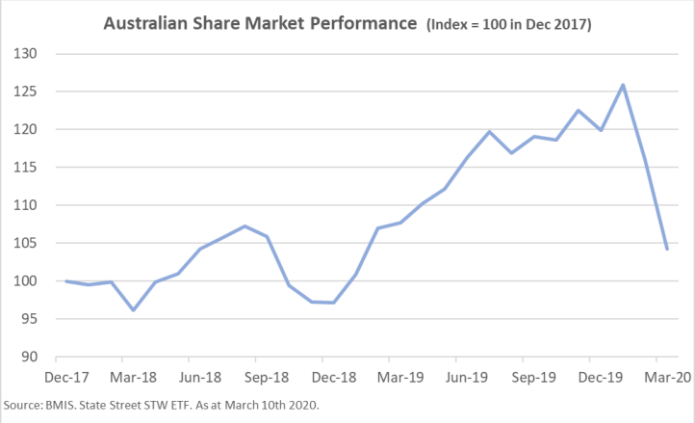
Short term sentiment now driving market direction March 2020

Movements in share market direction are often described as being the result of changes in the balance of the emotions of "fear" and "greed". In recent days, the fear emotion has clearly taken overtaken from greed in driving market sentiment. The sell-off on share markets has been substantial, with Australia's S&P ASX 200 Index (as at 10th March) now trading 20% below its peak level recorded just 3 weeks ago. Australian share market values have fallen back to levels last recorded in mid-January 2019.

Although similar declines have been recorded across many global equity markets, global diversification is likely to have resulted in some tempering of losses for Australian investors, as a decline in the $A has cushioned the impact on any unhedged foreign currency exposures. In addition, the surprising resilience of the Chinese equity market has resulted in relative outperformance from the share markets of emerging economies. Since the February highs, unhedged global equity valuations have fallen 16.5%, with emerging markets down by an average of 13.4%.



The escalation in negative sentiment on equity markets over recent days has been driven by the following two factors:

- The news flow in relation to COVID-19 (the coronavirus) has become progressively worse, with the number of new cases outside of China continuing to climb.

- Oil prices have plunged 25% this week following indications from Saudi Arabia and Russia that they would increase the supply of oil. This follows Russia's reported refusal to join an OPEC (Organisation of the Petroleum Exporting Countries) initiative to cut production in response to lower oil demand. Share markets reacted negatively to the rapid decline in oil prices due to the destabilising impact it would have on energy producing companies – potentially putting at risk the ongoing viability of some producers.

These may be temporary influences

As is typically the case in periods of extreme market sell-offs, the absence of any positive news flow means that the fear emotion dominates investor behaviour. It would also appear that the focus of investors becomes very short term in such periods. It could be argued that both the COVID-19 and the oil price fall are likely to be ultimately temporary influences on the broader health of corporate profitability. Clearly both events are significant enough to cause substantial financial disruption to some companies. However, it remains likely that both events have an end point in terms of their broader influence. As China is now demonstrating, returning to normal economic functioning is possible post a period of attempted containment of COVID-19. The severity of human and economic impact through this containment period remains uncertain; but may ultimately be assisted by normal seasonal decline in virus contagion and, eventually, a vaccine.

In the case of the oil price disruption, it is unlikely that producers will continue to supply oil at current prices and history suggests some form of supply control will prevail. Even if prices were to remain at current levels, the positive impact on household disposable income and company profitability could act as a material economic stimulus and more than offset the impact of disruption on energy producers.

The fact that the underlying causes of the latest correction on share markets are not permanent, reinforces the importance of investors maintaining a long term perspective and avoiding the temptation to allow the fear emotion to dominate decision making. Similarly, indiscriminate buying of assets in a highly volatile market should be avoided. There remains a likelihood that active cases of COVID-19 will continue to escalate and confirmation of such may continue to dominate news flow and market sentiment for the period ahead.

Corrections typically bring opportunities

However, large declines in equity markets will generally create opportunities for new investments to be made. A measured and cautious approach, with a focus on assets that have a resiliency to periods of economic weakness, should be adopted in relation to buying into a share market correction. Some areas that may present as opportunities for portfolio adjustment through this correction are discussed below:

- Global infrastructure has been sold off heavily over recent weeks, with the asset class dropping 13% since the February high. This is despite the fact that infrastructure revenues (from power utilities, toll roads etc) are generally defensive. Infrastructure also tends to benefit from falling interest rates, as yields become more attractive on a relative basis.

- Australian banks face a challenging period ahead with low interest rates placing pressure on interest margins and low loan book growth restricting revenue. None-the-less, unlike some other industrial companies, Australian banks have a low likelihood of extreme financial distress given high capital reserves and reliability of revenue. With prospective grossed up yields of some major banks now in excess of 10%, there is considerable compensation to investors for the risk of some further share price fall or dividend cut.

- Consumer staple businesses, such as supermarkets, have not been spared in the equity market rout, despite having relatively defensive cash flows that would be expected to be less impacted by a recessionary environment. Fiscal stimulus expected to be provided by the Commonwealth Government, combined with the positive impact of lower petrol prices, may also add to the resiliency of these businesses.

- With the $A dropping to the mid U.S. 60 cent level, the prospect that depreciation in the currency will continue is now more limited. This lower currency valuation may create an opportunity for some switching of foreign currency exposure from being unhedged to hedged, thereby reducing future risks associated with a reversion of the $A back towards its longer term fundamental value.

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