CLUCASGRAY

ClucasGray Private Clients

Quarterly Commentary

April 2020

"The fewer the facts, the stronger the opinion." Arnold Glasow

The future is full of many possibilities – once an event occurs, however, all of us are able to create a narrative. Nowhere has this been more prevalent than in the 1st quarter of 2020. Each of the following would in their own right be noteworthy developments, and in certain instances worthy of their own unique place in history:

- The Covid-19 global pandemic, and subsequent lockdown of all major economies
- Oil price collapse
- Emerging Market currency crisis
- US Treasury yields falling to record lows
- Liquidity and financial crises
- Credit and Emerging Market bond markets freezing
- Rating agency downgrades of South Africa.

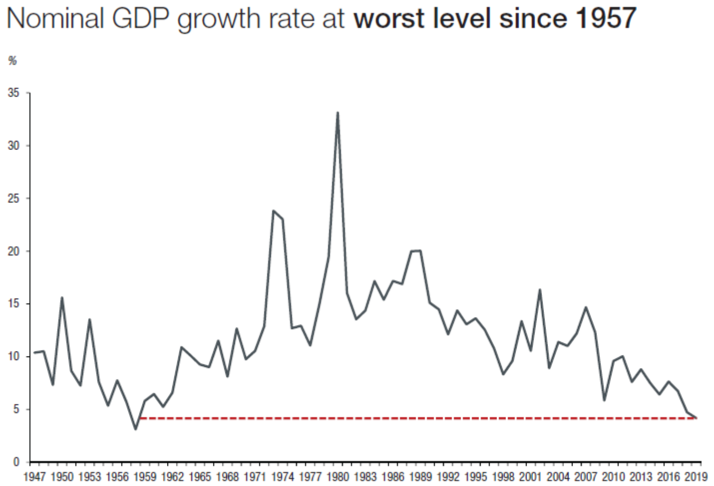
The fact that all of the above have occurred in the space of 10 weeks makes the start of the new decade all the more unforgettable! The confluence of all the above events, some linked, others independent of each other, has resulted in amongst the worst investment quarters in living memory.

The catalyst for much of the carnage has undoubtedly been the onset of Covid-19 that emanated from a relatively unknown province in China. Our, and seemingly the investment world's, error in judgement was in assuming the impact of this virus would be localized to parts of China, impacting global manufacturing supply, but not necessarily a structural decline in global demand. In fact our discussions with companies in the wake of these initial Chinese developments were around the stability of their supply chains, and how they intended to ensure inventories were available to meet customer demand – how quickly things have changed! Subsequently, governments in most industrialized nations (including South Africa) have ordered the complete lockdown of their economy to slow the progress of the virus. What started out as a medical crisis, and showed brief signs of a supply crisis, has morphed quickly into a global demand shock.

There is little doubt that the events over the last quarter will be debated and discussed for generations to come – the impact on social systems, political ideologies, economics and ultimately individual and state wealth has been seismic. At the time of writing, we remain in the midst of it – common sense dictates that the lockdowns should be lifted soon, but common sense has not been in abundance of late!

Lost in the frenzy of the last few months has been a constructive budget announced by the South African Finance Minister, Mr Mboweni – a pragmatic budget, acknowledging the financial constraints that the country finds itself under, and amongst other initiatives, announcing firm intentions to address the controversial issue of the public sector wage bill – setting up a confrontation with Trade Unions, a confrontation that was to potentially define the Ramaphosa administration, before Covid-19 that is. Yet all of this feels a life time ago, as we all have been forced, literally, to come to terms with the economic realities of the global lockdown.

It has been well documented that the South African economic backdrop has for some time been extraordinarily difficult for companies to operate in. The chart below from FirstRand highlights just how tough it has been – 2019 was the lowest nominal GDP growth rate in over 60 years! And this was before the arrival of Covid-19 – it would seem 2020 is not shaping up to be any better.



Source: FirstRand, March 2020

We have written extensively in previous quarterlies about the elevated interest rate environment in South Africa, and were pleased to see the Reserve Bank reduce interest rates by 1.25% in the quarter. This development has clearly been lost in the Covid-19 noise. Assuming inflation remains subdued, we believe there remains scope for further interest rate relief, which coupled with a material reduction in the price of fuel on the back of lower oil prices, should in time create a more constructive environment for a recovery in the consumer economy.

