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ClucasGray Asset Management

February and the Coronavirus Impact

"People, it has been well said, think in herds; it will be seen that they go mad in herds, while only recover their senses slowly, one by one."

Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds

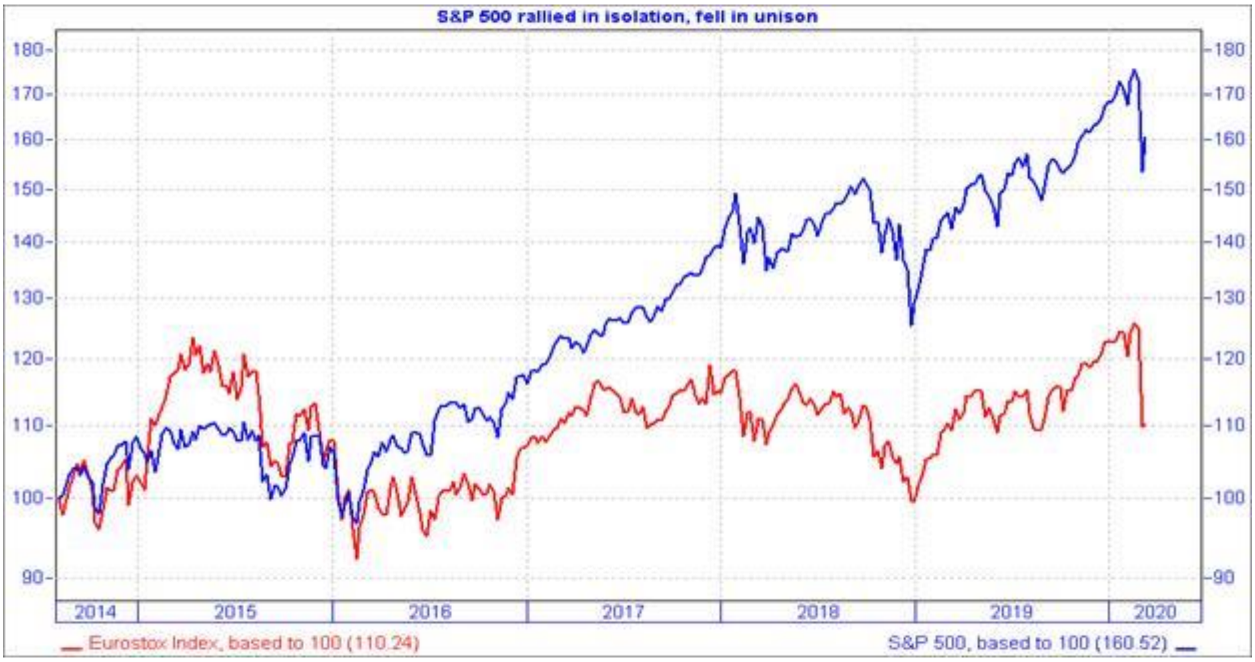
Weeks like the last week of February don't occur very often in an asset management career – with increasing concerns around the global spread of the Coronavirus (COVID-19), the JSE, along with most large global indices, collapsed over 10% in a week, making it the worst week for equity markets since the global financial crisis. It is not for us to comment on the sanity of others, but there was a point last week when the words of the above quote seemed to ring true. The table below outlines the performance of the JSE and numerous other global indices. It has certainly been an unpleasant start to the new decade!

