ALUWANI

CAPITAL PARTNERS

CORONAVIRUS- A BLACK SWAN EVENT

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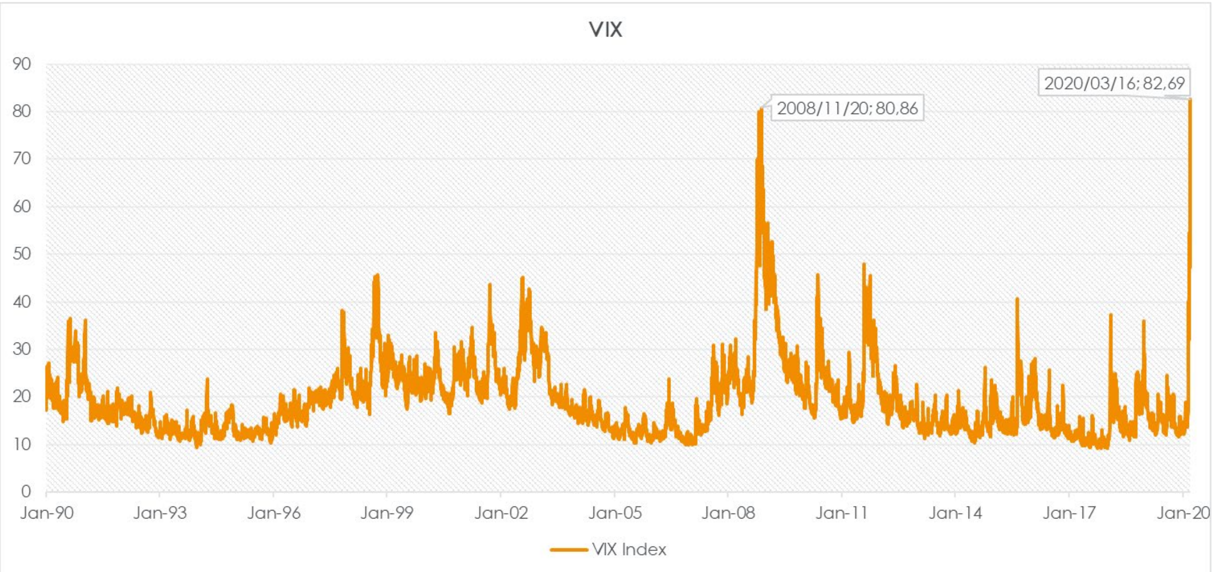
WHAT HAS BEEN THE IMPACT TO DATE?

From the 20th of February we have witnessed a synchronized sell off across global financial markets and asset classes on the back of fears around the spread of the Coronavirus and what it could mean for global growth and activity. The extent of the slowdown in global growth and how long it will last coupled with the negative impact it may have on supply chain is what is unsettling global markets. Adding further salt to the wound is the clear market share wars between Saudi, Russia and shale gas producers that is currently playing out in the oil market.

Central Banks globally are either cutting rates and/or providing stimulus packages. Markets are however not seeing this in a positive light as markets continue to spiral lower on the back of these cuts or stimulus measures pricing further deterioration in the underlying economies growth prospects. Where does that leave us? There is clear panic and severe market reaction with the current pull back being one of the sharpest we have seen in recent history. Several global activity indicators are pointing to severe global slow-down. A full-blown global recession will however be dependent on how long we remain in this situation of reduced activity. What is therefore critical to get on top of is how sustained or protracted demand destruction is going to be at a micro level and the impact of that at a fiscal or macro level. This in turn will be dependent on the rate of increase in infections globally and the consequent shut down of various economies.

