COMMENT ON

The Coronavirus-Oil price market downturn

PRUDENTIAL
INVESTMENT MANAGERS

By Pieter Hugo, Chief Client and Distribution Officer 11 March 2020

In the past few weeks global equity markets have taken a sharp downturn in reaction to the continuing spread and growing negative impact of the Coronavirus. This uncertainty has been exacerbated by the outbreak of an oil-price war between Saudi Arabia and Russia, leading to further sharp falls around the world. South Africa has not been spared in this increasingly “risk off” environment, resulting in South African equity and property, as well as bonds, selling off.

Investors are understandably concerned about this downturn. We would like to share with you our assessment of the current conditions, which of course are evolving all the time, and how we are managing your portfolios. We would like to assure you that we are continually monitoring the markets to ensure we protect our clients’ portfolios as best as possible.

At the moment, the news is dominated by coronavirus-related items, helping to instil panic among investors globally. In line with our investment philosophy, we are working to separate short-term “noise” from those developments that could have a serious, fundamental, longer-term impact on company earnings and balance sheets, and are incorporating these into our investment decision-making. The spread of the virus and oil price fall will both impact corporate earnings. The questions are: for how long and how severely?

We continue to apply the same consistent, well-proven investment process that we have used successfully through many previous market shocks in the past 25 years. This would include similar global viruses like the SARS outbreak in February 2003, the Avian flu (H5N1) in 2006, the new strain of Swine flu (H1N1) in 2009, the Ebola outbreaks of 2014 and 2018 and the Zika virus in 2016. And let’s not forget previous oil shocks and financial crashes like the 2008 Global Financial Crisis and the bursting of the IT bubble in 2001.

As you would know our process incorporates numerous risk management techniques that are very valuable in times of heightened risks and extreme volatility like these. This includes our strict limits on individual share and sector exposure as part of our portfolio construction process.

Multi-asset portfolios
We were already overweight SA equities in many of our client portfolios (where mandates allowed) prior to the last weeks’ downturn. This was driven by attractive valuations relative to history on several valuation measures, as well as relative to other SA and global assets.

SA equities have arguably become more attractive (with the ALSI having lost 14% of its value year to date as at market close on 10 March), although the exact extent is difficult to assess as the situation is fluid and the short-term impact on corporate earnings and balance sheets are still unclear at this stage. However, we do think that the probability that companies’ cashflows and earnings have been **permanently** impaired by 14% is low. Notwithstanding this, some companies’ near-term prospects may have been impaired by more than this quantum.

As such, we have been cautious about significantly increasing our overweight exposure to SA equities. This is because this is not a typical “risk event” like 9/11 or the invasion of Iraq; there are real economic growth effects and disruptions at work in global supply chains and in the application of quarantine measures by both governments and companies.

For example, we note that for now China's consensus growth rate for 2020 has been revised down to 5.6% from 5.9%, but the impact is reflected only in the first part of the year. In other words, the market is expecting a short-term negative impact on growth, but a recovery of much of the lost economic ground in the second half of 2020. This is at least partly premised on expectations that the widespread monetary easing we have seen as a response from key central banks around the world (most notably the emergency 50-basis point interest rate cut by the US Federal Reserve as well as the Bank of England) – in addition to fiscal stimulus from governments - should help to underpin economic growth once the spread of the virus is better contained.

Given the fluid situation, for now we have not adjusted any of our long-term expectations for real interest rates, risk premia or earnings growth as a result of the Coronavirus.

From an asset allocation perspective, as part of our normal managed portfolio rebalancing processes, we have been buying selected SA equities as the market has fallen, mainly out of SA nominal bonds, to maintain our relative portfolio positions. But we have not yet adjusted these relative positions, even in the face of assets that have become optically much cheaper.

Equity portfolios
Given the broad-based nature of the sell off, and a share like Sasol disproportionately so given the precipitous decline in the oil price, a diversified portfolio constructed with prudent weightings in shares remains important.

At present it is very difficult to be overly definitive. The virus is certain to have a short-term impact on the earnings of companies and sectors hardest hit by the virus, such as tourism, hotels, airlines, etc. Second-order impacts may result from supply chain disruption and the effects of quarantines, which may temporarily hit consumer-reliant companies and manufacturers. As alluded to above, the key uncertainty is the long-term impact on profits and balance sheets versus the current price declines.

Within our SA equity holdings, as the equity market has fallen we have seen local industrial and bank shares cheapen relative to global rand-hedge shares. This is not because the global shares have not fallen, but their hard currency decline has been offset by the weakening of the rand. For example, Richemont in rands has only fallen from R110 to R103 per share (as of the time of writing), even though its price in Swiss francs has declined by 20%. Consequently, we have done some selective switching into selected local shares and out of certain global rand-hedge shares to take some profit from these relative share price movements.

Conclusion
It is especially important to continue applying our proven investment philosophy and process during times of extreme market panic like we're currently experiencing. As prudent valuation-based investors with a long-term focus, it is times like this that create opportunities for our clients, and we believe their patience and long-term focus will be rewarded.