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Coronavirus infects markets

The infection from coronavirus is steadily spreading across asset classes. Currency and bond markets were the first to respond, and equity markets turned this week. Commodity markets and credit still appear to be complacent.

Is it time?

Overall despite the big moves this week we still see it as too early to return to equity markets for a few reasons:

- **Supply chain disruption risks**. We are only just beginning to understand the implications of the supply-chain disruptions on a range of industries.
- **Fear of the virus going global**. There is still so much uncertainty about how prolonged and significant the effects will be. Concerns will only grow if the virus looks like it could go global.
- **Valuations are still elevated**. Markets are more vulnerable to any shock when valuations are stretched and this is still a problem.

Other issues to consider

We will rely on valuations more than news flow to determine when to make significant portfolio moves. It is too difficult to try and pick when the crisis will start to abate. Instead our mindset will be on identifying opportunities to buy quality assets at or below fair value.

The starting point for Australian valuations was so high that it is still too early to consider returning to the overall market.

US stocks are likely to look attractive first because valuations were never as stretched, underlying macro fundamentals are stronger and there is less exposure to a Chinese economic slump.

Opportunities will arise at the stock level first. In these market events, investors sell what they own and not the stocks where the earnings risk might be largest. As a result there can be good opportunities to buy quality stocks at a discount. We will monitor this closely in coming weeks.

Investors should consider some currency hedging when returning to international markets. The $A might snapback on a resolution of the crisis and this might offset gains on underlying assets.

Those considering buying more portfolio protection should consider gold and inflation-linked bonds, both of which can be accessed through ETFs.

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Coronavirus infects markets

When the coronavirus issue first arose we were concerned that investors were under-reacting by simply assuming the effects would be similar to SARS. This assessment ignored the different response to the crisis, specifically the widespread quarantining that occurred in Wuhan. It also ignored the importance of China, and Wuhan in particular, in global supply chains. Wuhan is a major global logistics hub. It is the location of China's major inland port and a critical intersection point for rail, ship and road transport.

There was an additional problem because the virus hit in the middle of Chinese New Year when China's 300 million migrant workforce had returned to their villages. They have now become stranded a long way from their jobs. This is a particular problem for the construction, logistics and manufacturing sectors that draw on these migrant workers significantly. There was also the risk of the virus escaping China and going global; this has become a very real possibility in recent days.

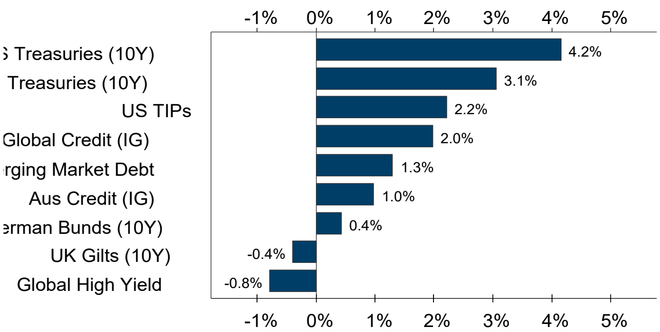
Looking at the market reactions

Different asset classes have priced in effects at different times and to different degrees

The earliest and most aggressive movements were in currency and bond markets. US 10 year bonds have hit record lows and the $A has fallen sharply.

Fixed Income Markets

Price Change (Since 22/01/20)

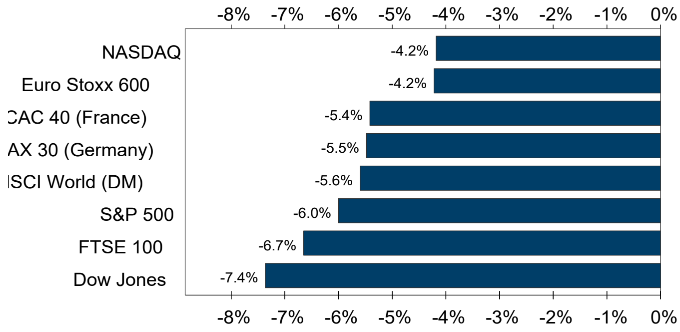


Source: Refinitiv Datastream, Evans & Partners

Equity markets have been slower to react and this has only become meaningful this week. The most affected markets have been in Asia given supply chain linkages although the biggest surprise is the small fall in the local Chinese markets. This may reflect mandated buying by local institutions.

