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in the moment

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COVID-19: Keep calm and wash your hands (updated to 24 March 2020)

Background

The latest strand of the Coronavirus, officially named Coronavirus Disease 2019 (COVID-19), is on the loose in the world and has now been classified as a global pandemic. As the social media wave of negative emotions has a life of its own, there is a rising risk that irrational and unreasonable behaviour will follow.

To be clear, we are not health experts and hence have little value to add in trying to guess how severe the global infection rate of this virus will be or how long it will last. Of course, from a humanitarian perspective, we acknowledge that the loss of every human life, including from COVID-19, is a tragedy and should be mourned.

However, as responsible custodians of our clients' money, we also know that irrational overreactions to similar news events have historically proven to be very detrimental to longer-term portfolio returns. As investors, we always need to keep perspective of the happenings around us.

In terms of viral infections, COVID-19, isn't the first global infection to hit mother earth and certainly won't be the last. Even the fact that its designated name is dated implies that somewhere in the future there could be a COVID-29 lurking. COVID-19 is a family member of the 2002 severe acute respiratory syndrome (SARS) virus that also originated in China.

Implications for financial markets

Global economic growth forecasts are now being cut aggressively, as more countries are introducing isolation measures for their populations in trying to stem the spread of COVID-19. It now looks certain that the world will experience a recession in the second quarter of 2020, with the risk that the recession spills over into the third quarter of 2020, unless the spreading of the virus can be contained before then. South Africa's (SA) own implemented social-distancing measures, on top of the rapidly deteriorating global growth backdrop, will likely push the SA growth rate meaningfully into negative territory for 2020 as a whole, from already being in technical recession in the fourth quarter of 2019.

COVID-19 has negative supply and demand effects on the global economy. On the supply side of the world economy, broken global supply chains, due to worker absenteeism, factory closures and logistics disruptions, will be detrimental for manufacturing, services (travel and tourism, bricks and mortar retail as well as large event cancellations) and even agriculture and mining (through logistical backlogs). Few sectors are likely to be unscathed from the virus.

Meanwhile, demand in the global economy will be held back, as consumer and business behaviours react to the spread of the virus. In this regard, social distancing and falling consumer confidence will have a direct negative effect on bricks and mortar retail spending (shops, restaurants and cinemas – the release of the new James Bond film called 'No Time to Die', for example, has already been postponed from April to November this year).
In contrast, online activity (such as shopping and gaming) could benefit, as people have to restrict their outside movements and are forced to stay indoors. Corporates will likely respond to this temporary lull in consumer demand by holding off on additional investment for now.

As all of this plays out on the global stage in the coming quarters, we will more regularly see excessively weak economic numbers being reported and companies issuing very negative profit guidance. It now looks certain that this will culminate in a global recession – it is just the magnitude and duration of the recession that is still unknown. Only once the virus shows signs of being contained globally with infection rates reducing, will global supply chains start to slowly unclog, leading to a bounce back in economic activity, although with a lag. The resultant economic growth trend during this time is thus likely to be more U-shaped than V-shaped.

Share price movements will have to reflect the new reality of lower interim profits in the coming quarters. We thus have to expect downward adjustments in equity markets during this time. Once there is a cyclical recovery in global growth and hence company profits in the aftermath of COVID-19, share prices will be due for a rebound again.

However, during the downward phase of global growth, profits and share prices in the coming months, history has shown that overreaction should be anticipated, as uncertainty and anxiety take over from rationality in financial markets. The old adage that 'markets take the escalator up, but the elevator down' is playing out again this time.

As market sentiment recalibrates from greed (associated with complacency) to fear (associated with capitulation), share prices are prone to overreact to the downside. Of course, such emotion-driven downside overreaction in financial markets do provide opportunities for the astute contrarian investor to build and protect long-term wealth by either buying fundamentally justified assets at attractive valuations or selling fundamentally expensive assets.

The recent COVID-19 experience has shown again how quickly things can change in financial markets.
On 19 February 2020, the US equity market reached an all-time high during the bull market that started after the global financial crisis (GFC) in March 2009. This was the second-longest bull market on record, only outlasted by the 1987 to 2000 bull market. By 12 March 2020, a mere 16 trading days later, US equities were in a bear market (defined as a fall of more than 20% from the peak) following on fears of the global economic effect of COVID-19. Research from Bank of America shows that this was the quickest switch from a bull market to a bear market outside of the Great Depression of the 1930s. On 23 March 2020, the US equity market was down 34% from its peak a mere month before.

