Daintree Market Update

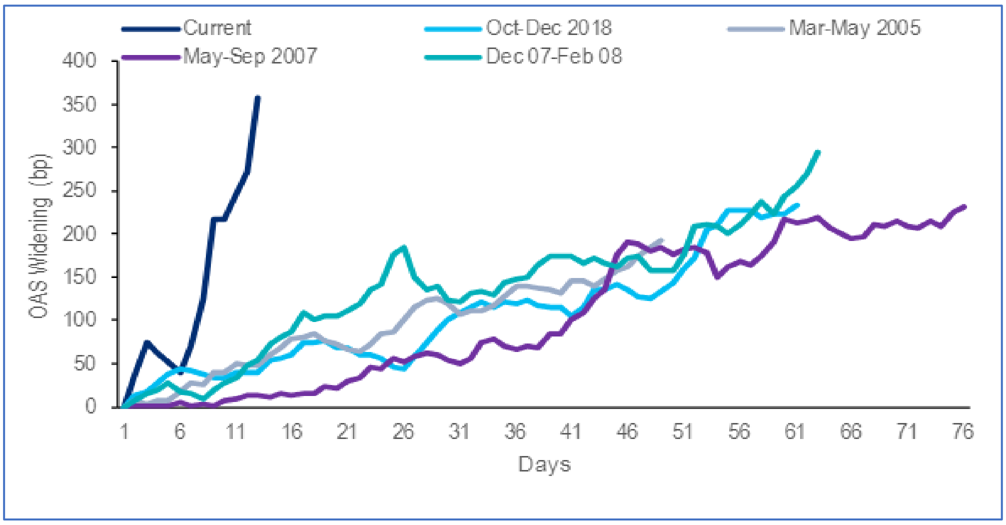
16/03/20

<u>What has happened?</u>

- A decade of easy money via low cash rates and central bank balance sheet expansion on the back of low inflation has created stretched valuations across almost all asset classes
- These stretched valuations created a precarious situation whereby any material catalyst could cause a potentially large correction.
- The likely supply and demand shocks associated with the coronavirus has been the catalyst to trigger a massive correction. When combined with the substantial correction in oil prices and realisation that many central banks are reaching the limits of what they can do, this has led to one of the most severe market corrections ever. This could fairly be described as a perfect storm of events.
- Central banks in the US, Canada, Australia and England have cut cash rates aggressively in a short space of time in response.
- The table below puts the speed and severity of these moves into context:

	1987	**2001**	**2008**	**2020**
S&P 500	-32%	-37%	-57%	-27%
Speed	14 days	388 days	516 days	22 days
Aussie IG Spreads*	No data	+150%	+990%	+248%
Speed	No data	730 days	480 days	24 days
US HY Spreads	No data	+104%	+226%	+131%
Speed	No data	595 days	183 days	59 days

*Aussie Itraxx for 2008 and 2020. CBA data for 2001
Source: Bloomberg, RBA, CBA



Source: Citigroup

- The table above looks at the drawdown in each market and how long it took to get there. Clearly this has been one of the worst risk asset corrections ever and certainly the worst since the '87 crash. The chart from Citi puts the severity of the HY sell off in perspective.
- US IG and HY funds saw some of the largest outflows on record last week

How has Daintree responded?

- Daintree has been modestly bearish risk assets for a little while, but the speed and severity of this correction has taken us by surprise. However, we had done a few things to try to protect capital including:
    - Tripled our cash holdings in our Core Income fund from 5% to 15%
    - Increased our duration from 1.0 to 1.8 years
    - Undertaken other hedging strategies using CDS and currency
- We will continue our defensive posturing in the portfolios and look for opportunities to pick up some cheaper assets when we feel the market has found a new clearing level, but we expect this to be at least a few weeks away.

What is the outlook?

- We wrote this note yesterday and said we were expecting cuts from the US Federal Reserve, RBNZ and RBA. These have been delivered more quickly than we expected via a co-ordinated response. And importantly the Fed, RBA and RBNZ have at the same time seemingly ruling out negative cash rates anytime soon.
- Based on the comments central banks have made, you could argue that most of them have reached their theoretical floor in cash rates (at least for now) and now they turn to asset purchases and pushing policy makers for an aggressive fiscal policy response. We expect an imminent yield curve control programme from the RBA.
- The fact that CBs would effectively cut to their "floor levels" outside of their normal meeting schedules and announce aggressive asset purchase programs is probably an indication of how bad they think things are about to get
- We will likely see technical recessions in many developed market economies this year. GS is calling for US GDP to shrink 5% in Q2
- Ultimately demand is not likely being permanently destroyed, but rather delayed until later in the year, however that doesn't help sentiment and risk appetite in the near term.
- The market response itself has also led to further stresses, for example higher treasury yields coinciding with lower risk assets last week as the demand for USD increased markedly. This sort of price action combined with leverage and illiquidity will cause some hedge funds in particular to come under pressure. It also causes substantial problems for asset allocators. These problems will continue if interest rates remain at the lower bound for a long period of time and volatility disappears from entire yield curves, as has been the case in Japan and as we expect to be the case in most other major markets at the conclusion of this episode.
- Fiscal policy is nonetheless the only game in town to offset the impact of these shocks on the real economy. This is despite the stretched government debt levels of many countries. Unfortunately, though, real fiscal policy success will only be forthcoming if a globally co-ordinated package is delivered, similar to the outcome of the London G20 meeting in 2009. Our expectations of this sort of policy intervention are low given the global political backdrop and the already stretched debt starting point in several countries.
- We might see the Fed expand their guidelines so they could potentially buy other assets including corporate bonds

- It’s important to understand this is not the GFC. Liquidity is readily available for commercial banks, trust is there and they are willing to lend to each other. And banks are much better capitalised than they were in 07-08.
- However, one key question will be how readily companies that will experience cash flow shortfalls in the coming months will have access to credit. CBs are doing what they can to encourage banks to lend to these companies but it remains to be seen if they will do so.
- We haven’t really started to see the negative economic numbers come through in a meaningful way, which will not help investor psychology when the negative data flow does start.
- Bear markets tend not to stabilize very quickly so the correction could go a fair but further. For what its worth GS is calling for 2000 on the S&P 500 so down another 27% from here.
- We see the market stress continuing for the next little while and would be watching the following to help stabilise markets before we would start increasing risk again:
    - The rate of Coronavirus infections peaking and then declining across the G20
    - A co-ordinated public/fiscal response across the G20
    - Continued monetary policy and liquidity support from central banks
    - Signs commercial banks are providing bridging financing to corporates in need
    - Markets showing signs of stabilisation with the likely view that enough bad news had been “priced in”
    - Capital market deals printing at new clearing levels.
- And finally, not to be all doom and gloom, we actually think this type of correction and potential acceptance by markets that central banks have reached the limits of what they can do to support risk assets will force markets to price risk more accurately. Capital will find its way to the businesses and projects that deserve it rather than too much money chasing too many questionable deals and zombie companies. Returns will likely be lower than we have seen in the past decade, but hopefully this reduces the risk of future major corrections like this. However, that might just be wishful thinking on our part 😊