Developed Equity Markets

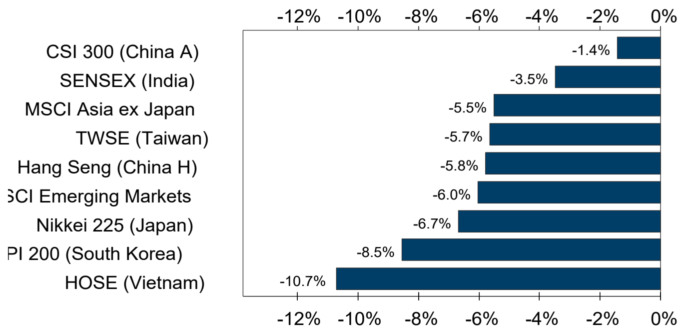
Price Change (Since 22/01/20)



Source: Refinitiv Datastream, Evans & Partners

Asian Equity Markets

Price Change (Since 22/01/20)

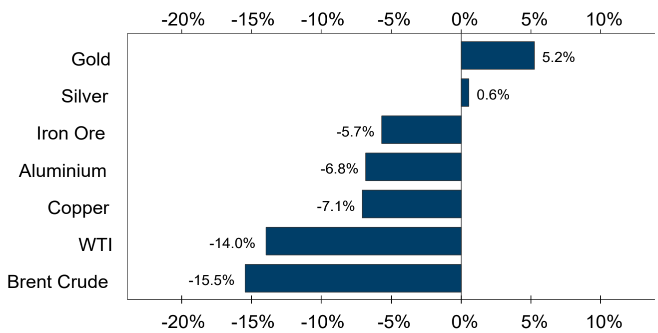


Source: Refinitiv Datastream, Evans & Partners

There are still several areas where the price reaction has been surprisingly small. Two examples are commodities and credit. Apart from oil, commodities have been resilient perhaps due to hopes of significant fiscal stimulus. The small reaction in iron ore is odd given the risks from weaker construction and manufacturing.

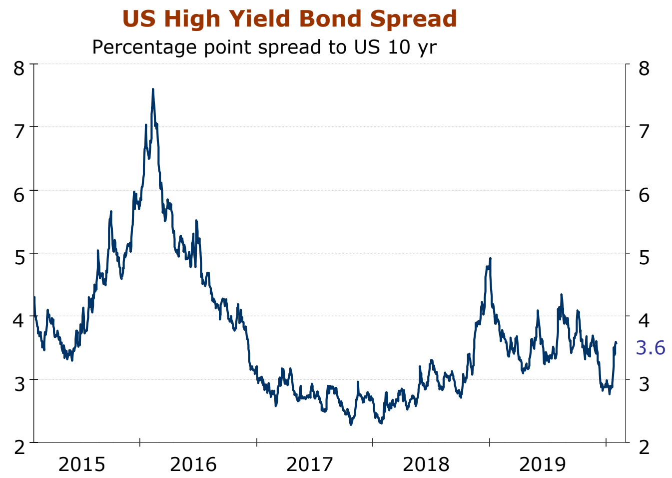
Commodity Markets

Price Change (Since 22/01/20)



Source: Refinitiv Datastream, Evans & Partners

Meanwhile credit spreads are a little higher but the rise is nowhere near as much the 2016 and 2018 selloffs. Given the amount of Chinese issuance in recent years and the typical link between spreads and oil prices, a further sell off appears likely.



