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COVID-19: Keep calm and wash your hands

Background

The latest strand of the Coronavirus, officially named Coronavirus Disease 2019 (COVID-19), is on the loose in the world. Due to the exponential presence of social media in our daily lives, concerns have been amplified that this specific virus will become a global pandemic. As the social media wave of negative emotions begins 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. Global fatalities so far from COVID-19 are only a fraction of the annual seasonal deaths in South Africa caused by the typical flu virus.

Implications for financial markets

While we do know that COVID-19 will have a negative cyclical effect on global growth, the magnitude of the growth slowdown will be determined by the unknown severity and duration of the virus. We also know that 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 (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, 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 restrict their outside movements and prefer staying 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 weak economic numbers being reported and companies issuing negative profit guidance. Whether this will culminate in a global recession or just a temporary growth slowdown is still unknown. Once the virus shows signs of being contained globally with infection rates reducing, global supply chains will start to slowly unclog, hence 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 likely to play 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. 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.

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.

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, 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 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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