THE GENERATOR

An investment in knowledge pays the best interest—Benjamin Franklin

Covid-19 Update III

The Big Bounce

Equity markets have rebounded strongly from their lows on 23 March through to the week ended 8th May . The US S&P500 is up 31%, whilst the major stock indexes in New Zealand and Australia have rallied 26% and 18% respectively. For the year to date, the US S&P500 is now only down 9%, the Nasdaq 100 is actually up slightly, and New Zealand's NZX50 has fallen by only 7%. This type of extreme market volatility is not without precedent. During the GFC, for example, we saw similar pricing behaviour occur on multiple occasions during late 2008, despite the ultimate low in markets not being reached until March 2009. The question therefore for investors today is where to from here? Will we follow the path of markets during the GFC and ultimately retreat towards the previous lows of March, or will the recent strength in prices continue?

In looking to answer this question we believe it is important to consider two distinct time frames. Over the long-term, the prognosis for equities appears very favourable. This is a consequence of the policy responses that have been enacted by the fiscal and monetary authorities across most Western countries. In the US, for example, the Federal Reserve has essentially socialized all immediate economic risk by pushing down interest rates, buying back bonds and printing money on a scale never seen before. They have even begun lending directly to businesses, as would a commercial bank. Their objective of keeping the economy alive is clear, as are the implications for interest rates into the foreseeable future. They are close to zero today, and that is where they will stay. In that environment the attractiveness of equities relative to bonds is compelling.

Unlike the GFC, corporate behaviours are not to blame for this crisis and so the Fed has indicated it will "do whatever it takes" to stabilize the economy and markets.

A more challenging thesis to arrive at though, is where do stocks trade over the next 3-6 months? In a normal world, this short-term perspective is less relevant.

(continued page 2)

Feel free to give us a call or email if you have any questions around what is happening to your investment

GENERATION WEALTH MANAGEMENT

Albany Office
[PO Box 64001, Botany, Auckland 2163]
TEL. 09 448 5083
EMAIL. albany@generationwealth.co.nz

Botany Office
PO Box 64001, Botany, Auckland 2163
TEL. 09 272 9030
EMAIL. botany@generationwealth.co.nz

Pukekohe Office
PO Box 66, Pukekohe 2340
TEL. 09 238 3322
EMAIL. pukekohe@generationwealth.co.nz

KiwiSavers

Don't change long term plans due to short term "noise"

Be calm – for most KiwiSaver members investing is a long-term activity and investment decisions should be made based on your long-term goals and expectations.

It may be a good time to review your appetite for risk but now is not the time for uninformed or rash decisions that will have big effects on your retirement.

If you would like to discuss your KiwiSaver provider or risk level please contact us.

Inside

- *Keeping an eye on the risks*
- *GOLD - the currency of last resort*

The Big Bounce ......

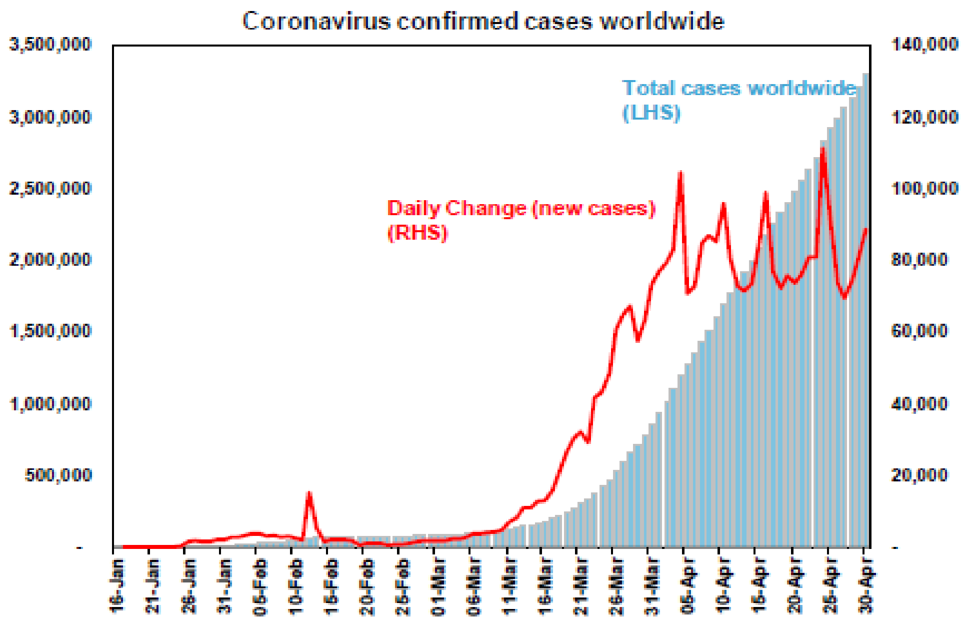
But in a world where markets are moving with the ferocity that we have seen over the past four weeks, successful positioning today is important. The overwhelmingly consensus view, from financial analysts and commentators, is that stock markets will fall. In their opinion this will happen because of the economic chaos that is occurring and because of the corporate earnings impact that must be felt (and ultimately be reflected in prices).