The Oil dynamic and consequences

In 2016, an oil-exporting alliance between OPEC (read Saudi Arabia) and Russia was formed, loosely termed "OPEC+". Against a backdrop of reasonable global economic growth since then oil demand has steadily grown – that is until February 2020 when the first real signs of demand destruction from the COVID-19 virus outbreak became apparent. OPEC+ negotiations commenced late February with Saudi Arabia taking a strong stance that oil supply from the consortium should be curtailed in an attempt to balance the market. Russia opposed this move citing market share loss at the expense of (largely) U.S. shale oil frackers. The chart below from Alpine Macro clearly highlights this point. On Friday 6th March, the OPEC+ negotiations collapsed. Saudi Arabia's response was brutal, announcing that it would immediately increase production by 30% and offer deep discounts to early buyers of its oil. So, in the wake of COVD-19 demand destruction supply ramped substantially leading to an inevitable collapse in crude oil prices.

Every oil producer suffers from low oil prices but none more so than the U.S. industry given a cost of production that exceeds OPEC+ producers by as much as 400%. Recognising the threat to its own oil industry the U.S. administration urged OPEC+ members and others to get together to cut production. The irony of America calling for collusive behaviour in the biggest traded global commodity is palpable! Subsequent negotiations concluded on the 12th April have seen OPEC and its allies reach an agreement to cut production by 9.7 million barrels per day, an unprecedented level of supply reduction. In the short term however this supply cut is unlikely to result in a higher oil price given that oil demand is currently forecast to be some 15 million barrels per day lower than just two months ago.

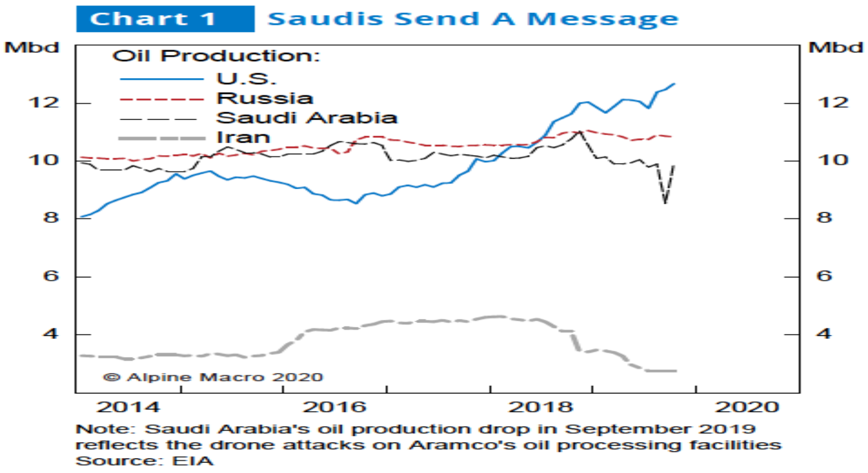


Chart 1 Saudis Send A Message

Note: Saudi Arabia's oil production drop in September 2019 reflects the drone attacks on Aramco's oil processing facilities
Source: EIA

Source: Alpine Macro, March 2020

The implications of the collapse in the oil price is widespread. There are valid concerns around the sustainability of higher cost producers (e.g. US shale producers) and employment within the industry. These are rightly being reflected in specific areas of global credit markets. However, aside from the direct impact for specific companies and oil exporting countries, the relevance of a low oil price is the potential benefit which it is able to provide in assisting economic recovery. Historically a low oil price has provided relief to the consumer economies and importers of oil around the world. Alongside the enormous financial packages which have been announced by governments around the world, a low oil price is likely to provide its own form of "stimulus" which will aid the recovery of large parts of the global economy.

