Flock of black swans and a case of severely ruffled feathers

The much-awaited global economic recovery early this year was disrupted by the emergence of COVID-19, which started in China but quickly spread to the rest of the world. The outbreak caused disruption not only to trade flows, tourism and travel industry but also to normal business and social activities. As the number of infections spike, more countries are resorting to drastic “lockdowns’ to combat the contagion of COVID-19.

In short, the pandemic outbreak led to disruptions of an epic proportion to countries all over the world. As a result, we see responses of an epic proportion in the financial markets with pronounced market swings as the market price in new information at a breakneck speed.

As if the pandemic was not enough of a black swan, the OPEC+ agreement collapsed on 6 March, resulting in a severe oil price war between Russia and Saudi Arabia. With supply of oil ramping up and demand down due to COVID-19 outbreak, oil prices plunged from USD50-55/bbl (end-Feb 2020) to USD25-30/bbl as of the publication of this note.

Central banks and governments worldwide have responded by cutting rates (e.g. US, Australia, China, UK and Malaysia), loosening monetary policies and unveiling large stimulus packages to provide relief to the economy (China, Singapore, US, Australia, Hong Kong, Italy, Malaysia and Indonesia). To illustrate the magnitude of responses, US alone announced a USD1.2 trillion stimulus package to resuscitate the economy while the Federal Reserve (Fed) cut rates by a whopping 1.75% to near zero in March 2020. US, Australia and Japan also embarked on some form of quantitative easing and/or bonds-buying programme. These coordinated stimulus measures are meant to keep the economic and financial system stable and hence tide us over the pandemic.

In Malaysia, we were jolted by an unexpected political development, which saw a sudden change in government and Prime Minister end-February 2020. Since then, newly appointed Prime Minister, Tan Sri Muhyiddin Yassin has unveiled a new cabinet comprising representatives from the Perikatan Nasional coalition. To date, the transition in government has been relatively smooth and free from violent protests or demonstrations. In all honesty, impact to economy and financial markets from this event has to a large extent been overshadowed by the myriad of external factors happening simultaneously. Over the longer term, ultimate impact will likely depend on the stability of current government, changes to government policies and the ability of the government to handle the challenges from COVID-19 and oil price plunge.

Malaysian government has been quick to announce a stimulus package worth RM20 billion (1.3% of GDP) not long after the COVID-19 outbreak started. The stimulus injection is expected to widen the fiscal deficit target to 3.4% of GDP in 2020 from the initial projection of 3.2% of GDP. When announcing the stimulus, Ministry of Finance lowered its GDP growth forecast for 2020 to 3.2%–4.2%, from the initial projection of 4.9%. As infection rate spiked in Malaysia, the government declared a restricted movement order between 18 March – 31 March 2020. Against this backdrop, Malaysia’s economic growth could slide further, especially if the pandemic worsens and restricted movement order is tightened or prolonged. Meanwhile, Bank Negara Malaysia (BNM) has cut the Overnight Policy Rate (OPR) by 50 bps this year in two consecutive Monetary Policy Committee meeting; we do not discount further cuts to the OPR given the rapid escalation of downside risks to growth.

Being an oil-producing country, we note that the plunge in oil price has a negative impact on the oil-and-gas sector as well as the government’s revenue capacity. This, in turn, applies pressure on Malaysia’s fiscal health and sovereign rating.

As the pandemic outbreak and oil crisis are still evolving, it is challenging to discern the directions they will take over the next few months. Notwithstanding actions from governments and central banks or the trajectory of the pandemic outbreak, the risk of global recession is indeed rising. Many has drawn comparisons to what happened in the 2008-2009 Global Financial Crisis (GFC) and the 1997-1998 Asian Financial Crisis (AFC). While the current scenario could well be worse off than GFC, the Malaysian economy and market are in a better position to navigate the choppy waters compared to the AFC days for the following reasons:

- Interest rates are low and there is coordinated effort across the governments worldwide to tap into their arsenal of monetary policies and fiscal stimulus to alleviate impact on economy.
- Balance sheets of corporates today are healthier and are less leveraged. Pre-AFC days, many Malaysian companies were highly leveraged and had poor cash flow structures.
- Corporates have less currency mismatch between their cash flow and debt.
- Absence of a property and stock market bubble.

Nevertheless, short term market weakness and volatility will likely prevail given high degree of opacity in outlook. Strong global risk-off sentiment has led to sell-off in equities market. Companies in the tourism, aviation, retail, oil & gas as well as commodities sectors bear the brunt of market weakness. Other sectors such as banks, insurance companies and property developers may also see indirect impact should there be further decline in asset prices and a global recession. For now, we prefer to focus on more defensive sectors such as healthcare, glove and consumer staples.

As for local bonds, although market benefitted in the initial risk-off stage, we saw a sharp reversal in trend recently as the financial market shock translated into tighter liquidity and fund flows out from Emerging Markets. Under such circumstances, the impact to our funds is moderated as we invest mainly in corporate bonds, which are less vulnerable to said outflow risks.

Over the longer term, weak economic growth and easing bias from central banks actually serve as positive catalysts. That, coupled with strong domestic liquidity, is expected to drive recovery in bond prices once global financial market stabilizes.

Our long-term strategy remains unchanged; portfolio positioning is driven mainly by bottom-up stock and credit selection. As the issues we have discussed resolve themselves over time, we are optimistic that investor sentiment will stabilize, thus opening up opportunities for fundamentally-strong and selected oversold securities.

Setting aside the chaos and disruption arising from the pandemic outbreak, we believe this episode in human history will either trigger or expedite key structural changes to the economy and society, amongst them the adoption of technology to facilitate remote working or e-commerce, diversification of supply chains and industry consolidation. For our equities portfolio, we will take this opportunity to invest in companies or sectors which will benefit from these industry trends.

Disclaimers

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