RETIREWELL
WEALTH MANAGEMENT SOLUTIONS

eNewsletter
Exclusive Client Email Newsletter
12 June 2020

To Clients and Friends of Retirewell,

Big Bounce in Shares – But Is It Sustainable?

Unkind Thoughts on Government: A Government which robs Peter to pay Paul can always depend on the support of Paul. *George Bernard Shaw*

We hang the petty thieves and appoint the great ones to public office. Ae*sop – Greek Philosopher*

The only difference between the tax man and the taxidermist is that the taxidermist leaves the skin. *Mark Twain*

Summary

- The strong rally in shares since their March lows reflects a combination of economic reopening, signs of recovery, policy stimulus, and once pessimistic investors upsizing underweight holdings and closing positions.
- Shares are vulnerable to a short-term consolidation or pullback. But if April was the low in economic conditions, then shares are likely to be higher on a 6 to 12 month horizon.

Introduction

After a roughly 35% plunge from their February high point to their lows around 23 March on fears regarding a global recession on the back of the coronavirus shutdowns, share markets have since rebounded sharply, led by US shares. The rally has pushed the Australian ASX 200 back through 6,000, for the first time since March.

The rebound in share markets

Share market	% fall from high to March low	% rise from March low	% distance from high
US	-34	+43	-5
Eurozone	-38	+38	-14
Japan	-31	+39	-4
UK	-35	+27	-17
Global (MSCI)	-33	+39	-7
Australia	-37	+35	-14

Source: Bloomberg, AMP Capital

A common concern is that the rebound in share markets is "too optimistic" and "irrational" – how can share markets rebound so rapidly when economic conditions are so weak, coronavirus uncertainty remains high, the US is seeing civil unrest and US/China tensions are rising? We also have been surprised by the speed of the rebound and think that maybe the markets are ahead of themselves. This has been seen before and we are reminded of the quotation from the investor Sir John Templeton that "bull markets are born on pessimism, grow on scepticism, mature on optimism and die of euphoria", since this rally has occurred against a lot of pessimism with shares climbing a wall of worry. But as the quote reminds us, that's what they often do. The plunge in shares into March led the coronavirus hit to activity and fear of recession on the way down and in the process surprised many at the severity of the fall, and now it's led on the way up despite still lots of worries.

In Australia, this week's falls in job advertisements and continued weakness in the employment and profitability component of the NAB Survey suggest that the worst is yet to come, at least as far as the economy is concerned. In the US, the Federal Reserve seems to hold a similar view.

Key Drivers of the Rally

So what's driven the rally? In our earlier Newsletter of 9 April, we set out a Table with signposts to watch for, as to whether shares have bottomed. The key signposts are updated in this Table.

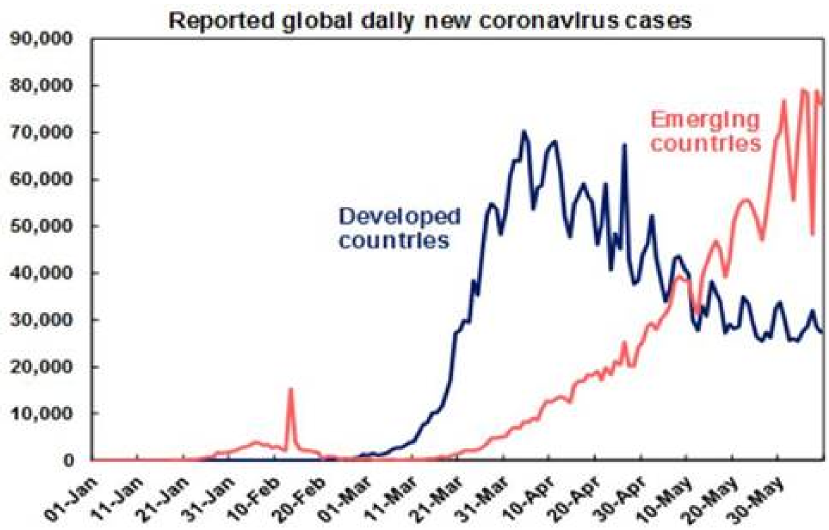
Signposts to assess the outlook for markets

