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Nikko Asset Management

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Opinion: Fergus McDonald

COVID-19 and the fundamentals of living on a timed borrow

Towards the end of last year, I provided a 2020 outlook piece – one I regret to say that failed to foresee a pandemic – that referenced the estimated US$250 trillion of government, corporate and household debt underpinning the global economy. That debt burden is now forecast to increase significantly as Governments and central banks around the world pledge extraordinary levels of stimulus to protect their citizens from the worst outcomes of COVID-19.

In the immediate response to the economic turmoil created by the COVID-19 outbreak, lower interest rates once again proved the first global policy response to calm market and economic nerves. This has been followed almost instantly by Quantitative Easing (QE), but the effectiveness of these twin measures in stimulating economies slowed by lower demand and disrupted supply chains is still the cause of much debate and scepticism. The slower and more politically difficult – but ultimately more effective – response will require a coordinated, global Government effort to control and slow the spread of the coronavirus until a northern hemisphere summer naturally slows the transmission rates or a vaccine can be created and widely distributed.

We are now seeing unprecedented quarantining in many countries, including our own, and Governments pledging to assist people and businesses impacted by the virus spread. This will help soften the financial blow for many. However, for financial markets, how deep the economic damage cuts and how long it lingers is unknown. Until this becomes clearer, we should expect a wild ride.

The US Federal Reserve, as the most influential central bank in the world, and the RBNZ can mitigate the virus impact by providing liquidity and ensuring financial markets continue to function. However, they can't prevent the virus spreading. The Fed has increased QE by injecting vast quantities of short-term liquidity via loans to banks and buying assets. The RBNZ and RBA are following suit. Perhaps this will shore up confidence, but ultimately it won't address the economic hit from social distancing and the closure of schools, shopping centres and the cancellation of crowd-drawing events.

If Governments seek to support their people and business by more spending, then they will need to increase their borrowing levels significantly. This increase in spending will coincide with a likely reduction in government tax take, as company profitability reduces in some sectors, unemployment rises and GST receipts fall along with lower activity especially in tourism and hospitality. The previously announced infrastructure spending commitment is ongoing and will be helpful for the economy. Unfortunately though, while the recent $12.1 billion package along with likely subsequent measures will seek to bridge the gap, this spending won't come quick enough to avert the economic slump we are going to experience.

As debt levels increase, economies and the people and organisations operating within them simply won't be able to afford higher debt servicing costs associated with higher rates. Indeed, the increasing debt load is one reason why interest rates should follow the lead of Japan and the Eurozone and remain low over a number of years. Once an economy is used to operating with low rates, it is often hard to wean itself of the stimulatory effect - and any attempt to increase rates often has an outsized impact on financial markets and confidence in general.

Even if debt is cheap, it can often be tough to escape from once the load becomes too heavy. Solid economic growth and inflating asset prices are often the easiest ways out, but unfortunately these are not always forthcoming. The good news for us remains that New Zealand may be one of the lucky countries that can increase debt levels to support the economy and invest in our future to provide a growth dividend that will ultimately pay off our increased debt burden.

We have all witnessed the fluctuating fortunes of global equity markets since the outbreak of COVID-19. Often when equities fall in price, bonds perform well. But in this environment even bonds have not been a safe haven. The March month to date return of the US Treasury Index is up 0.8%; but the US High Yield Index has fallen 11.5% and the Global High Yield Index is down 13%. The NZ Government Bond Index has fallen by 1.4% and the Bloomberg NZ Credit Index is down 1.2%

We have seen significant credit margin widening both globally and domestically, especially in lower grade and sub investment grade debt sparked by the prospect of weaker balance sheets, lower profitability and low levels of confidence. Falling equity markets, lower oil prices, pressured corporate cash flows, lower consumer demand, falling economic activity and dwindling levels of financial market liquidity have all encouraged many investors to remain on the sidelines. Liquidity and widening buy/sell spreads have not been helped by the increasing numbers of traders who are working from home or have implemented other forms of business continuity arrangements.

Good quality bond issues have had their yields pushed higher without much trading occurring. Even though the RBNZ has cut the OCR by 0.75% to 0.25% and pledged to keep rates there for a year, yields on corporate bonds have still risen. NZ Government bond yields have also risen mainly due to the higher levels of bonds that will need to be sold to fund the recently-announced $12.1 billion stimulus package.

The adverse impact of credit margin widening will be seen in the mark to market valuations of bond funds over the next month or so. However, as long as the fund's assets are of good quality, today's loss will result in higher returns over future periods. This is of course only valid if we don't see an uptick in issuer defaults. The Government's COVID-19 stimulus response is a good start to prevent this from occurring.

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About Nikko AM

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* All data as at 30 December 2019