ClucasGray Summary: Source Bloomberg			
Data to:	2020-02-28		
DOMESTIC MARKET	1 Month	YTD	1Y
JSE All Share TR	-8,99	-10,53	-5,71
JSE CAPPED SWIX TR	-9,55	-11,87	-9,57
GLOBAL MARKETS (Local Currency)	Month	YTD	1Y
MSCI All Country WORLD INDEX TR	-8,08	-9,09	3,89
S&P 500	-8,23	-8,27	8,19
Nasdaq	-6,38	-4,52	13,74
Euro Stoxx 50	-8,46	-10,90	3,69
Shanghai	-3,23	-5,57	-2,06
FTSE 100	-8,99	-12,04	-2,66
MSCI Emerging	-5,27	-9,69	-1,88

There is a vast amount of literature, news and potentially justifiable panic surrounding COVID-19. We are sensitive to the fact that the virus has been the cause of the loss of considerable number of lives, and aware that there is always the risk that infection rates and causalities get exponentially worse. The World Health Organisation is, naturally, closely monitoring the developments and spread of the virus – at this stage it has not declared it a pandemic.

More recent examples of outbreaks of similar diseases, SARS (2003) and Swine Flu (2009), coincidentally occurred towards the end of two major stock market meltdowns – they were not in and of themselves the cause of any financial meltdown. So firstly, it is difficult to extrapolate the reactions then to markets today, and secondly the COVID-19 has arrived in the midst of a decade long bull market, with a US market priced for perfection.

The reality is that the US equity bull market over the last number of years has not dragged global equity markets along with it – the chart below evidences the rally in the S&P 500, whilst Eurostox has barely moved over the last 6 years. The JSE and other major indices have more closely mirrored the Eurostox than the S&P 500. We have previously argued that US equity has little relative valuation support, hence it was intriguing to see global markets decline in unison with US markets, notwithstanding the disparate valuations of the indices.



We are not experts in virology, and given the prevalence of information circulating on COVID-19, we would assume that most readers would have formulated their own views on the virus. To us, whilst we understand the importance of containing any potential outbreak, the reaction of governments seem at odds with the current known reality of the disease. The shutdown of manufacturing production, travel, public gatherings, and enforced quarantines – all seem perfectly rational responses given the public and media outcry. We believe that anyone getting infected is one person too many, but disease is unfortunately a part of life, and our concerns would be that the current approach to stemming the outbreak is coming at a great economic cost.

In the last few days, we have seen some normalization of traffic congestion patterns in major Chinese cities, and there is evidence that production facilities are again operating after a prolonged Chinese New Year holiday. However the shock to global supply systems could potentially be dramatic – supply shocks and inventory shortages can take longer to fix than demand shocks, where monetary and fiscal stimulus can have an immediate impact. Nonetheless we would expect some form of stimulus from most economies.

It remains to be seen how long this period of economic stagnation will last – the shorter term earnings impact on companies is likely widespread - in theory equities are the longest duration asset class, and a short term hiatus in earnings should not have too material a bearing on a company's intrinsic value. However, we remain extremely wary of companies with weaker balance sheets, which will be poorly placed in any protracted period of economic stagnation. Allied to that, we are equally wary of elevated valuations which are likely to provide no comfort in these uncertain times.

In the panic of last week, selling was clearly indiscriminate, and indiscriminate selling invariably provides opportunities. As a result, we made some changes to our portfolios. In the ClucasGray Equilibrium Prescient Fund we have taken advantage of the sell-off to add to exposures in attractively priced companies – we were net buyers of equity in last few days of February. In addition, South African bonds have been relatively resilient in the face of the recent Emerging Market driven currency weakness - we believe they continue to look attractive, more so given collapse in global bond yields over the last month.

In the ClucasGray Equity Prescient Fund, we reduced weightings in companies that have held up relatively well, and added to companies that have been unduly punished. We believe we have been afforded the opportunity to invest in resilient business models, with strong balance sheets at extremely low valuations by their historic standards.

The net effect of all of the above is that February was a terrible month – the last week was as bad as any since Global Financial Crisis. We are acutely aware that the nominal performance of both the Equity and Equilibrium Funds over the last 12 months is disappointing. Whilst it has been a painful journey getting to this point, the only silver lining in the otherwise ominously dark clouds, is that many valuations are now as compelling as they have potentially ever been.

Please feel free to contact us at any stage if there is anything you would like to discuss or engage on,

Regards

Andrew & Grant