SGH Equity Market Update

As you would be aware, with worldwide headlines being dominated by COVID-19, the recent week has seen a vigorous sell-off in equity markets worldwide. Indeed in the US, it has been the most rapid (6 days) and largest (12%) sell off since the Great Depression. Quite understandably, fear and panic are gripping markets, and this has continued today in the Australian markets.

Many people are asking – is this a time to buy? Or is there further to go, in which case, should we be selling even now? This, unfortunately, is only a question that can be answered in hindsight.

We have been cautious about the markets. Markets have been stretched on valuation following a stellar run; even after the pullback they don't look overly cheap, particularly if there is downside to earnings. This is not just about COVID-19, it is also about the equity risk premium and valuation. So, while we were not surprised by a pullback, we were surprised by the extent and rapidity of the falls last week. Having said that, it's probably still a bit too early to call it a new bear market, as we were trading at record highs just a couple of weeks ago. In a normal scenario, given the wipe-out we saw last week, we would expect to see a rally later this week. What is interesting to note is that the Shanghai index was only down 5% last week, less than half the US falls. Whether or not there is a rally, we will continue to assess the market and the stocks in the portfolios.

We expect the coronavirus concerns to linger for some-time until:

- The rate of infections peak and slow
- There is a coordinated global response e.g. G20 meeting - which will probably require the WHO to first declare it a global pandemic.
- It gets off the front pages of the newspapers; and
- There is a cure announced.... Hopefully, soon!

We do expect that the March quarter economic numbers will be terrible, and we expect this is not fully reflected in company earnings. The recent reporting season saw most companies unable to quantify the impact of the COVID-19. We expect to see lots of company earnings downgrades over the coming months as the impacts become clearer, particularly in the travel, hospitality, discretionary retail and education sectors. As this is now a global demand shock, instead of an initial China supply disruption, we would expect to see monetary authority and government responses. The pivot in Federal Reserve rhetoric and Australian Government commentary over the weekend highlights central banks and governments will likely stimulate economies via a combination of interest rate cuts and spending programs - perhaps starting in the next couple of weeks.

Longer-term, with interest rates making record lows, this is bullish for the share market - and once fears around COVID-19 subside, we wouldn't be surprised to see a stronger equity market, either later this year or next year. The only question is how low we go before this happens. It may be quite a bit further, because despite the recent falls, the Australian market is still up more than 10%, plus dividends, since 31-Dec 18, and despite the sell-off, valuations still remain somewhat elevated.

The Australian market is still trading on a Price to Earnings Ratio of 16.9 x forward earnings, above history and the average of 14 x, albeit interest rates remain very low. Only time will tell, and it is so very dependent on how widespread the virus becomes, and the preventative measures that government authorities take to contain its spread. Indeed we worry that the preventative measures have the scope to hurt economies and markets far more than the actual virus itself.

So, our view, as we sit here today, is that the harsh impacts are likely to be short to medium term, not long term. At some stage, the effects of the virus will subside and the market will regain some of these losses. We continue to invest for the long term and believe our portfolios are well structured to weather the current storm. Stock selection remains extremely important and we will continue to focus our research efforts on uncovering great companies at even better prices.

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