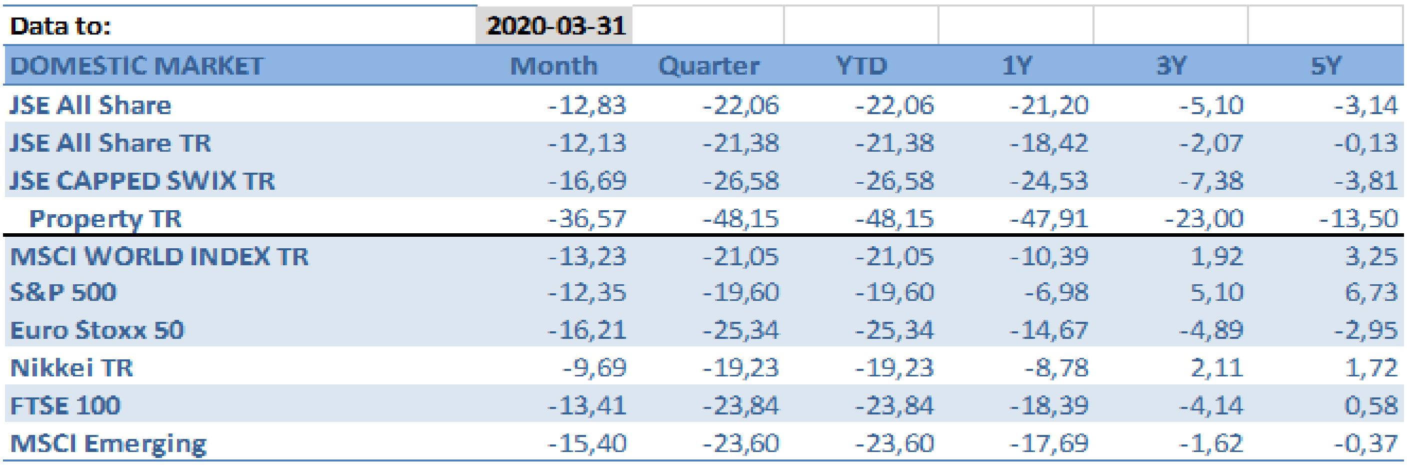
Investment Performance

"The bad news is we're in a bear market – the good news is it's almost over."
Sir John Templeton, during the 1987 stock market crash.

The 1st quarter of 2020 has produced poor performance numbers – for the industry in general, but of more relevance to clients, for portfolios. We were simply not positioned for the Covid-19 crisis, and certainly not for the complete lockdown of many global economies. Whether we agree with the approach taken by governments or not, the reality is the economic landscape changed seismically when the lockdowns were decreed. Reflecting on the quarter requires a significant amount of contrition – the quantum of the downward moves in the quarter has had a material impact on the longer term returns in portfolios.

The Covid-19 storm will eventually subside, and life will return to its new version of normal. The longer term trail of destruction, both medical and economic, left in its wake is still to be determined, but certainly the starkest and most visible illustration of its economic damage to date will be the performance of global investment markets in the 1st quarter of 2020. In the 6 weeks from mid-February to late March, the S&P 500 fell 34%, while Monday the 16th of March saw the largest single day fall in global equity markets since the October 1987 crash – the original and infamous Black Monday. Panic is an unfortunate, and typically costly, approach to investing. In a number of instances we have acted decisively, but are mindful of the consequences of overreacting – more so when valuations on many companies now rival those on offer in the depths of the Global Financial Crisis of 2008/09.

The table below illustrates just how poor the first quarter was, and what its impact has been on 5 year returns across the investment world.



Data to:	2020-03-31					
DOMESTIC MARKET	Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share	-12,83	-22,06	-22,06	-21,20	-5,10	-3,14
JSE All Share TR	-12,13	-21,38	-21,38	-18,42	-2,07	-0,13
JSE CAPPED SWIX TR	-16,69	-26,58	-26,58	-24,53	-7,38	-3,81
Property TR	-36,57	-48,15	-48,15	-47,91	-23,00	-13,50
MSCI WORLD INDEX TR	-13,23	-21,05	-21,05	-10,39	1,92	3,25
S&P 500	-12,35	-19,60	-19,60	-6,98	5,10	6,73
Euro Stoxx 50	-16,21	-25,34	-25,34	-14,67	-4,89	-2,95
Nikkei TR	-9,69	-19,23	-19,23	-8,78	2,11	1,72
FTSE 100	-13,41	-23,84	-23,84	-18,39	-4,14	0,58
MSCI Emerging	-15,40	-23,60	-23,60	-17,69	-1,62	-0,37

