The COVID-19 pandemic led to an extreme equity market sell-off across the globe. What has gone relatively unnoticed, however, is that the vast majority of investor sales have taken place within the exchange-traded fund (ETF) space. ETFs had grown exponentially in recent years. For some investors, ETFs represented a magic bullet that appeared to generate positive returns with much less volatility than the broader indices. While the market downturn was clearly sparked by the COVID-19 pandemic, we think any number of events could have produced a sharp decline and led to massive ETF redemptions. They were marketed as highly liquid vehicles, which made them the foremost beneficiaries of the market rally—and the easiest sale to make when the market faltered.

The problems of COVID-19 remain very much with us. Insufficient attention to necessary testing regimens and outright denials that the outbreak had the potential to morph into a pandemic left many countries woefully ill equipped to deal with the outbreak. Ironically perhaps, the sports and entertainment industries took the swiftest actions to deal with the infection, which is spread by person-to-person contact. Sports venues were abruptly closed and concerts canceled.

In the United States, as face mask and toilet paper inventories proved inadequate to deal with panicked demand, the authorities belatedly stepped in and rolled out testing and treatment facilities. Many states instituted further emergency measures. Rapid testing in the United States should at last show how quickly COVID-19 spread.

In the midst of the chaos, a few successes stand out. Japan, for its part, immediately closed its border to visitors from southwest China and enforced a quarantine on a cruise liner that sought to make port on its shores. As a consequence, infection rates and deaths have been kept at a minimum while countries like Italy and Iran buckle under the inadequacy of health facilities to cope with the problem. Japan is also unique in that hygiene has long been a societal priority. Regular hand washing, traditional bowing rather than shaking hands, and evening baths have helped to keep the country from a widespread increase in coronavirus cases. Elsewhere in Asia, China closed off Wuhan, the source of the outbreak, and the number of cases there has now plateaued. South Korea took steps to ramp up testing systems quickly when it became clear how extensively the disease had infected the country, going as far as opening drive-through testing.

The Japanese market was certainly not spared in the selling deluge that hit the world. The country’s domestic securities industry fully participated in developing new-age ETF solutions. The biggest irony in this trend is that the Bank of Japan was one of the largest buyers of ETFs. The BoJ now owns an inordinately large stake in corporate Japan as a result. It should not come as a complete surprise to see public institutions pushing for better governance practices within corporate Japan. When the market does find a bottom, Japanese stocks with clean balance sheets should appear very cheap and benefit as demand starts to recover. We believe “smart money” should find a way to invest in what we see as this historically great opportunity.

Summary

• While the market sell-off was clearly sparked by the COVID-19 pandemic, we think any number of events could have produced a sharp decline and led to massive ETF redemptions.
• Japan’s swift reaction to the COVID-19 outbreak helped minimize infection rates and fatalities.
• Japanese stocks with strong balance sheets appear very cheap and could benefit as demand starts to recover.
Outlook on Japan

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