A recent study by the Bank of America across global fund managers supports this view and identifies that investors are extremely bearish, they have reduced their exposure to equites to levels last seen during the worst of the GFC and have raised cash in a manner commensurate with their response to the 9/11 terrorist attacks.

This level of consistency in view can be comforting for some but it almost assures that the outcome will be different - because who is left to sell? This fact, together with the increasing possibility that the economic destruction that will be evident over the next three months should prove temporary (due to the policies described above), is providing a credible case that the worst could be behind us.

Notwithstanding the fact that stocks are due a pause in their recent recovery, and could possibly drift lower for a while, the prospect of markets returning to the levels we saw on March 23 is looking less likely. It is worth remembering that real companies exist under these volatile share price movements. Most of which, while doing it tough right now, will survive and ultimately prosper. Economic predictions have a bad accuracy record at best of times but are likely to be particularly unreliable in the medium term as high levels of volatility remain. Expect markets to reflect that.

These are unprecedented times, but the policy response has also been unprecedented. After targeting an initial $20 billion of stimulus, the New Zealand Government appears open to doubling or even tripling this amount over time. Fortunately, a succession of Finance Ministers have behaved very prudently over the last 20 years meaning that New Zealand went into this crisis with a very strong government balance sheet (debt to GDP at only 20%).



However, any expenditure should be carefully targeted as this is money that ultimately, we, and our children, will have to pay back.

We are working hard to keep ourselves as informed and up-to-date with developments as we can

Did you know

The Amsterdam stock exchange (now part of the Euronext exchange) first listed shares in 1602. The first stock to be traded was that of the Dutch East India Company, a multinational mega-corporation granted a monopoly by the Dutch government to conduct trade with Asia. The company operated for almost two centuries, paying out an 18% annual dividend for almost the entire time.

Summing up

- *Talk to your adviser if you’re worried*
- *maintain your disciplined investment strategy*
- *think of your long term goals and how they are best achieved*

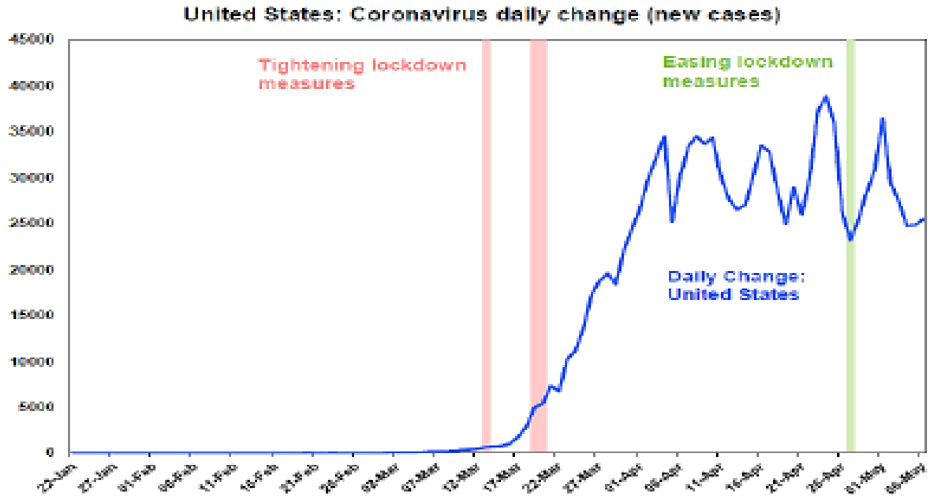
Keeping an eye on the risks

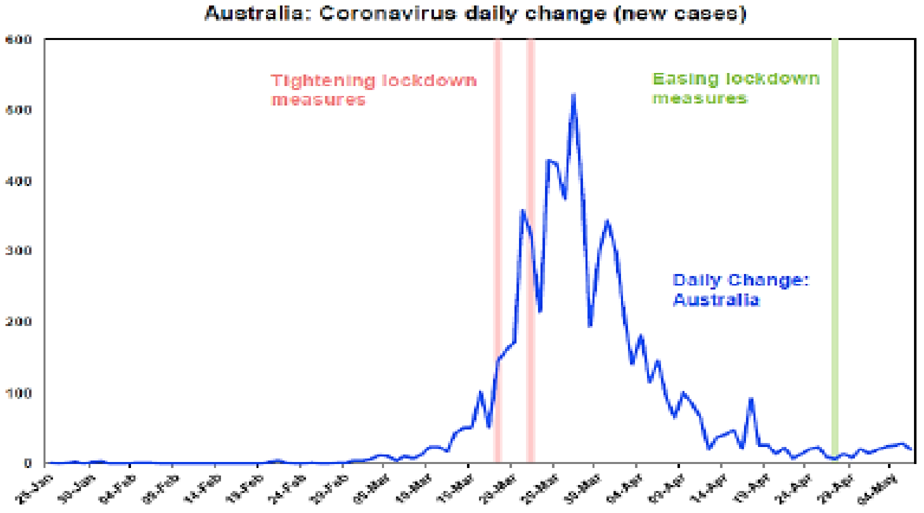
We believe that there are three big risks to keep an eye on over the next few months:

A second wave of coronavirus cases. This should be manageable with ramped up testing, quarantining and contact tracing but the US is perhaps most at risk on this front as it appears to be trying to reopen its economy without first getting on top of the spread of the virus (see below)

Collateral damage from the shutdowns in the form of permanent company closures and rising defaults. So far so good but its early days and this will be critically important in terms of the speed of the recovery. This reinforces that the quality of the companies you invest in is more important than ever, as to get a return **on** your money, first you have to get the return **of** your money!