Signpost	Why	Current status
Control of the virus		
Suppression	Is social distancing stringent?	This was seen in most major countries
Curve flattening	Are new cases slowing?	Yes - in developed countries. Not in emerging
Containment/ quarantine	Are new cases being quarantined?	Successful in several countries. So far so good in Australia
Anti-virals/vaccine	Could end the virus threat quickly	There are some positive signs on this front
Government support for the economy		
Fiscal support Monetary support	To limit damage & boost the recovery	There has been significant gov support
Collateral damage minimised/signs growth momentum is bottoming		
Credit spreads narrowing	Sign of functioning financial markets	Credit spreads have narrowed
Default rates up only slightly	Is public support working?	So far so good, but still too early to tell
Weekly activity indicators stabilise	They are timely	These have turned up in developed countries
PMIs improve	Sign of momentum	Up from lows in April
Market technical signs of a bottom		
Extreme oversold conditions		Yes - in March
Ultra-negative investor sentiment	Bottoms have max bearishness	Yes - in March

Source: AMP Capital

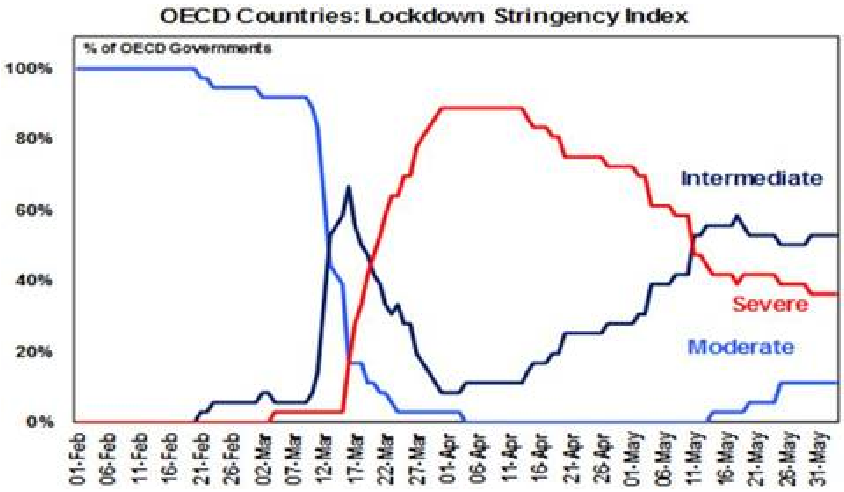
Virtually all of the signposts now tick off positively for developed countries. These are highlighted in green. So, put simply the rebound in shares has been driven by a combination of:

- Falling new coronavirus cases in developed countries.



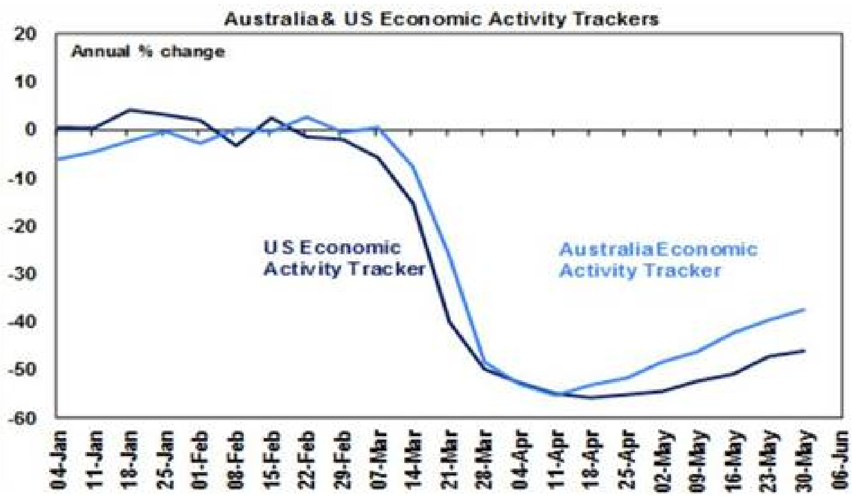
Source: ourworldindata.org, AMP Capital

- Positive news regarding anti-virals and vaccines.
- The reopening of developed countries as lockdown measures have been eased. This includes Australia, which has gone from a mildly severe lockdown to an intermediate one.