Source: Bloomberg, April 2020

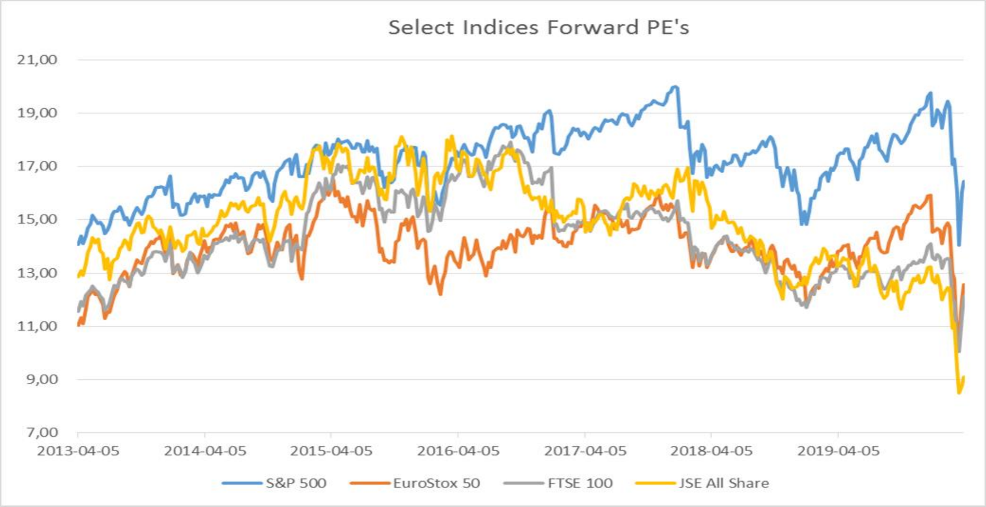
Investment markets

"The stock market valuation of a company is merely a blip on the screen indicating where supply of shares meets immediate demand."

The above quote, from a recent Baupost investment letter, is stating the obvious – we have all read differing versions of the same truism – the stock market value is not necessarily the intrinsic value of a company, and our role as active managers is to assess whether the market price is a reflection of our value of a company and act accordingly. However, the reason this quote feels more relevant today is due to the liquidity crisis that enveloped all markets globally. The immediacy of the need for liquidity to fund redemptions, margin calls and general expenses in the lockdown, has in our view contributed to share prices trading at extraordinary levels.

Whilst we have for some time been wary of the valuations in US equity markets, we did (and continue to) see value in many other equity markets, including South Africa. A respected global manager wrote about the markets in January that "Everything is not only not expensive, but in select cases downright bargain priced." This unattributed quote was not written about South Africa, but could easily have been – it was written before Covid-19, pertaining to the US markets – long held to be expensive, where the dominance of large companies which were priced for perfection had created a distorted view that all equities were expensive.

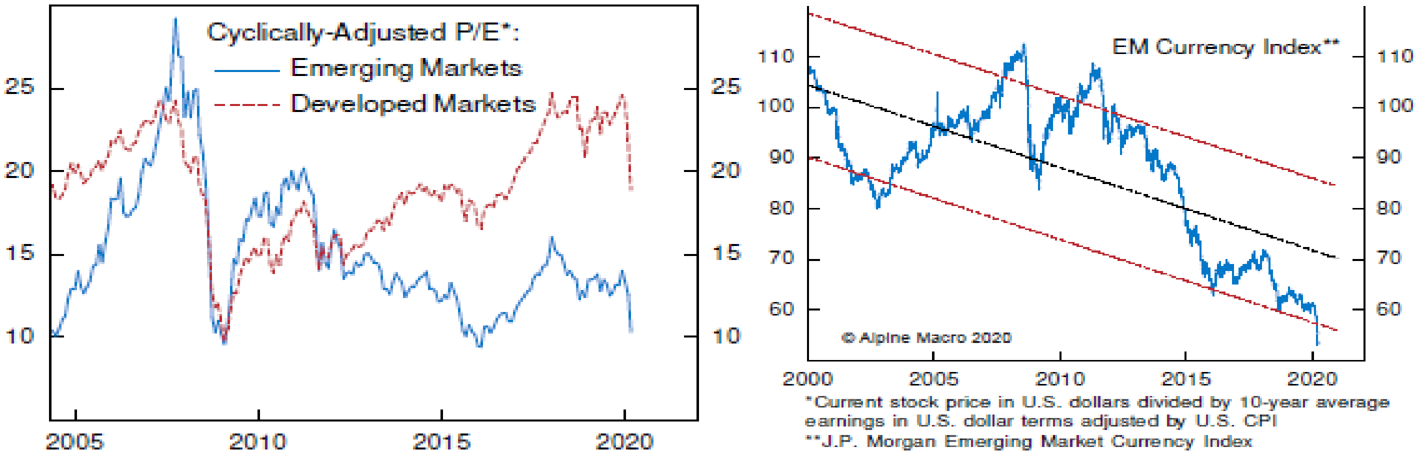
The chart below shows the relative valuation gap that had opened up between the S&P 500 and other markets over the last 5 years. With the selloff being indiscriminate, all markets have sold off equally aggressively, and the clear distinction between now and early January, is that while the US may remain relatively expensive, it has de-rated appreciably – other regional markets, including South Africa, continue to look extremely attractive on this particular measure.



