HOBSON WEALTH

First Quarter 2020 Tactical Thoughts

Key Highlights

- Extremely challenging first quarter as markets struggle to deal with the Covid-19 outbreak.
- In the face of heightened volatility, asset allocation remains a key tenet to long term wealth creation.
- When the virus passes, the world will have changed significantly. We provide a glimpse of some changes.

The first quarter of 2020 was not an easy one. While there were warning signs that we were in the late stages of the economic cycle, nobody could have predicted the severity of the impact that coronavirus has had across New Zealand and the globe. As markets moved to reflect the rapidly developing situation, equities fell sharply, with the worst returns coming in March.

The S&P/NZX 50 Gross Index fell -14.8% over the quarter but outperformed many other major markets including the US, Europe and Australia. From record highs in mid-February, the market quickly turned as the scale of the Covid-19 outbreak began to be felt outside of China.

Australian equites fell -20.7% in March and -23.1% for the quarter. As March progressed investors increasingly formed the view that Covid-19 would have a dramatic impact on the economic outlook. All ASX 200 sectors declined in March. The best performing sectors were Consumer Staples, Health Care and Utilities while Real Estate was not as defensive as investors had hoped.

The Dow Jones Industrial Index suffered its worst quarter since the 1987 crash, and one of the worst first quarters in its history as the US struggled to contain outbreaks particularly in the New York region. A very substantial fiscal stimulus package was agreed, worth over 10% of GDP, which managed to buoy sentiment as market volatility spiked to levels not seen since the GFC. In the face of a severe liquidity crunch, the package aimed to provide credit backed by the US Federal Reserve to investment grade companies.

Central bankers have thrown the kitchen sink at coronavirus, cutting rates to their lower bounds, and have restarted asset purchase programmes of massive quantum. The Fed's commitment to purchase as many government bonds as necessary is a substantial step, which should keep government borrowing costs low, despite the massive fiscal stimulus that is required to deal with the economic consequences.

The oil price war between Saudi Arabia and Russia in late February did not help equity market sentiment. Oil suffered its worst month ever in March (-54%) and its worst quarter in history, losing almost two thirds of its value from the start of the year. Beyond geo-political tensions, oil was also dragged from the expectations of lower global demand, as global economies began shuttering. Not all commodities were negatively impacted though and gold has seen a decent rally driven by central bank policy easing and safe-haven buying.

European and UK equities fell sharply in March as news emerged that the spread of the Covid-19 virus was accelerating across the continent in particularly Italy and Spain. Investors sold shares driven by fears of an impending global recession as governments began implementing extreme containment measures to limit the spread of the virus. Bank stocks in particular fell on fears of a prolonged economic downturn. The pain was exacerbated when the European Central

Bank (ECB) asked banks to suspend all dividends and buybacks until at least October in order to conserve precious capital.

Asian equity markets were weaker too amid the widening spread of Covid-19. Concerns grew about the outlook for global growth with an alarming rise of infections outside of China. Supply chains were impacted as the number of industrial shutdowns increased. In the second half of March, central banks stepped up with notable monetary and fiscal stimulus to counter the ensuing economic slowdown. This helped ease market fears and drove a mild recovery towards month end. Mainland equities were down on the month, but outperformed the region as China seems to have emerged from the darkest days of the epidemic. A renewal in economic activity was seen following an easing of restrictions.

One does not need to wait for traditional economic data to be released to appreciate the scale of the hit to the global economy, which has been magnified by lockdown measures. Central banks have responded with an unprecedented and co-ordinated policy response. In New Zealand, the Government announced a massive stimulus package equating to at least 4% of GDP to provide support across all aspects of the economy adversely impacted by the pandemic.

Given the uncertain outlook, we believe an underweight to equities and an overweight to fixed interest makes sense. Our local equity market has held up better than many others, and if it continues to do so we recommend potentially trimming holdings of lower quality companies. With central bank and government support, better capitalised companies will be more resilient, and we believe a selective approach to both bonds and equities is prudent at this time. We continue to see merit in owning solid cashflow backed businesses and expect gentailers, gold and defensive equities to hold up better in these challenging times.