An escalation in US/China tensions. Given the hit to the US economy and its very poor performance in managing coronavirus, Trump will find it hard to get re-elected and will be tempted to "wag the dog" in order to get a "rally around the flag" and distract voters. A fight with China over the source of the virus may be part of this and looks to be starting to escalate already. Trump is limited in terms of what he can do without further damaging the US economy though, but it could still cause bouts of weakness in share markets.





Summing up

- *No one makes good decisions when they are panicking. A considered approach always wins*
- *The world is becoming unrecognisable. Is your financial planning taking account of the reality of the future?*

Gold—the currency of last resort

The COVID-19 crisis has been met with governments announcing large stimulus packages. Central banks have also announced large quantitative easing programmes where they will be buying government bonds. This is classic currency debasement, where the central bank is funding the government deficit by expanding their balance sheets.

This begs the question as to whether this action will create hyperinflation as seen in Germany in the 1920s and more recently in Zimbabwe and Venezuela. We think this is unlikely as hyperinflation typically occurs when the printing of money is combined with a scarcity of goods. The COVID-19 virus and resulting global lockdown has not destroyed capacity so, once the lockdown is relaxed, goods should be in plentiful supply. Nevertheless, as discussed below, the risk of inflation has increased.

Increasing risk of inflation

Today, governments and central banks are following the same playbook as used during the 2008–09 Global Financial Crisis, i.e. cut interest rates, provide liquidity and increase government spending. However, the impacts of those past actions have still not been fully rewound. As a consequence, at the start of this crisis the level of interest rates was lower and government debt was higher than in 2008. Other things being equal, this means the actions of central banks to provide liquidity and of governments to increase spending must be larger to achieve the desired outcome. This is exactly what we are seeing today.

In addition, the secular headwinds of an ageing population and increasing health costs, which are only going to get larger after COVID-19, are even more relevant. Unfortunately, we are also seeing a rise in nationalism and protectionism. All of this adds to the risk that once the world starts recovering from this crisis, inflation may also rise. Arguably, given the high level of government debt we will be looking at, governments are incentivised to inflate their way out of their debt position.

We therefore think there is a risk that, over the next five to ten years, inflation may rise back to the levels experienced during the 1970s. So how does someone protect themselves against this risk? Invest in assets which are scarce and likely to provide a hedge against rising inflation. This is why we have purchased gold in the portfolios.

Historic Price Action

To get a guide of how gold may react during this crisis, we think it is worth revisiting the 2008–2015 experience. Over this seven-year period we saw four distinct phases.

At the start of the crisis, gold appreciated as investors sought safe havens. However, at the peak of the crisis, gold declined as liquidity constraints forced holders of gold to sell their holdings to offset other losses within their portfolios. Once the Federal Reserve announced quantitative easing in late 2008, the liquidity constraints dissipated, and the fear of inflation saw a 150% increase in the price of gold over the next three years. However, by 2013 inflation had not eventuated and consequently the 'fear premium' built into gold unwound.

So far during this crisis we have seen the first two phases. At the start of the year, as news about COVID-19 started to filter out, gold appreciated from around US$1,500 to US$1,650 (a 10% increase). We then saw gold decline sharply in late March to US$1,470 (-11%). Exactly on cue, the Federal Reserve announced quantitative easing and governments announced fiscal stimulus packages. This was the signal we were waiting for.

The price of gold has since recovered and is currently trading at US$1,717. While the first two phases occurred reasonably quickly, we think the third phase will take longer to play out. As economies recover, the fear that inflation may rise will become more extreme. Our short-term price target for gold is therefore US$2,000 while our medium-term target is US$2,500.

We are aware that higher inflation did not eventuate over the last decade. We will therefore continue to actively manage the position and take profit should our view on the risks of rising inflation change.

By David Wilson
NZ Funds Management Ltd

__DISCLAIMER:__ This publication has been prepared for your general information. While all care has been taken in the preparation of this publication, no warranty is given as to the accuracy of the information and no responsibility is taken for any errors or omissions. This publication does not constitute financial or insurance product advice. It may not be relevant to individual circumstances. Nothing in this publication is, or should be taken as, an offer, invitation, or recommendation to buy, sell, or retain any investment in or make any deposit with any person. You should seek professional advice before taking any action in relation to the matters dealt within this publication. No part of this publication may be reproduced without prior written permission from our company.

Next step

••• *See us about the best investment options for you.*