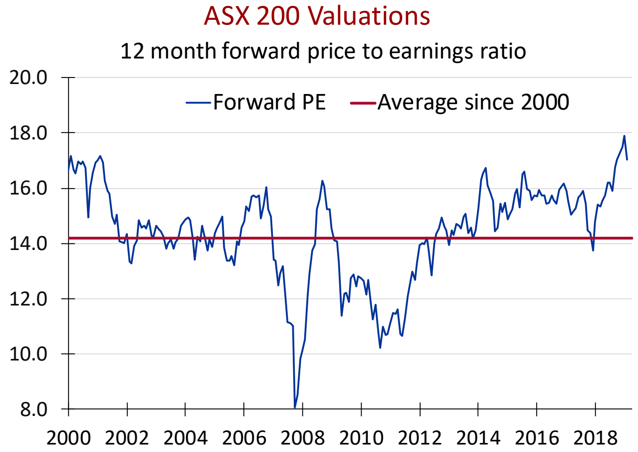
Source: Refinitiv Datastream, Evans & Partners

Is it time to consider buying equities?

While it is good that markets have started to price in some risks it is also the case that the starting point for equities was so elevated that attractive valuations have not yet emerged. The melt up in markets was so sharp in January that the recent falls have not even taken the ASX 200 back to where it was at the start of the year.

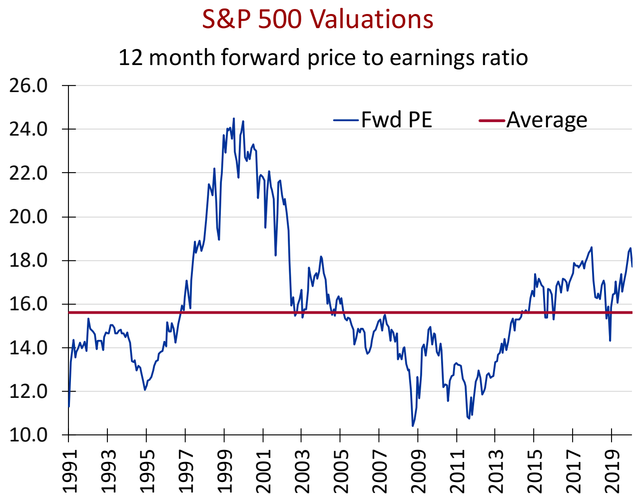
Source: Refinitiv Datastream, Evans & Partners

This point is made even clearer when we look at valuations. Australian forward PEs hit a record high in January and the recent falls have only partially reduced valuation concerns. The forward PE is still at 17.2x. The PE would only fall back into its normal range at around 6,300 where the PE would be 16x.



Source: Refinitiv, Evans & Partners

The US market is not as stretched relative to history as Australia. The US economy is also on a stronger footing and there will be less direct effects on the US economy from a China slump. As a result, we are likely to return money to the US market before Australia.



Source: Refinitiv, Evans & Partners

Our strategy for returning to markets

Overall, we see it as too early to return to markets for a few reasons:

- **Supply chain disruption**. We are only just beginning to understand the of supply-chain disruptions on a range of industries. Also, extensions on travel bans and quarantine rules for migrant workers in China means that the disruptions may still get worse.
- **Fear of the virus going global**. There is still so much uncertainty about how prolonged and significant the effects will be. Concerns will only grow if the virus looks like it could go global.
- **Valuations are still elevated**. Markets are more vulnerable to any shock when valuations are stretched and, as shown above, this is still a problem.

Our strategy will be to rely on valuations more than news flow to determine when to make significant portfolio moves. It is too difficult to try and time the news cycle and pick when the crisis will start to abate. Instead our mindset will be on identifying opportunities to buy quality assets at or below fair value.

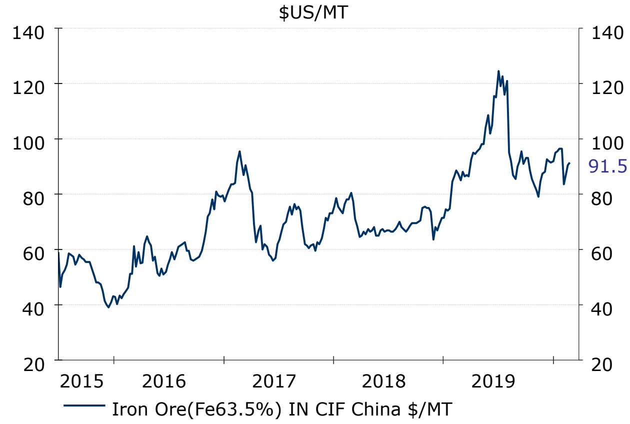
Importantly there may be opportunities at the individual stock level before overall markets appear interesting. Investors are typically forced to sell what they own rather than the stocks that are at most earnings risk. As a result, these events tend to create opportunities to pick up quality stocks at reasonable levels. We will on the lookout for such opportunities over coming weeks.