While it is very difficult to make predictions at this time we would like to focus on the positives. Interest rates are now essentially at zero. The Reserve Bank has committed to keeping them low for at least the next 12 months if not longer and is buying bonds to ensure they stay low. Banks have reduced deposit and mortgage lending rates and so far seem to be bending over backwards to help affected customers. This in conjunction with the government providing enormous fiscal stimulus by putting money directly into people’s pockets to mitigate the impact of reduced incomes.

This is a crisis but one that collectively we know we will get through and on the other side this dramatic and brutal challenge to business models is expected to result in significant consolidation in certain sectors, but also changes in behaviour that will be for the better. Given the hit to the global economy and uncertainty over how soon we can start to dig our way out of it, it is tough to be strategically bullish risk assets in a meaningful manner. We also are of the view that it is hard to adopt the playbook of previous crises, so keeping some powder dry is prudent.

A sustainable recovery in equity markets is unlikely until there are signs that the pandemic is under control, especially in the US. Numbers in the US have yet to peak, and a more stringent testing regime will be needed. Only after we see a peak, will volatility likely recede that will then allow for a recovery to begin. Unfortunately, this all seems some way off in our view.

We wish you an enjoyable Easter with those in your bubble and please stay safe.

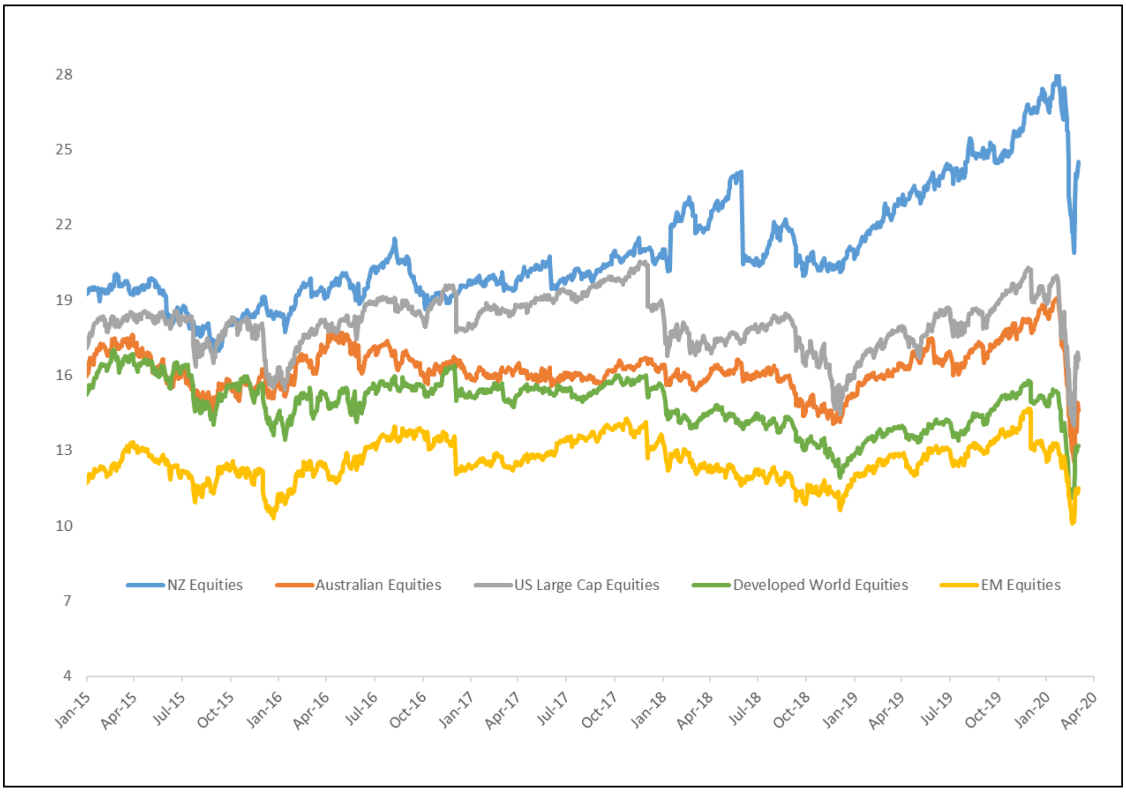
Recommended Tactical Asset Allocation

Underweight □□■□□ **Overweight**

Asset Class	Tactical	Rationale
NZ Equities	□□■□□	While we are encouraged by NZ's lockdown efforts, we stay cautiously Neutral. We see further volatility ahead and pullbacks as potential opportunities to add.
Australian Equities	■□□□□	We see a full lockdown as inevitable in Australia and with superannuation funds scrambling to meet redemptions, we have cut our call to Underweight.
US Large Cap Equities	□■■□□	US$ strength has buoyed returns to NZ$ investors. Many US large caps should be resilient through this period, but clients may look to trim to boost cash.
