

Beware when the market and the economy are out of sync

21 April 2020 | Roger Montgomery, Montgomery Investment Management

Following its one-month 36 per cent decline from peak (20 February 2020) to its low (23 March 2020), the ASX200 has bounced 20 per cent. That's a return most investors would be happy with over a year. The question is whether such optimism is warranted.

The bounce reflects the relatively simplistic and arguably misguided idea that peak virus infections and deaths will pass quickly and that central bank interventions in the bond market, which cheapen credit to businesses and households, and government stimulus such as wage subsidisation, will subsequently trigger a surging return to prosperity.

But it is important to note that, prior to the outbreak, economic growth was already faltering. Growth in China was slowing, a recession in Europe was widely predicted and US job availability, employment and wages were sliding.

When an economy is growing very slowly and asset prices are extremely stretched, not much is required to burst the bubble. COVID-19 represents a serious pin.

What we are now left with is a plethora of concurrent uncertainties.

First there's the pandemic itself and getting on top of the virus is the first step. Herd immunity and or immunisation is the end goal. But today, lockdowns and curve-flattening are the tools to prevent outbreaks overwhelming medical systems. Amid 134,000 deaths globally, our best guess is that compliance with lockdowns might be in the region of 70-90 per cent. In Australia, for example, that means 2.5 to 7.5 million could still potentially spread the virus either because of dissension or they are essential workers.

The South Korean experience indicates that even with very effective draconian measures in place, the numbers decline much more slowly than they rise.

Falls dawns are likely. We may see countries relax the lockdowns before re-implementing them. As my colleague Tim Kelley noted, while improved testing, tracking and treating should see us move progressively closer to normality, even absent a vaccine, full normality could take quite a while. A return to normal too early risks a second outbreak and another lockdown as China's Jia County has just discovered.

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Meanwhile the speed with which the world has come to a crashing halt has seen the International Monetary Fund's managing director, Kristalina Georgieva comment that the economic crisis is "like no other," adding, "It is way worse than the global financial crisis."

Restarting the economy will take time, if only because a population concerned about its health and safety is much more an anchor than one merely concerned about the economy. And as I have previously pointed out, we can't truly return to normal until we have a vaccine.

Even if we get the virus under control, the optimism in the market may turn to dismay when investors appreciate the depth and reality of the resultant economic challenges. Workers unemployed for extended periods suffer from a reduction in the relevance of their skills, uncertainty surrounding employment and income prospects thwart spending, as does the plunge in savings, dependence on welfare rises and supply chains are damaged.

The US jobless queue is far above even the most pessimistic forecasts and unprecedented in history – while underscoring the damage already impacting the U.S. economy. And keep in mind these are numbers from a period before the worst of the crisis had impacted the US economy.

In that context it is easy to see why the trillions spent through fiscal support programs are just that, support programs. They aren't stimulatory. Trillions in GDP are being lost every month. The positive economic impact of a few trillion in stimulus is debatable. The misplaced optimism in markets due to the stimulus, less so.

Elsewhere, with interest rates at virtually zero, many European governments are able to borrow as much as they want to navigate the crisis. But Italy's 10-year bonds now trade at a yield of 150 basis points – 200 basis points higher than German Bunds. Consequently, geopolitical fissures are emerging in the European Union. In normal circumstances fears of a rupturing of the EU would put markets in a spin. But in the goulash of current circumstances, a collapse of the European Union is just another ingredient the market has no capacity to taste or appreciate.

Back in the US, many are quickly realising how dependent the nation is on China. When the majority of inputs for everything from antibiotics to electronics come from China – a country now considered notorious for obfuscation, IP theft and revisionism – a rethink of the very globalisation that made China is likely.

Here at home, economists are expecting a neat 3.5-4 per cent economic contraction. Perhaps they haven't chatted to the Minerals Council of Australia, which warned miners might cut production by half or cease operations altogether if state borders remain closed, blocking labour from travelling.

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Meanwhile, expect a conga line of equity-destroying capital raisings and cost cutting. Flight Centre raising \$700 million and jettisoning 50 per cent of its 1600 stores, and Auckland Airports raising \$1.2 billion, is just the tip of the iceberg.

In fact, for as long as fund managers continue to fund these capital raisings there is probably still too much optimism for the market to bottom.

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