What to do in the meantime

While on equity markets we are waiting to see how the situation evolves, investors should consider action in some other asset classes.

1. Considering lightening exposure to credit and commodities

As mentioned, we are surprised by the underreaction of credit and commodity markets given the typical cyclicality in these asset classes. This is most relevant for industrial commodities (iron ore, copper) and high-yield credit.

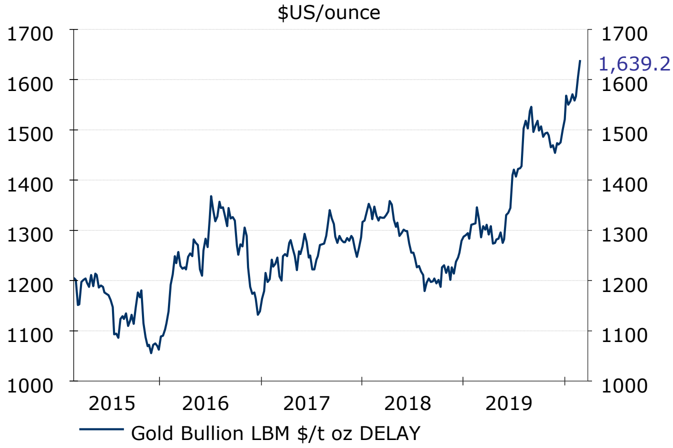


Source: Refinitiv Datastream, Evans & Partners

2. Consider ways to add overall portfolio protection

Investors should also consider adding other assets in their portfolio that are defensive and will provide protection if conditions worsen. Three possibilities are gold, inflation-linked bonds and direct $US exposure.

Gold exposure could be gained through physical gold ETFs (such as GOLD). Gold should act as a safe haven if conditions worsen. The gold price has already moved significantly but could go further in the case of a global pandemic.



Source: Refinitiv Datastream, Evans & Partners

Global bonds could rally further. The best option is inflation-protected bonds (there is an ETF called TIP). This is better because it has longer duration and there is also some risk of inflation from shortages if Chinese production does not recover. It is also in $US and this will should keep rising in a bad scenario.

Investors could also **buy USD, which** will benefit from safe haven flows. An ETF option is ZUSD.

3. Be vigilant for opportunities

Investors should be on the lookout for individual stocks that are particularly hard hit. We continue to monitor stocks that have a direct link to Chinese concerns, and these are shown in the table below.

There is also the possibility that other stocks will be significantly affected and we will continue to watch for opportunities.