US Small Cap Equities	■□□□□	US small caps have fared worse from Covid-19 than large caps and we believe this will continue until US cases peak. We go to full Underweight.
Developed World Equities	■□□□□	Developed markets particularly in Europe are facing a dire situation due to Covid-19. We drop our rating from Neutral to Underweight.
EM Equities	□□■□□	EM equities have been hurt by the strong US$. China has held up well as it looks to have made it through the Covid-19 storm, and thus we remain Neutral.
NZ Listed Property	□■□□□	While low rates will benefit listed property, working from home and lockdowns may have profound implications for the sector.
Fixed Interest	□□■■□	While Fixed Interest has not been as liquid as we would like, we continue to seek its defensive properties and recommend high quality issuers.
Cash	□□■■□	We upweight Cash to build reserves to take advantage of future opportunities.

Market Price Earnings ratios

Price Earnings ratios 2015 – 2020*



Price/Earnings ratios are Bloomberg Best estimates for forecast year one.

Price Earnings ratios versus average*

Price Earnings*	NZ Equities	Australian Equities	US Large Cap Equities	US Small Cap Equities	Developed World	EM Equities
As at 31 March	24.5	14.6	16.6	22.9	13.2	11.5
10-year average	18.5	15.1	16.5	25.0	13.9	11.9
5-year average	21.0	16.2	18.1	26.8	14.8	12.6

*Price Earnings ratios are Bloomberg Best estimates for forecast year one.

NZ$ FX performance percentage returns to 31 March 2020

Currency Pair	1m	3m	6m	12m
NZ$/ US$	-4.6%	-11.6%	-4.9%	-12.5%
NZ$/ AU$	1.3%	1.2%	4.7%	1.3%

Source: Eikon, Bloomberg, March 2020.

Index Returns to 31 March 2020

Index percentage returns in their currency

Asset Class	Index		1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	NZ$	-13.0	-14.8	-10.3	-0.5
Australian Equities	S&P/ASX Accumulation 200	AU$	-20.7	-23.1	-22.6	-14.4
US Large Cap Equities	Russell 1000 Total Return	US$	-13.2	-20.2	-13.0	-8.0
US Small Cap Equities	Russell 2000 Total Return	US$	-21.7	-30.6	-23.7	-24.0
Developed World Equities	MSCI EAFE*	US$	-13.8	-23.4	-17.5	-16.8
EM Equities	MSCI EM*	US$	-15.6	-23.9	-15.2	-19.8
NZ Listed Property	S&P/NZX Property Gross	NZ$	-20.7	-20.4	-20.9	-3.7
Fixed Interest	S&P/NZX Corporate A	NZ$	-0.8	1.2	0.0	4.2
Cash	ANZ New Zealand Call Rate	NZ$	0.1	0.2	0.5	1.2

Source: Eikon, Bloomberg, March 2020 (*not total return index).

