Covid19: Long-term gains exceed short-term shocks

By Andrew Dittberner

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If time flies when you're having fun, then the opposite must be true when times are tough. The past few weeks have certainly been gruelling, and the first quarter of 2020 will undoubtedly go down in the history books.

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We are currently experiencing what is possibly the most significant global event since World War II, and we have witnessed the fastest infection from a bull market to bear market globally. We certainly live in very interesting times.

While reactions to the Covid-19 outbreak were initially quite blasé, it quickly became clear that the virus is much more severe and represents a major global threat. As we are not healthcare experts, we will not attempt to give in-depth opinions from a medical perspective.

Suffice to say, our understanding of the situation is that the real issue is the rate of infection and the strain it places on a country’s healthcare system. Overrun hospitals and sick healthcare professionals pose a very real risk to society. As such, we need to take the prescribed social distancing very seriously, irrespective of the interim economic fallout.

A chain reaction

The extreme market volatility that has ensued recently is unprecedented. The sell-off has been swift. Compounding the volatility, OPEC+ failed to agree on the oil production cuts required to stabilise the falling oil price.

This resulted in the oil price, along with anything oil-related, plummeting to record lows. Given the current environment, central banks around the world have reacted aggressively by cutting interest rates.

At the same time, governments are ready to support the economy through fiscal stimulus measures of varying degrees. Yet, despite these efforts, equity markets continue to trend lower – an indication that market participants believe that these efforts may not sufficiently manage the crisis.

Unsurprisingly, investor reactions vary widely. While we have received many questions, they all ultimately boil down to the same thing: what should we do? Offering a definitive view is no more than guesswork and is likely to be incorrect. In the short-term, whether markets go up or down from here will largely be driven by investor psychology, and we do not know what the immediate future holds.

Every crisis is different, making it increasingly difficult to draw inferences from previous pandemics. It is important to remember that all market participants are human, and irrespective of the façade put forth, it is likely that everyone has had a moment or two of panic. While this is a human reaction, it is important not to allow those emotions to drive our investment decisions.

With central banks acting incisively, it is positive to see that fiscal stimulus is following suit. Fiscal stimulus is viewed as the more appropriate response given that the panic we are witnessing is due to a cash flow crisis. Business owners face mounting costs, yet cash flow is diminishing as the economy slows. Fiscal intervention and potential bailouts should, therefore, be viewed as positive developments in this environment.

Our view on markets

Heading into 2020, our view on both local and global equity markets was neutral. While we viewed SA equities as attractively priced, we were not confident that local corporates would be able to deliver sustainable earnings growth in a depressed economic environment. Globally, we were concerned about ever-rising valuations in a slowing global economy.

Given the recent sell-off, the local market has become even more attractively priced. However, the likelihood of earnings growth from SA corporates this year is diminishing. Globally, equity markets certainly appear more attractively priced today.

Similar to South Africa though, we expect to see steep declines in company earnings in the first half of 2020, and possibly into the second half too. We will be in a better position to gauge market levels relative to economic reality once data becomes available, and we begin to see the extent of the economic fallout.

It is important to note that markets tend to bottom before the bad news does. Therefore, it is prudent not to sell out of the market during times of volatility, as one is likely to miss the recovery that ultimately ensues.

Similarly, it is prudent not to invest all of ones' capital in the first leg down of a bear market. Investors often forget how low markets can go; and as John Maynard Keynes famously said, "Markets can remain irrational longer than you can remain solvent".

Patiently wait and assess the opportunities

Going back to the question around what investors should do, our answer would be: exhibit patience and avoid panic. The market will present opportunities that we will look back at one day as once-in-a-lifetime bargains. Investors need to be ready and prepared to capitalise on them when they occur.

In identifying opportunities, valuations will always remain important. However, in these circumstances, we believe that focusing on companies' balance sheets is critical. Can companies survive a sustained downturn in the economy without having to raise further capital? This consideration should be at the top of the checklist.

Secondly, is the impact of the coronavirus a transitory event, or is it likely to lead to a permanent impairment of all future earnings and cash flows? The answer to this question needs to be taken into account when valuing the business. If it is transient, the longer-term impact on a company's valuation is likely to be less significant. Similarly, certain companies will benefit in the current environment.

Equally important is understanding whether consumer behaviour and preferences will change permanently, or whether behaviour reverts to normal post-Covid-19.In these times, it is far easier to hold a pessimistic view. Hearing that the world is coming to an end is interesting while hearing that things will get better in time is less so.

Paraphrasing from a Morgan Housel article, "the difference between pessimism and optimism often comes down to time". In the short term, there is a vast amount of uncertainty that lies ahead of us.

However, history has repeatedly proven that long-term gains exceed short-term shocks. And, given our innate ability to evolve and adapt to situations, we see no reason why the ultimate outcome should be any different this time around.

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