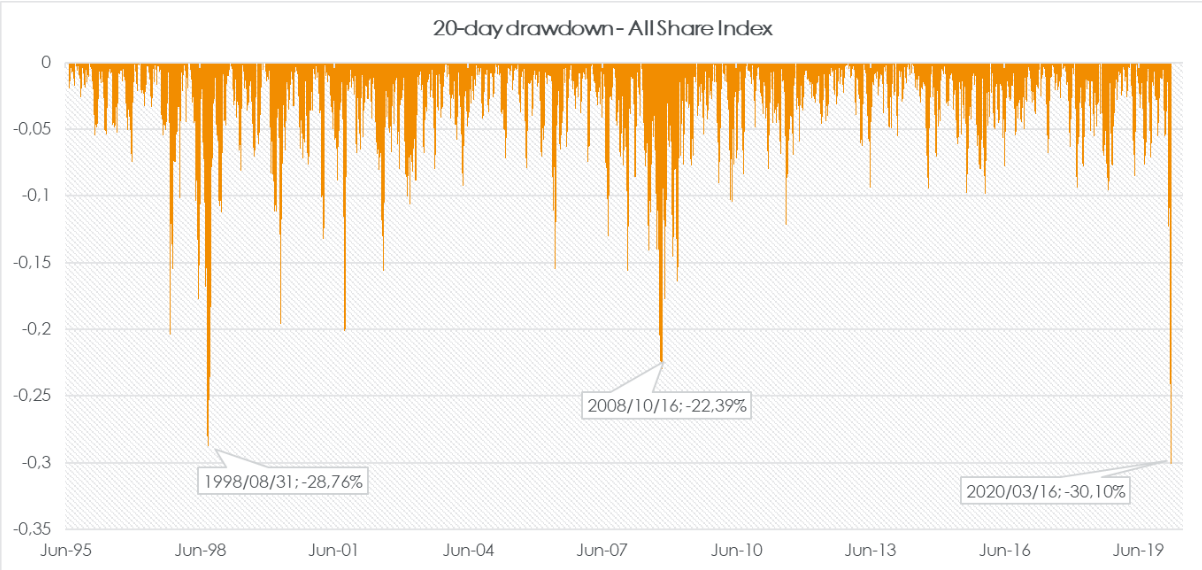
The markets seem to be fearing the worst, this is evident by the fact that over the last 3-4 weeks we have seen sharp and highly correlated moves across asset classes with market volatility reaching its highest level in the last 30 years (Figure 1). The speed at which markets are reacting points to the fact that there are still significant unknowns within the system.

Figure 1



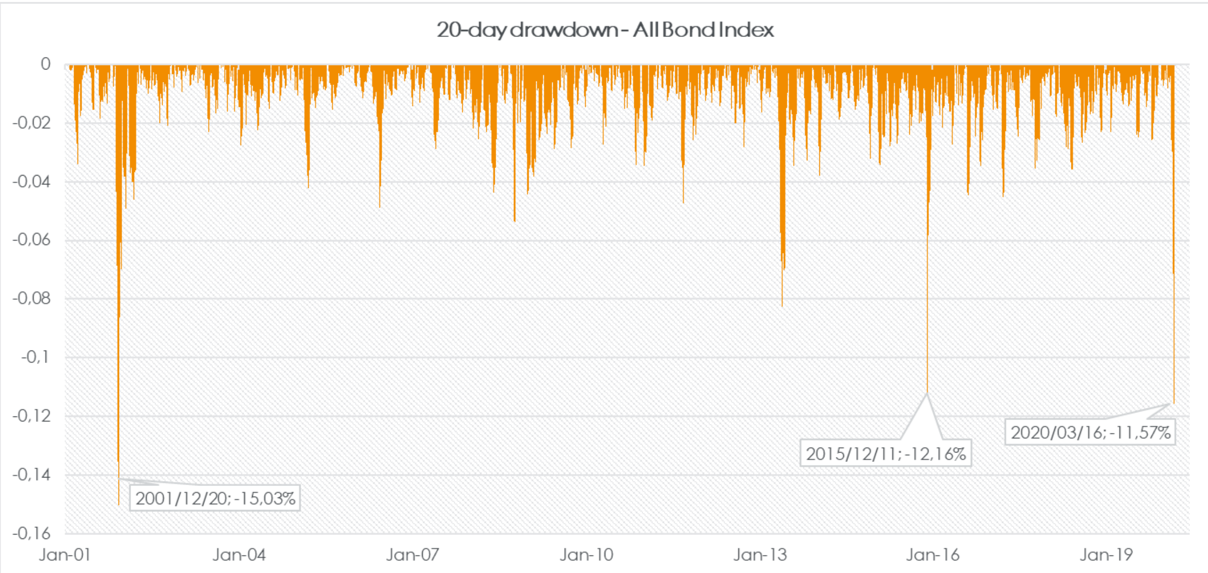
The drawdown charts below (Figure 2) show that within the local equity asset class we have experienced the deepest 20-trading day (roughly 1 month) drawdown ever in the All Share Index. A total of 30% peak to trough compared with 22% in 2008 and 29% during the Emerging Market crisis.