We understand our investors are concerned about the state of the market and what they can do to protect themselves. No doubt the biggest question on everyone's minds is how long this bear market will last and how low equity markets can go during this time? While we do not know the answers to either of these questions with any certainty, below are some beacons we can follow to guide us to a likely range of probable outcomes for markets in coming quarter:

- Firstly, as long as economic growth and corporate profit forecasts around the world are still decreasing to levels lower than those discounted by financial markets, prices of growth asset classes like equities or property will continue to adjust downwards. At a high level, the magnitude and duration of growth decreases will be determined by the unknown severity and duration of the virus.
- Research from the Bank of America shows that bear markets linger for a while after the initial 20% drop, with further downside for about three to four months.

If history is any guide, this would point to a likely bottoming in equity markets around the middle of 2020. In the interim, market volatility is likely to remain high, as the market digests the severity of COVID-19 and its negative effect on global growth and company profits.

- At the 23 March 2020 equity market close in the US, the S&P 500 Index was down 34% from its peak, which is more than the median (28%) and average (31%) drawdowns experienced in the past 25 bear markets, in line with the 2001 dot-com bear market (35% down), but still smaller than the peak-to-trough declines in the 1973 oil crisis (48% down) and the GFC bear market (52% down).
- For markets to bottom sustainably, there will first have to be eventual capitulation by investors once the fear stage is reached, which could still be some time away. During this phase towards capitulation, it is common for financial markets to be driven to overreaction as behavioural biases come to the surface, swept up by negative emotions and sentiment.
- Finally, due to the likely barrage of fiscal and monetary policy responses from global policy makers in reaction to COVID-19, there should be a strong lagged cyclical recovery in global growth and company profits in the aftermath of COVID-19, with share prices discounting this beforehand. This should provide a good buying opportunity for equities and other growth asset classes at the time.

Global policy response

As stated above, COVID-19 induces a supply-side shock to the global economy through its effect on world-wide supply chains. As such, the typical demand-side stimulus responses of monetary and fiscal policies are likely to be less effective to immediately counter the interim negative growth effect, as these only have limited effect on the demand side of the economy (through the confidence avenue) and have no bearing on the supply side.With global rates already at or near historical lows, there is also only limited scope for monetary policy outside the realm of renewed quantitative easing (QE) by global central banks. Specifically targeted government support to global supply chains to help restore the flow of goods and services as soon as possible and direct assistance to businesses severely affected by the economic lockdown would be more helpful in addressing the global growth fallout from COVID-19.

Investor response

As investors, we need to realise that the current outbreak of COVID-19 will have a short-term negative cyclical effect on global growth and company profits. As such, global equity markets will experience downside pressure, while valuations adjust to the interim reality of lower profits amid spiking volatility. During the indeterminate time the virus continues to spread, uncertainty will rise and markets are likely to overreact, as they always do. The overreaction could even be amplified this time due to the rising effect of social media in spreading half-truths and even outright fake news about COVID-19. Once the virus effect has played out and global supply chains become unblocked again, there will be a significant rebound in economic growth and profits, discounted by rising share prices at the time.

While short-term investment returns will be negatively affected by COVID-19, history has shown that long-term returns are largely unaffected by these kind of events, which in retrospect are barely discernible on longer-term graphs of asset class returns and hence turn out to be far less significant than they are deemed at the time. We are very aware that opportunities will likely present themselves to enhance long-term returns by taking advantage of asset price dislocations during market overreactions to the virus on the back of sentiment-driven market behaviour.

We remain steadfast in our mission to keep our focus on our clients' long-term investment goals by not overreacting to short-term events in a way that could have a detrimental effect on the probability of attaining these goals. As such, our overriding guiding principle is to encourage our clients to stay invested throughout all market cycles, rather than attempt the timing of markets at times like now when there is an outbreak of the latest coronavirus. Selling into market weakness locks in potential losses and then also exposes investors to the risk that they miss any eventual rebound in markets if they have not reinvested by that point.

We are also unwavering in our belief that a diversified portfolio is the most efficient way to achieve the long-term investment outcomes for our clients – even more so in uncertain and volatile market environments.
Of particular benefit should be our exposures to a range of investment strategies that may be less affected by daily market moves and sentiment changes – these include allocations to alternative and real asset classes or strategies. Additionally, the investment managers appointed to our underlying mandates have full discretion to take advantage from any opportunities or mispricings that may arise.

So let's stay calm, as COVID-19 plays out in coming months and wash our hands.

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