Index percentage returns translated into NZ$

Asset Class	Index	1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	-13.0	-14.8	-10.3	-0.5
Australian Equities	S&P/ASX Accumulation 200	-21.6	-24.0	-26.1	-15.5
US Large Cap Equities	Russell 1000 Total Return	-8.8	-9.3	-8.2	5.6
US Small Cap Equities	Russell 2000 Total Return	-17.8	-21.1	-19.5	-12.7
Developed World Equities	MSCI EAFE*	-9.5	-12.9	-12.9	-4.5
EM Equities	MSCI EM*	-11.3	-13.4	-10.5	-7.9
NZ Listed Property	S&P/NZX All Real Estate	-20.7	-20.4	-20.9	-3.7
Fixed Interest	S&P/NZX Corporate A	-0.8	1.2	0.0	4.2
Cash	ANZ New Zealand Call Rate	0.1	0.2	0.5	1.2

Source: Eikon, Bloomberg, March 2020 (*not total return index).

Interest Rate and FX Forecasts as at 31 March 2020

Rate	1Q2020A	2Q2020E	3Q2020E	4Q2020E	1Q2021E
Australia Cash Rate	0.25	0.25	0.25	0.25	0.25
Australia 10yr govt	0.80	0.85	0.90	0.90	0.95
US Fed Funds Rate	0.75	0.00	0.00	0.00	0.00
US 10yr Treasury	0.55	0.55	0.75	1.00	1.00
NZD OCR	0.25	0.25	0.25	0.25	0.25
NZ 10yr Govt	1.00	1.00	1.05	1.10	1.15
NZ$/ US$	0.540	0.510	0.540	0.560	0.570
AU$/ US$	0.550	0.530	0.550	0.580	0.600
NZ$/ AU$	0.9818	0.9623	0.9818	0.9655	0.9500
EUR/ US$	1.050	1.050	1.100	1.090	1.080
US$/ JPY	107.0	103.0	105.0	107.0	105.0
GBP/ US$	1.150	1.180	1.220	1.250	1.250

Source; Macquarie Securities, March 2020.

Market Outlook and Portfolio Positioning

New Zealand equities

The New Zealand share market (NZX50) had its worst calendar month return ever in March, a fall of -13.0%, eclipsing June 2008, the worst month during the GFC, where the market fell by -11.8%. The NZX50 was down as much as -24.5% in late March before rallying into the end of the month. Obviously, everyone is aware of the severity of the coronavirus outbreak, but there still remains considerable uncertainty as to the virus's trajectory and the ongoing economic consequences, both current and future.

During the month, the New Zealand Government announced a $12.1b fiscal package which included $5.1 billion in wage subsidies for affected businesses. The wage subsidies initially came with a cap but that was subsequently removed, potentially injecting a further $4 billion into the economy. The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by an unprecedented 0.75% to 0.25% and stated that at the OCR will remain at this historically low level for at least 12 months. It also effectively introduced quantitative easing with the implementation of the $30 billion Large Scale Asset Purchase Programme, signalling it will be buying New Zealand Government bonds of all maturities.

Tactical Positioning

The lockdown in response to the coronavirus outbreak has delivered a severe shock to the New Zealand economy. The collapse in corporate profits is likely to be broadly spread across all major sectors. Companies' ability to pay out dividends during these unprecedented times may be materially impacted. We have already seen the likes of those in the travel and tourism sector cut dividends, but the Reserve Bank took the pre-emptive step to shore up the domestic economy by enacting measures that local banks cannot pay dividends until we get through this. We expect this trend to continue while the country battles the outbreak.

We are encouraged by New Zealand's isolation efforts and see our economy as one of the first out of lockdown. As a result, we are optimistic about domestically focussed businesses at current prices, but see further volatility ahead and opportunities to add. We think the market could rally in relation to a better than expected virus outcome but view that as an opportunity to lighten up, building up cash for what we see as a protracted economic downturn for at least the next six months. As a result, we are Neutral at this time.

Australian equities

The March quarter was the worst quarter on record for the benchmark Australian ASX 200. Australian equities fell -21.5% in March alone and -24.4% for the first quarter, wrapping up the biggest quarterly loss in the index's 20-year history. Australian equities proved they were considerably more volatile than their New Zealand cousins, as six trading days in March were among the worst 20 down days since 1980. An increasing number of companies now are withdrawing prior guidance in response because they cannot estimate how long a shutdown may last or the impact on their business.