Source: Bloomberg, ClucasGray, April 2020

Perhaps what makes this crisis all the more uncomfortable for South African and other Emerging Market (EM) investors is that it has arrived at the end of what has been a sustained and structural period of EM underperformance. The charts below show that over the last 7 years, EM equities and currencies have depreciated materially against Developed Market equities and the US Dollar respectively, with the currency weakness in particular causing macro-economic stress in many emerging economies – a situation South Africans have sadly become all too familiar with.

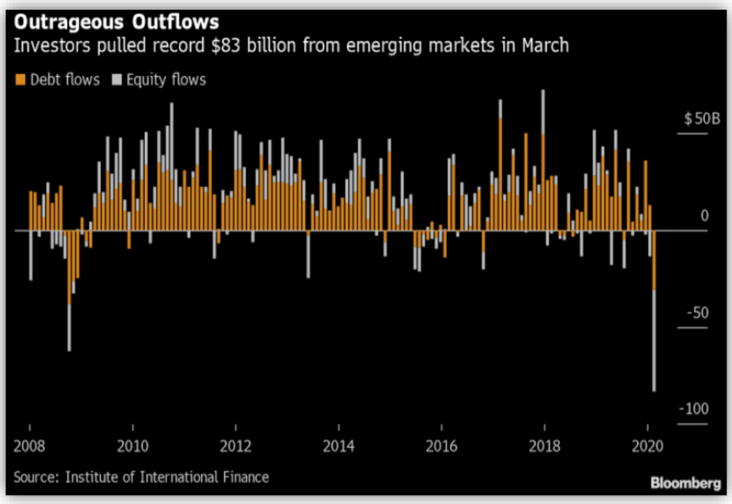
Chart 4 EM Equities And Currencies: Valuation Perspective



*Current stock price in U.S. dollars divided by 10-year average earnings in U.S. dollar terms adjusted by U.S. CPI
**J.P. Morgan Emerging Market Currency Index

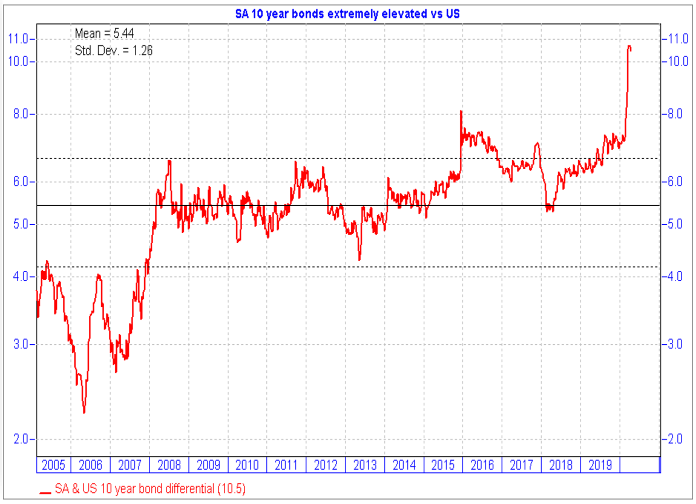
Source: Alpine Macro, April 2020

Developments in the credit markets have brought back painful memories of the global financial crisis – the scramble for liquidity saw EM equity and bond funds experiencing one of the largest quarterly outflows on record (chart on left below). The Rand collapsed, and South African bonds were not spared, with the relative yields against US Bonds going to levels we had previously thought unimaginable (chart on right below).


