## Extreme uncertainty creates extreme volatility March 2020

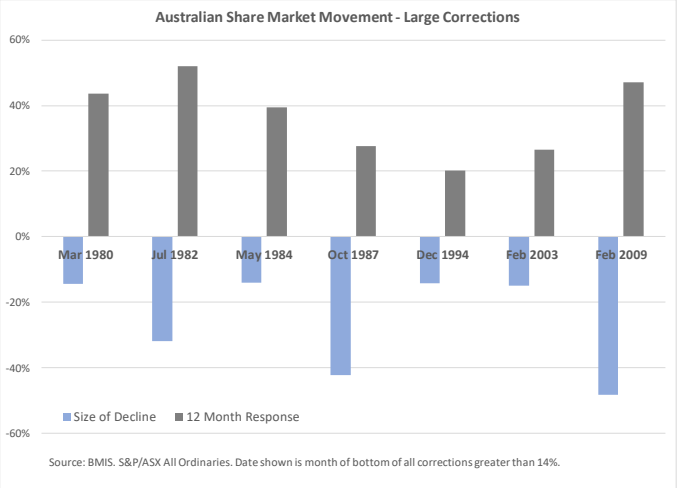
Extraordinary barely describes the movement on share markets over recent days. The daily changes of more than 10%, in both directions, on Australian and overseas markets are largely unprecedented. The only explanation for such extreme volatility is that market participants are faced with extreme uncertainty over how current events will impact on the earnings and ongoing financial viability of companies. Triggering the step-up in volatility has been the rapid introduction by Governments across the globe of new measures to contain the spread of COVID-19. These new measures, involving greater restrictions on human movement and interaction, will have the effect of further slowing economic activity, thereby limiting the normal operations and profitability of individual businesses.

Not only are the new containment measures more significant in terms of impact, but the approach now being taken in countries such as Australia and the U.S. appear likely to be in place for a longer duration than may have previously been envisaged. Integral to the strategies now being adopted is the attempt to "flatten the peak" of the virus spread, which implies lengthening out the time taken for the normal bell curve of virus spread and abatement to take place. This approach has been deemed necessary to minimise the extent to which the peak in infections overwhelms the capacity of the healthcare system. Understandably, no politician or healthcare official wants to be in a position whereby they are forced to implement policies that effectively turn away ill-patients due to a lack of healthcare facilities.

### *What do the new containment measures mean for share markets?*

With the impact of the containment measures now more significant for an extended duration, it was logical that equity markets would fall further in response. However, as the volatility of the market response implies, assessing the magnitude of impact is extremely difficult. Although the effect of a temporary loss of revenue for individual companies can be estimated, what is not known is how significant and long lasting a broader economic downturn will be - potentially involving a spike in corporate bankruptcies and a material lift in unemployment. Though it could also be argued the substantial fall in share market values that already had taken place since late February did factor in at least some this uncertainty and potential escalation in in the COVID-19 and associated containment policies.

What we do know about share markets based on past behaviour is that they will tend to overreact or "overshoot" in the downward direction in periods of heightened risk and uncertainty. Consequently, higher than normal returns are often experienced once the uncertainty dissipates. The accompanying chart shows the return prodcued on the Austsralian share market in the 12 months following the bottoming of a significant correction. As indicated, returns subsequent to market corrections have been well inexcess of longer term average rates of return.



However, whether or not the latest downward adjustment on equity markets has taken us to the bottom of this current cycle remains to be seen. At the time of writing (18th March 2020), the Australian share market had declined by 25% from its late February peak. This places the correction amongst the most significant experienced over the past few decades. At face value, share prices now appear cheap. For example, the large Australian banks are now trading at fully franked dividend yields of around 12% (assuming historical dividend levels). At this level, even if dividends were cut materially, the banks could still provide shareholders with very attractive relative returns from this point forward. However, it is the uncertainty and unprecedented nature of current events that makes valuing shares in this environment so difficult – hence the extraordinary volatility we are experiencing.

### *There is a glimmer of hope*

It will be the duration of the current containment period that ultimately determines how much medium to longer term damage is done to company earnings and the broader economy. Once there is broader consensus on this duration and impact, then share markets will switch their focus to the recovery period. History suggests that share markets are very willing to "look through" short term impacts once they are known. This is why speculation as to whether or not there will be a recession is largely irrelevant for equity investors. By time we have confirmation (in September) of whether the economy entered into a technical recession in the first half of 2020, the focus of share markets will be firmly on the period ahead and, hopefully, on the recovery from the current crisis.

Although it remains early days, there is hope that the carnage caused by COVID-19 will be a one off event. Human trials of a vaccine have commenced in Seattle, creating the possibility of a successful vaccine rollout in approximately 12 months. In addition, the scale of the virus containment action now in place around the globe may be successful at slowing the virus spread, enabling a lower peak economic impact than is now entrenched in worst case scenario forecasts. Efforts in other countries such as China, South Korea and Japan appear to have significantly shortened the period of exponential growth in the virus spread.

There does remain, however, any number of very different scenarios that could play out from here. As an investor, it would be dangerous to place too much conviction in either a highly optimistic or highly pessimistic scenario. Maintaining adherence to longer term investment strategies has proved to be a successful approach in past periods of heightened risk, and there is little to suggest that this period of substantial uncertainty warrants a different approach.