Investment market impacts of coronavirus. Part II

By MLC

Financial markets, which had until now adopted a 'wait and see' attitude to the coronavirus pandemic, seem to have changed course.

On Monday, global shares had their worst day in two years and the Australian share market has in recent days seen its biggest sell-off since the depth of the US-China trade wars last August.

There appears to be a realisation that economic dislocations stemming from the coronavirus may be more significant than markets previously assumed.

While more Chinese provinces have downgraded their emergency response levels on reports infections have plateaued in the country, the virus is spreading to more countries with Iran, Italy and South Korea now among key sources of worry.

The vast majority — 90% of the new infections in South Korea, were in Daegu (population 2.5 million), the country's fourth-largest city and the epicentre of the country's outbreak, and the neighbouring province of North Gyeongsang.[1]

Stories out of China of people told to stay at home and not return to work; factory shut downs freezing global supply chains for everything from mobile phones to autos and pharmaceuticals; and dramatically lower consumer spending is causing investors to re-exam previous assumptions of a limited global economic impact.

Also under question are expectations of a post-Covid-19 economic bounce. The 2003 SARS parallels investors are looking back to as a guide may be inadequate, emphasising our view that the past can be a poor steer to the future, especially when the data set is limited.

It seems a stretch to assume Covid-19 will play out like SARS simply because both originated in China!

The Investment Futures Framework captures pandemics

Generally, investment professionals think about what is likely *to happen*, as distinct from what *can happen.*

By contrast, our Investment Futures Framework actively steers us away from this kind of comfort zone thinking towards understanding the many things that could happen **(Chart 1)** and then identify the most appropriate trade-off between risk and return for each of the portfolios we manage for clients.

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[1] Source: *Coronavirus latest updates: WHO mission director warns world is 'simply not ready' for pandemic.* Wednesday 26 Feb 2020. https://www.theguardian.com/world/live/2020/feb/26/coronavirus-latest-updates-who-mission-director-warns-world-is-simply-not-ready?. Accessed 26 February 2020.

Chart 1: Our Investment Futures Framework considers many possible futures, including a global pandemic (scenario 25)

1	2	3	4	5	6	7	8	9	10
Steady state	Deflation – (reform driven productivity driven boom)	Stagflation (generic)	Rising inflation /shock (weak productivity)	Debt-driven growth	Disinflation	Inflationary growth	Investor pessimism –rise in risk premiums	Prolonged global growth and productivity boom	Strong growth, Australia and resources boom
11	12	13	14	15	16	17	18	19	20
Australia-only bust (world economy not weak)	Aust. economic crisis (world weak)	Profit share mean reversion	Credit / monetary expansion	Credit / monetary contraction	Steady/trend growth with mean reversion	Slowdown	Recession	Recovery	Aust. deflation – destructive (Japan 1990s)
21	22	23	24	25	26	27	28	29	30
Global depression stagnation (1930s)	Severe inflation risk	Financial collapse risk	Oil price shock – geopolitical risk	Global pandemic	Global catastrophe	Global catastrophe adverse economic environment	Global war / conflict	Protectionism – adverse growth and inflation	Exogenous risk drives investor uncertainty
31	32	33	34	35	36	37	38	39	40
China and emerging market risk aversion	Multi-speed world (zero probability)	Adverse productivity shock	Asian growth leadership	Paradigm shift – lower values for shares (higher return potential)	Paradigm shift – higher values for equities (lower return potential)	Speculative bubble	Bubble bursts (economy okay)	Policy supports higher inflation (expectations lag)	Debt deflation (weak growth, low inflation)

Source: MLC Asset Management Services Limited

Rather than imagining one or even several sets of outcomes and their associated investment returns, the Investment Futures Framework recognises the possibility of a vast number of scenarios with a great breadth of return possibilities. This includes highly likely scenarios as well as 'long shots' like pandemics, such as the current coronavirus outbreak.

The coronavirus and the way it is disrupting societies, economies and markets demonstrates the Investment Futures Framework's practicality and elasticity. Having pandemics as a possibility, even if remote, means that we're not taken by total surprise when low probability events occur.

We're not caught scrambling to analyse on the run. Perhaps the worst time to begin thinking about a low probability event is when it's already underway.

Portfolio changes

For some time, we've been emphasising risk control in our MLC Wholesale Inflation Plus portfolios. In our MLC Wholesale Horizon and MLC Wholesale Index Plus portfolios, the overweight to foreign currency has helped to cushion these portfolios during recent market moves.

Likewise, options-based strategies in our Inflation Plus portfolios[2] have helped the portfolios to mitigate the weakness in a number of share markets. Our gold futures position in these portfolios have also contributed positively to returns as investors flee risk for traditional safe-haven assets, including precious metals.

Events and markets are moving fast. We are continuing to be vigilant on behalf of our clients.

[2] Investors in MLC Wholesale Horizon and MLC Wholesale Index Plus portfolios have exposure to these strategies through their investments in real return strategies.