Outrageous Outflows

Investors pulled record $83 billion from emerging markets in March

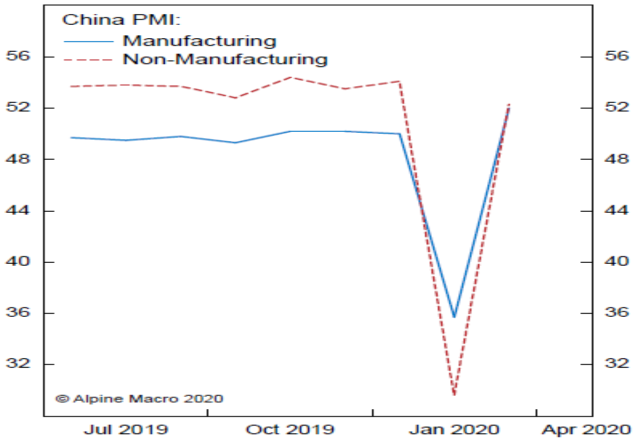
Source: Institute of International Finance


SA 10 year bonds extremely elevated vs US

Source: Bloomberg, April 2020

China was the epicenter of the crisis, and also the first to seemingly emerge from it. We have been encouraged by evidence of an increase in economic activity following their lockdown - traffic volumes in key cities is returning to normal, factories are productive, PMI data (chart below) has picked up and key commodities such as iron ore have been resilient – indicative of robust demand.

Chart 2 China's V-Shaped Economic Rebound



Source: China Federation of Logistics & Purchasing

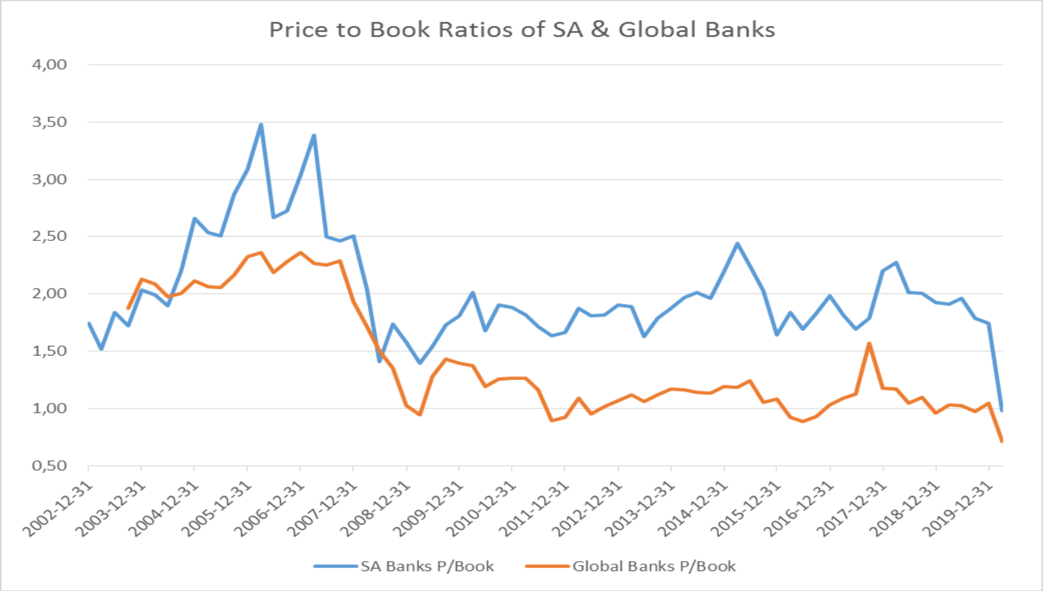
Source: Alpine Macro, April 2020

Whilst it is still early to draw firm conclusions on what a post Covid-19 world may look like, the incrementally positive economic data emanating from China does give us some comfort that economies should steadily recover in due course.

Investment market implications

So what does all this mean, and how should active managers position portfolios in the wake of the crisis, the speed of which has few parallels in history. Clearly valuations have retraced materially, but how long will it take for economies to extricate themselves from the collective state of economic lockdown.

If we use the banking sector as a proxy for the local market, the extent of the selloff is highlighted in the chart below. Banks, and to a lesser extent, Life companies, have been caught up in the vortex of the Covid-19 liquidity crisis. The South African banking index fell 45% in the quarter – the worst performance since the Asian crisis of 1998, when interest rates in South Africa spiked to 25%. Given the uncertainty around earnings forecasts in 2020, we thought looking at the price to net asset value of the sector would be instructive. The local banks now trade in line with their NAV – a level they have never previously got to, and 33% cheaper on this metric than they were at the worst of the global financial crisis.