The RBA and Australian Government have responded with significant firepower, amounting to A$320bn (~16% of GDP). Subsequent to the RBA's historically unprecedented rate cut from 0.75% to 0.25% and the introduction of a quantitative easing program, the Australian government has since introduced two fiscal packages, carrying a wide array of supportive arsenal for households and businesses, including loan guarantees, wage subsidies and superannuation access allowances, with additional measures expected to be announced in the coming weeks.

Tactical Positioning

We expect Australian GDP to suffer materially in 2Q20 due to the significant restrictions in place across most states. Unemployment is also likely to spike in the coming weeks too. We think corporate Australia's earnings downgrade cycle has further to go. So far the estimated contraction is in the magnitude of high single digits, but this looks light in a global context. An extended economic shutdown and widespread equity raisings that we are seeing more of are additional factors that could further reduce earnings per share.

We expect volatility to persist and with more downgrades likely coming, we see a growing risk of downward moves in stock prices. We therefore maintain our call to stay Underweight the Australian equity market.

One of the few saving graces is the unexpected relative strength of the New Zealand Dollar against the Australian dollar. The Kiwi dollar hit parity intraday on March 18th, and has been particularly strong especially compared to long run averages. We do think this offers a window for new money to invest in Australia at an opportune time, but conversely less attractive for clients bringing funds back to New Zealand. For those that do want to invest in Australia, share prices of many listed stocks have fallen out of favour, and may offer a number of compelling opportunities at prices that may reward long-term holders over time.

International equities (excluding Australia)

US equities

The longest-ever bull market in US history ended abruptly in March with declines so sharp that rarely used mechanisms to halt trading were activated by exchanges on a number of days. The S&P 500 recorded its biggest quarterly decline since 2008 with the Dow Jones Industrial Average having its worst period of performance since 1987.

The US government and the Federal Reserve intervened to help restore calm. In an emergency move the Fed slashed US interest rates close to zero, provided short-term lending support and boosted the flow of US dollars around the word. The US Senate passed a US$2 trillion coronavirus aid bill - the largest economic stimulus in US history. The plan includes direct payments of US$1,200 to most American adults and aid to help small businesses pay workers. As well as US$350 billion in loans for small firms, a US$500 billion fund was set aside to help larger companies, including loans to hard-hit sectors such as airlines.

The measures provided a degree of support to US equity markets as they regained some lost ground during the final week of the quarter although trading conditions remained volatile as the number of new Covid-19 infections in the US and Europe continued to rise.

Tactical Positioning

We are encouraged by US policy makers' aggressive moves to provide monetary and fiscal stimulus in the wake of such an economic and social shock. However efforts to control the coronavirus outbreak in the US have sadly been underwhelming. Testing has been limited and only once this becomes widespread can they be on a path to contain the pandemic.

From clients' perspective we are fortunate that safe haven demand and firming up funding lines has driven huge demand for US dollars. The NZ dollar weakened materially over the quarter so from a domestic investor here, returns from US equities do not look as bad.

Our outlook assumes a reacceleration of the global economy later this year, and a rebound in global EPS in 2021. We stay constructive on US equities though we continue to have a strong preference for large caps over small caps. Technology stocks have been remarkably resilient through this and the benchmark index, the Nasdaq was actually up for the quarter in NZ$ terms.

For clients looking for liquidity we believe the strong US dollar presents an opportunity to lighten up some of their exposure, but for others we continue to believe the US remains the preferred quality trade.

Developed World equities

The MSCI World Index of Developed Markets excluding the United States was down -23.9% for the first quarter. Outside of China, Europe was the first major region to be affected by the coronavirus and the markets have born the brunt of this so far. The region remains in dangerous territory with most countries following Italy's footsteps, and issuing nationwide lockdowns in varying degrees of severity.

