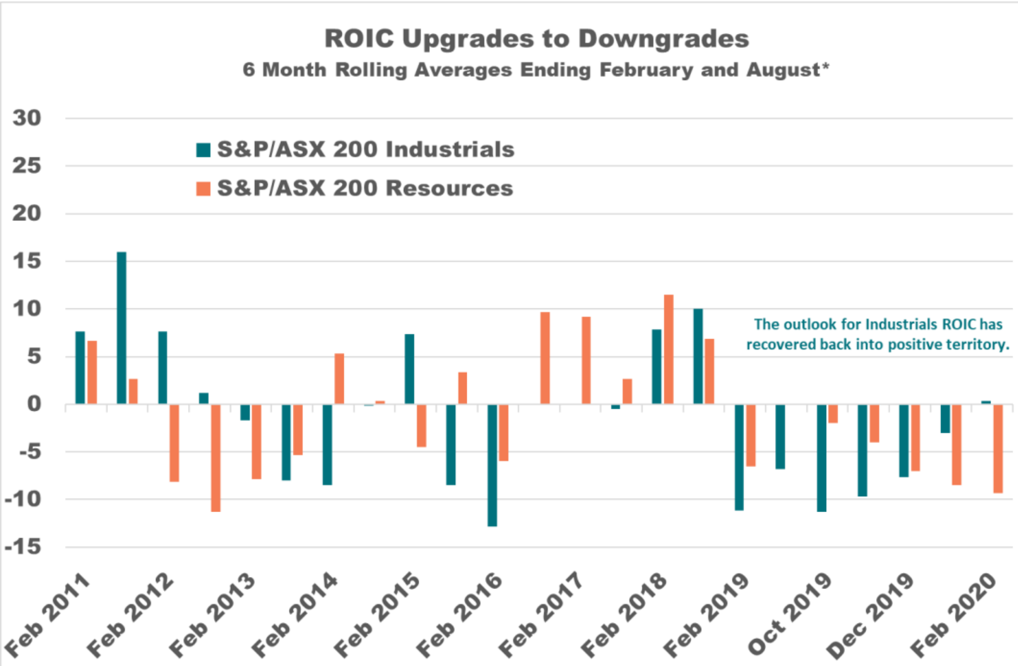
Chart of the Month – Australian Earnings Season – Better than Feared, but Worse to Come? Quality may be the Key.

In these bulletins, we aim to share interesting observations from global investment markets. This month we again draw on the 10 million+ statistics in our database[1] to see what we learned on the state of Australian listed companies during February's 'earnings reporting season'.

Having started brightly with surprisingly reassuring news on the health of the domestic housing market and the Australian consumer, the earnings season turned decidedly negative as the month progressed. Companies gave increasingly pessimistic outlooks, partly reflecting uncertainties associated with the global spread of the coronavirus.

Over the first half of the month, stronger-than-anticipated results for JB Hi-Fi and Domino's Pizza showed that the Australian consumer was not as moribund as feared. This was backed up with both REA Group and Commonwealth Bank of Australia expressing optimism over the housing market. It was little wonder the S&P/ASX 200 Index hit all-time highs on 20 February. Even though the coronavirus outlook steadily deteriorated from then on and equity markets suffered their worst weekly falls since the Global Financial Crisis, the level of earnings upgrades to downgrades (for both large cap and small cap stocks) still improved over levels in either December or January. Earnings quality, as measured by returns on invested capital (ROIC), upgrades to downgrades also lifted across the month for both small caps and large caps. As shown in the chart, the improvement in earnings quality across Industrial stocks was particularly strong – net upgrades turned positive for the first time since the third quarter of 2018.

"This is supportive of our approach." says First Sentier Investors' Head of Australian Equities Growth, Dushko Bajic. "We seek growing companies with improving returns on capital. We believe the lift in earnings quality generates superior shareholder returns over the long term and tends to provide downside protection during periods of market volatility."



* To August 2019, we then show monthly results from October 2019 to February 2020 to highlight recent trends

Source: First Sentier Investors and S&P/ASX. Shows number of firms enjoying ROIC upgrade levels in upper tercile of results since the inception of our database in August 2010 less the number of firms suffering ROIC downgrade levels in the bottom tercile of results over the same period.

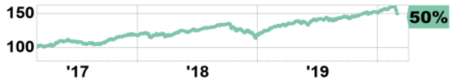
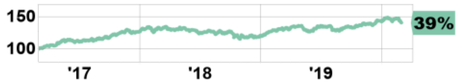
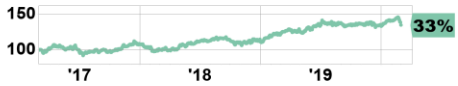
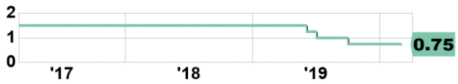
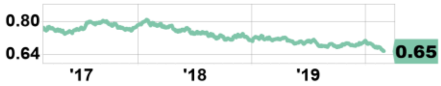
The benefits of quality exposure during periods of uncertainty was also a theme emphasised by Dawn Kanelleas, First Sentier's Senior Small Companies Portfolio Manager, "It has been an unpredictable reporting season, with share price movements not necessarily attributable to the quality of a company's earnings or outlook. Our risk-aware approach and focus on quality companies have seen us generate alpha during the month, contributing to our long term outperformance."

As well as its strong focus on value factors, the First Sentier Investors' Realindex team also targets quality factors such as improving returns on assets and improving returns on equity. Scott Hamilton, Senior Quantitative Analyst observes, "We find that quality factors complement our value factors and help our processes make better informed decisions on relative valuations. Quality factors also tend to diversify well with value factors and moderate returns when value factors struggle."

So even if company fundamentals do start to deteriorate again and market returns fall further, exposure to companies with (improving) earnings quality appears to be the key – not only to protect against downside volatility, but also to generate superior long-term returns.

[1] Our Australian equities teams are able to draw upon our proprietary collection of market statistics drawn from 10-12 brokers on a monthly basis over the last 8+ years. The database includes more than 10 million statistics, covering 100 data types on ~400 stocks over a minimum 5-year time frame.

MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
EQUITIES						
MSCI World (Gross of withholding tax, in AUD)	3,719.18	-4.90%	-1.57%	16.12%	14.36%	
MSCI Emerging Markets (AUD)	1,125.99	-1.64%	1.89%	8.68%	11.64%	
ASX 200	6,441.20	-7.69%	-5.18%	8.64%	8.59%	
ASX Small Ordinaries	2,728.20	-8.68%	-5.87%	1.64%	8.31%	
S&P 500 (USD)	2,954.22	-8.23%	-5.50%	8.19%	9.87%	
REITs						
ASX 200 A-REIT	1,579.40	-4.86%	-3.27%	11.80%	9.86%	
FTSE EPRA/NAREIT Developed (AUD)	3,816.95	-4.68%	-2.24%	13.49%	11.60%	
CASH and FIXED INCOME						
Official Cash Rate Australia	0.75%	0.00%	0.00%	-0.75%	-	
10-year yield Australia	0.82%	-0.13%	-0.22%	-1.29%	-	
10-year yield US	1.15%	-0.36%	-0.63%	-1.57%	-	
Foreign Exchange						
AUD/USD	0.6515	-2.64%	-3.67%	-8.16%	-14.91%	

Source: Factset and Bloomberg, at 29 February 2020

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