Source: Bloomberg, ClucasGray. April 2020

As mentioned, it is fair to assume that the 2020 earnings of most companies are going to be materially impacted by Covid-19. Given this aberration in company earnings, we believe it is more important to calculate what a company will be able to earn in a more normalised environment. In the case of the banks, we have a reasonable sense of what ROE's they should be able to generate in 2021/22, and hence are able to estimate their earnings. Based on these assumptions, the implied valuations appear extreme.

We did an exercise looking at the earnings generated by all companies over the last 5 years, and comparing the current share prices to historic earnings. We found it instructive how many companies are trading at very low multiples compared to earnings they were able to generate three or four years ago. So even if it does take a while for our economy to recover to the undemanding levels of 2019, our conclusion was that too many good companies are trading at what we would deem undemanding ratings.

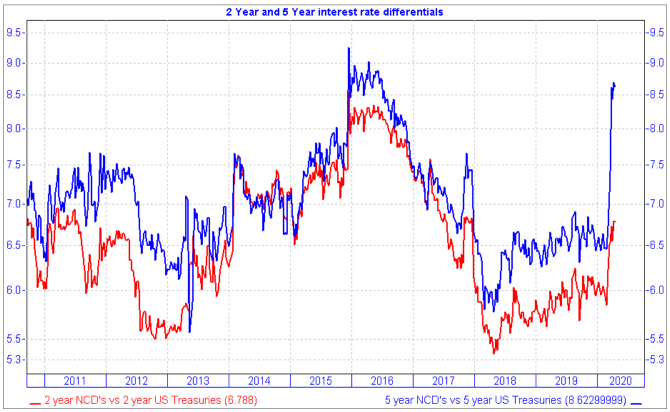
We acknowledge that we remain in the heart of the Covid-19 crisis, and there is much uncertainty as to the final outcome – indeed given the uniqueness of the current crisis, no one can really talk with much confidence as to what the post Covid-19 world and economy looks like. Investors need to determine which of the changes are likely to be temporary and which more structural in nature – which companies and industries will be able to brush Covid-19 aside, and which are to be permanently impacted.

I read recently that investors are caught between Panic and FOMO (fear of missing out) – with global equity market movements, up and down, being so extreme, investors feel they have too much equity one day, and too little the next. As fundamental investors, our reliance on an investment process attempts to eradicate these emotional swings. Certainly, as alluded to above, a return to any semblance of a normal economic environment would highlight the current normalized valuation appeal of many companies.

Asset Allocation

Given the emerging market issues globally, and South Africa's own unique set of circumstances, it has been a difficult period for the Rand. As if the fall-out from Covid-19 wasn't enough to deal with, Moody's downgraded the sovereign debt to junk, followed soon thereafter by another notch downgrade by Fitch. The net effect of this has been a significant weakening of the Rand. Incidentally, although bond yields had risen sharply in the global liquidity crisis, they have calmed down somewhat post the downgrades – as has the Rand.

From an asset allocation point of view, all investors continually grapple with the trade-off between the high yields on offer in South Africa, and the risk of currency depreciation. We believe the chart below is instructive – it shows the yield differential between 2 year and 5 year NCD's in South Africa, relative to 2 year and 5 year US Treasuries. The Rand would need to depreciate materially from current elevated levels to offset holding higher fixed income weightings in South Africa than offshore.



Source: Iress, April 2020

As mentioned earlier, we believe interest rates in South Africa are likely to reduce further, diminishing the attractiveness of cash as an asset class.

This argument is amplified by the compelling yields on offer in the longer duration fixed income market, and the valuations referred to earlier in the equity market. None of us have any greater insight as to when the environment settles down, but we are firmly of the view that the current opportunity set is as compelling as we can recall ever seeing.

Conclusion

In numerous economies, lockdown and isolation strategies are showing signs of helping curb the spread of the virus, which is clearly encouraging. It is our understanding that no government desires the status quo to remain in place for too much longer due to the economic cost and social implications thereof. We believe risk assets are currently pricing in a prolonged extension of this economic inactivity, and any sign of improving activity levels could unlock significant value. As difficult as it feels right now, on the back of a particularly tough quarter, we believe now is not the time to give up on risk assets. Indeed, as at the time of writing, we have experienced a significant recovery in many markets, including the JSE, since the 23rd of March 2020

If there is any interest to engage further, please don't hesitate to get in touch with us.

Kind Regards

The ClucasGray Team

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