The UK equity market also suffered significant losses, and the index posted its biggest quarterly fall for more than three decades as the economic costs of the global health pandemic continued to mount. Defensive sectors such as utilities, consumer staples and health care held up better than more cyclical areas of the market with consumer discretionary stocks, financials, industrials and real estate seeing the biggest falls.

Japan's equity market ended March and the quarter lower as the Government announced that the Tokyo Summer Olympics had been officially postponed, with the games now scheduled for July 2021. It looked more likely that Japan would fall into a recession and the country has begun steps to instigate full lockdowns in the key metropolitan areas. The Bank of Japan issued an emergency statement stating the Bank 'will strive to provide ample liquidity and ensure stability in financial markets through appropriate market operations' together with increased asset purchases.

Tactical Positioning

We believe Europe may not be as affected as China because the composition of GDP is weighted more towards services, which is less exposed to supply chain disruptions and allows for companies to implement work-from-home strategies. Secondly, the European Union is quickly responding with income support and liquidity to ensure that job losses and business failures are minimised. Neither of these steps will prevent a large contraction in the second quarter but once case numbers plateau and then fall away, they should help initiate a recovery later in the year.

As we go to press this month, Boris Johnson, the UK Prime Minister, is in hospital with the coronavirus. While we wish him a speedy recovery, we are extremely cautious on the UK at this time. A key indicator of sentiment, the British Pound has already fallen reflecting this new uncertainty, but this is in addition to all the unknowns related to Brexit.

The Japanese Government finally made the tough decision to delay the Tokyo Olympics until next year. This had been a significant beacon for the country and market sentiment and without this we are cautious. In the last week, the Abe government, has declared state of emergencies in the most populated Tokyo and Osaka regions as the country braces to deal with the outbreak in a more sustained manner.

Although the ECB and Bank of Japan has more firepower to help contain financial stress in the short term, many market participants believe further measures may still be required. As countries across Europe struggle to contain the spread and Japan has only now admitted that the outbreak might be more severe than initially indicated, we move to full Underweight Developed Markets.

Emerging Market equities

Emerging equity markets fell sharply over the quarter in anticipation of a global recession as the spread of Covid-19 intensified. While remedial measures to contain the virus weighed heavily on economic activity, governments responded with stimulus packages to cushion the impact. Interest rates were also lowered in several countries.

India was one of the weakest performing equity markets in Asia along with Indonesia and the Philippines. In the biggest isolation effort to date, India locked down 1.3 billion on 25 March and on the following day announced a US$23 billion stimulus plan to help the poor impacted by the travel restrictions.

Wuhan in China was ground zero for the coronavirus but the Government initiated tough containment measures which now seems to have paid off and the rest of the world is striving to replicate. As a result, equity losses in China were less severe than many other countries as officials have begun to lift restrictions in the Hubei province. Chinese manufacturing activity rebounded strongly in March with sentiment surveys showing a big improvement from the previous month.

Oil prices recorded a historic decline as Saudi Arabia and Russia sparked a major selloff after by failing to agree on the level of production cuts. The collapse in commodity prices, led by the 55% drop in Brent crude, was particularly felt in Latin America as equity markets registered their biggest monthly losses in March since 1998. The Brazilian equity market lost almost half its value during the March quarter in US$ terms, given its heavy composition of energy stocks.

Tactical Positioning

The global macro-economic backdrop is improving thanks to a large coordinated stimulus package and hopefully an imminent peak in virus numbers. But at this point, this outlook only applies for Developed Markets. Emerging Markets are in a much weaker spot. This quarter has been characterised by fund outflows and EM currencies remain under pressure.

Emerging markets particularly those outside of Asia are worse placed, because the virus impact took longer to be felt there and because the health systems are less well equipped to deal with the pandemic. Furthermore, fiscal and monetary headroom is much more limited.

We fear we will see an escalation in infections across Emerging Markets, but these must first stabilise before we can be bullish. Sadly we see this as some way off. Over the long term we are constructive on the opportunity set and recommend retaining some exposure, hence recommend a Neutral weighting. Within EM we favour Asia, in particular China.