Chinese linked Australian stocks

Code	Company	Price	Market Cap $B	PE ratio 12 mth fwd	PE ratio Prem to 10 yr ave	Div Yield %	Earnings Growth rates FY1	Earnings Growth rates FY2	Earnings Growth rates FY3	Earnings revisions past 6 mths EPS	Earnings revisions past 6 mths Sales	Recommendation	Change since 22nd Jan %
Travel Related													
QAN	Qantas Airways Ltd	5.72	8.6	9.4	19.7	4.5	-9.4	28.9	14.8	-22.3	-2.0	Neutral	-15.8
VAH	Virgin Australia Holdings Ltd	0.13	1.1	----	29.6	-	44.5	112.0	525.0	455.3	-0.6	NR	-16.7
FLT	Flight Centre Travel Group Ltd	35.00	3.6	14.2	15.0	4.0	-14.7	15.2	10.0	-18.1	-0.5	NR	-14.6
WEB	Webjet Ltd	11.06	1.5	14.4	19.3	2.2	7.6	20.7	14.9	-15.3	-7.5	NR	-19.2
CTD	Corporate Travel Management Ltd	14.85	1.6	16.1	24.9	2.4	-11.8	26.7	14.7	-22.7	-9.8	NR	-29.5
SYD	Sydney Airport Holdings Pty Ltd	8.00	18.2	44.4	45.9	5.0	-1.9	17.7	6.7	-7.8	-3.8	Positive	-6.9
AIA	Auckland International Airport Ltd	7.80	9.5	36.0	30.2	2.7	-3.4	3.3	3.4	-2.2	-3.2	NR	-9.7
SLK	Sealink Travel Group Ltd	4.34	1.0	15.2	17.3	3.5	3.5	34.0	12.6	-4.2	165.4	NR	0.0
Tourism relatived													
CWN	Crown Resorts Ltd	10.71	7.3	22.1	18.8	5.6	-15.3	9.1	3.4	-17.5	-5.7	Neutral	-11.9
SGR	Star Entertainment Group Ltd	3.79	3.5	14.6	18.4	5.3	8.7	2.0	-5.1	-2.9	-1.8	Positive	-14.4
SKC	Skycity Entertainment Group Ltd	3.27	2.2	17.4	16.1	6.0	-25.7	4.8	14.4	-16.5	-5.9	Negative	-16.8
EVT	Event Hospitality and Entertainment Ltd	11.85	1.9	17.5	16.3	4.5	-2.9	13.1	6.6	-10.7	-2.8	NR	-12.9
VRL	Village Roadshow Ltd	3.72	0.7	22.8	16.1	1.5	8.1	42.4	17.3	-24.9	-4.0	NR	-4.6
Consumer related													
SCG	Scentre Group	3.58	18.9	14.3	17.2	6.5	-1.9	4.0	3.5	-2.5	-7.4	Neutral	-8.7
URW	WFD Unibail Rodamco NV	9.44	26.9	9.7	11.7	9.6	0.4	2.6	-4.5	0.2	-4.8	Positive	-11.7
TWE	Treasury Wine Estates Ltd	11.01	8.0	16.9	25.7	3.5	-2.9	17.6	15.0	-19.9	-8.8	Positive	-37.5
TGR	Tassal Group Ltd	3.98	0.8	11.6	12.5	4.6	1.9	9.1	15.0	-2.3	-7.1	NR	-9.8
HUO	Huon Aquaculture Group Ltd	4.19	0.4	15.5	19.1	1.6	-8.8	95.5	37.4	-57.8	-0.1	NR	-6.9
BGA	Bega Cheese Ltd	4.05	0.9	24.1	23.3	1.0	-33.2	66.3	26.5	-44.2	-16.8	Positive	-11.0
A2M	A2 Milk Company Ltd	15.00	11.1	30.0	37.9	-	22.5	21.7	16.9	2.0	-1.5	NR	-3.8
BKL	Blackmores Ltd	68.05	1.2	36.1	23.1	0.9	-61.9	90.9	33.6	-62.0	-11.8	Positive	-22.8
BWX	BWX Ltd	4.05	0.5	28.1	24.8	1.1	33.7	43.4	23.2	-5.1	0.4	Neutral	-7.7
Education related													
IEL	IDP Education Ltd	23.08	5.9	54.4	37.7	1.1	34.2	26.6	23.4	7.8	3.2	Neutral	13.9
Major Miners													
FMG	Fortescue Metals Group Ltd	10.88	33.8	7.2	10.7	13.2	30.8	-39.0	-23.1	12.8	3.5	Neutral	-14.3
BHP	BHP Group Ltd	35.55	171.1	12.2	16.3	6.0	8.5	-4.2	-1.5	-8.9	-5.4	Neutral	-13.7
RIO	Rio Tinto Ltd	91.89	131.3	11.0	11.4	6.2	-14.6	-14.4	23.6	-11.1	-4.7	Neutral	-14.4
Others													
WTC	Wisetech	17.57	5.6	65.4	88.1	0.2	22.1	37.1	47.2	-20.2	-5.9	Positive	-29.7
BSL	Bluescope	12.44	6.3	13.0	25.7	1.1	-55.1	30.2	7.1	-8.9	-3.5	NR	-19.7

Source: Refinitiv, E&P. Pricing as at 27th February

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