Source: Oxford University, AMP Capital

- Massive fiscal and monetary support measures which have swamped those seen in the GFC. This has helped preserve businesses, jobs and incomes preventing defaults. Low interest rates also help make shares attractive for investors.
- Green shoots of recovery. With the progressive relaxation of lockdowns, timely measures of economic data such as consumer confidence, restaurant bookings, retail foot traffic, credit card data, mobility indices and jobs data suggest that US and Australian economic activity bottomed in April. See the next chart. Global business conditions indicators often referred to as PMIs also started to turn up in May after a plunge into April. This follows a similar pattern in China.



Source: AMP Capital

- Investors being pessimistic and underweight shares after the plunge in March. This has meant there has been more investors who can be motivated to buy shares than sell.

These considerations have simply swamped concerns about civil unrest in the US (which now appears to be settling down anyway) and US-China tensions.

Confirmation from Other Markets

It's not just shares that have rebounded, as the rally has been confirmed by other growth sensitive assets/yields. In particular:

- Oil and metal prices are up sharply from their lows.
- Commodity currencies like the $A have rebounded at the same time that the safe haven US dollar has fallen.

- Bond yields have lagged the upswing in share markets, but they have now started to rise, albeit they remain very low.

So Why Has the US Share Market Led on the Way Up?

The US share market has a relative high exposure to tech and health care stocks that have been key beneficiaries of the coronavirus shock – for example, Amazon is now 55% of retail stocks' market capitalisation- and the US has also seen more money printing or quantitative easing (QE) by the Fed compared to other countries including Australia. By contrast, non-US and Australian shares are more cyclical – but should start to benefit more as the recovery continues.

Correction Risk

After huge rallies most shares are technically overbought, which could mean we see a correction over the next few months. But many shares in many share markets are at overbought extremes often seen in the aftermath of major bear market lows and this augurs well for returns on a 6-12 month basis.

But What About the Slump in Earnings?

Earnings are taking a big hit from the impact to economic activity and this has seen earnings estimates slump and price to earnings multiples surge. This is clearly a concern, but note a typical "cyclical" rebound in shares goes through three phases.

- Phase 1 sees an unwinding of cheap valuations helped by easy monetary conditions, but with receding downside risks causing some investors to snap up undervalued shares. This is the phase where shares climb a "wall of worry".
- Phase 2 is driven by strengthening profits.
- Phase 3 sees euphoria with very bullish investors pushing shares to extreme levels. This is despite shares becoming expensive and central banks raising interest rates.

Right now, we are nearing the end of Phase 1. As economic conditions recover, profits are likely to strengthen and we will move into Phase 2. While price-earnings ratios (PEs) are now high, it's noteworthy that the equity risk premium, which can be crudely measured as the gap between earnings yields (using forward earnings) and bond yields, is still reasonable, reflecting ultra-low bond yields. But an improvement in earnings will be a key thing to watch for.

Source: Thomson Reuters, AMP Capital

What Are The Key Risks?

The three big risks are:

- <u>a second wave of coronavirus cases</u> (which should be able to be avoided with lots of testing, tracking and quarantining, and even if it does occur may not have the same negative economic impact as any renewed lockdown) is likely to be milder and deaths are likely to be lower given greater preparedness;
- <u>collateral damage from the shutdowns</u> resulting in a delayed or very slow recovery as bankruptcies surge and unemployment goes higher (so far so good – with government and central bank support hopefully heading this off);

- and risks around the US election (such as Trump ramping up tensions with China if he feels he has nothing to lose or investors fretting about higher taxes and more regulation under a Democrat victory across the Presidency, House and Senate).

Concluding Comment

Shares are vulnerable to a short-term consolidation or pullback - particularly after the next round of earnings reporting, which could see some shockers in earnings downgrades. The fragile state of the US recovery also highlights that any danger to the expectation of a V-Shape recovery that markets have presently priced in, could see stock prices tumble very quickly – the V could very quickly become a W. However, if April was the low in economic conditions then shares are likely to be higher on a 6 to 12-month horizon. The experience of the last few months highlights just how hard it is to time market bottoms – a good approach for long-term investors is to average in over a number of months after major falls.

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