New Zealand listed property

Domestic listed property much like the broader equity market has had a very challenging first quarter in 2020. The S&P/NZX All Real Estate was down -20.4% which has essentially unwound any gains made in the sector over the last 12 months. The lasting impacts of this global pandemic are still unknown, but note it is clear the pandemic will have a material impact on the sector's forward performance and rental receipts. It is too early to quantify the impact of disruption on future income, asset values and cash flows. Kiwi Property Group has already suspended its final dividend and we think this prudent capital management is likely to be consistent across the sector.

Tactical Positioning

We move to an Underweight recommendation for New Zealand listed property. While low rates will benefit listed property, working from home and lockdowns may have profound implications for the sector.

Fixed Interest and cash

It has been the worst performing quarter for credit markets since the global financial crisis as concerns around corporate defaults intensified and markets weighed up the full impact of Covid-19. Even assets such as gold and government bonds no longer worked as expected. Fixed income markets broke down and liquidity evaporated. This resulted in record selling as asset managers were forced to liquidate their most liquid positions to satisfy redemptions, which in fixed income markets equates to government bonds. So even the safe-haven of government debt no longer existed due to relentless selling pressure which pushed government bond yields higher and prices lower.

Exacerbating these moves, were the rumours of large sovereign wealth funds redeeming into an illiquid market added further dislocation. Corporate bonds exhibit less liquidity than government bonds, so to say that liquidity was challenging in our market would be an understatement. To highlight this, which was also well documented in Australian newspapers, fixed income asset managers considerably widened their sell spreads. This was to compensate for the significant widening of bid/offer costs in the underlying corporate and government bond markets.

This broad dislocation in asset markets forced central banks and governments to intervene. Locally the RBNZ announced large scale asset purchases of both government and council bonds to help inject liquidity into the system and attempt to restore confidence to financial markets. At the time of writing, this has had an immediate impact for government debt but liquidity and pricing environment for corporate debt remains challenging.

Tactical Positioning

We move to a Moderately Overweight tactical position in Fixed Interest. Whilst the events of the last month have been unnerving, we now believe the yields being offered on high quality corporate names due to significant credit spread widening, are such that they offer excellent medium to long term value in what is a historically low interest rate environment.

As for cash, while we see no meaningful return on cash holdings due to effective zero interest rates, we upweight cash to build reserves to take advantage of future opportunities.

Hobson's Corner

Glimpses of a post-pandemic future

Ed Glennie - Investment Strategist

Never has it been clearer how interconnected our world was until the Covid-19 crisis hit. The globalisation of modern business and travel has meant that Covid-19 has become the most disruptive event we collectively face since World War II.

I read an interesting report this week from Citi Research that looked across all major industries to explore what impact Covid-19 has had, and its potential forward impact. Citi identified companies and themes which may be well-placed against this backdrop, and those less well placed.

Key themes referred to were:

- **Crisis as a catalyst for consolidation and restructuring:** the dramatic and brutal challenge to business models is expected to result in significant consolidation in certain sectors, as poorly capitalised companies struggle to survive or are forced to raise capital.
- **Focus on 'working from home':** investors have been starkly reminded of the underpinnings of such phenomena as e-commerce, telehealth, digital leisure, video gaming, remote office productivity, data centres, cloud business models, etc, within the more recent lens of 'working from home'.
- **Existing 'mega-trends' likely see acceleration:** automation across industrial sectors, digital banking, shift from physical to online consumption including food and product delivery services.
- **Ethical, Social and Governance (ESG) engagement priorities likely to shift:** in the short-run, many investors are trying to understand how to prevent a short shock from turning into permanent damage; focus to shift to employment and benefits, deferring liabilities, direct assistance etc. Longer-term, the bar is likely raised for risk management overall; implications for offshore supply chains in high social utility key sectors such as food and medicine production; as well as labour practices and policies.

If you would like further insight in some of the shorter and longer term implications and what this means for investors, please don't hesitate to reach out to your advisor.

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