Figure 2



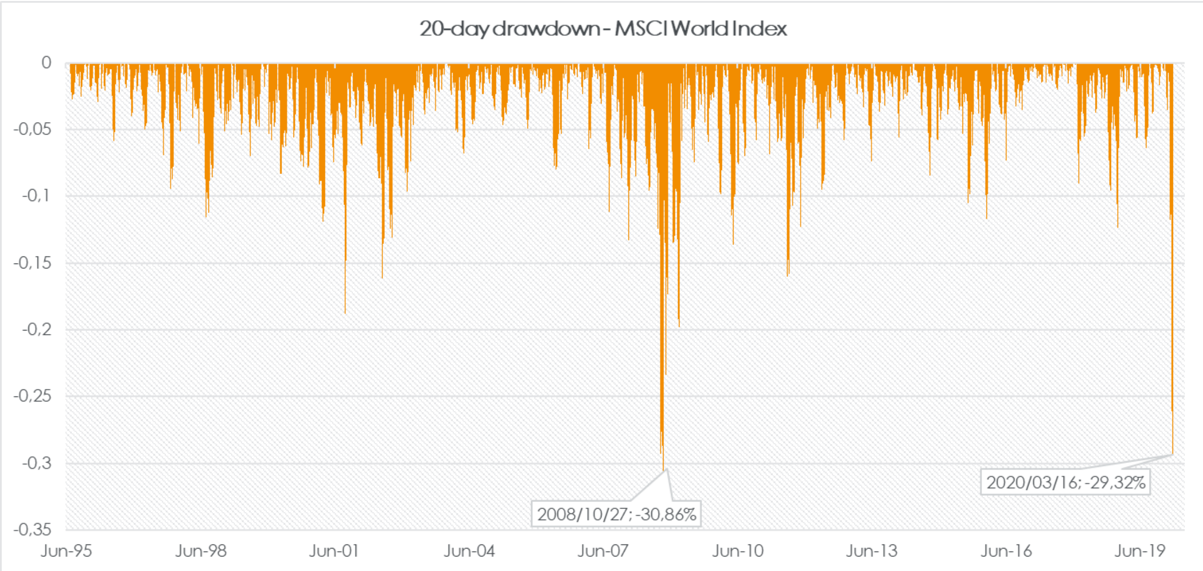
Within local bonds (Figure 3) although not as severe previous crisis (namely emerging market crisis in 1998 and Nenegate in 2015) the impact has been pronounced.

Figure 3



Lastly, looking at global equities (Figure 4) one can see the sell-off has been very close to the worst we have seen in history with a current drawdown of -29% versus 30.9% in 2008.

Figure 4



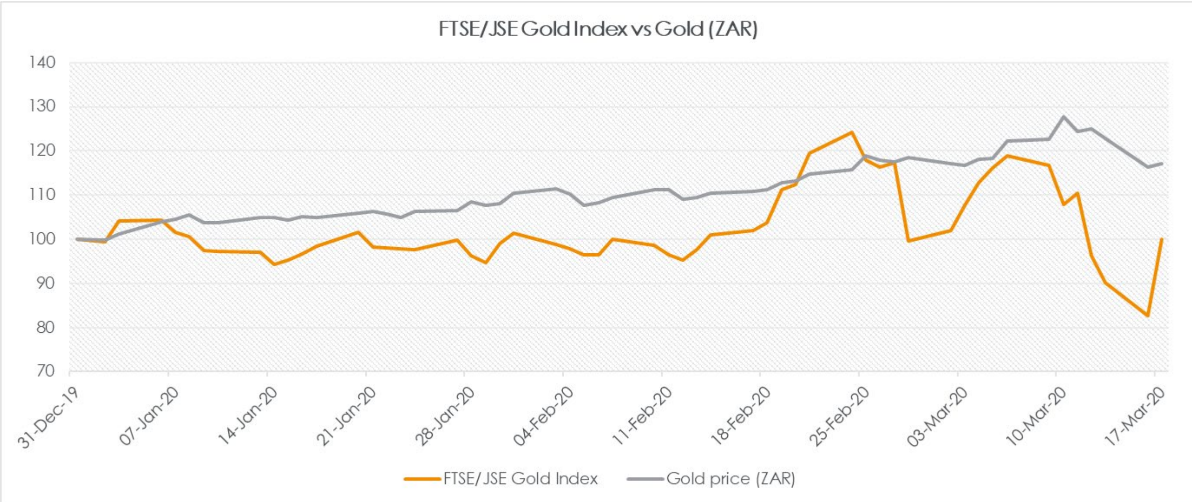
While we note that global pandemics do not go away in a quarter, it is critical not to panic and be pragmatic while continuing to take long term views. We fully expect global economies to continue to have to deal with the virus throughout 2020, it is however difficult to gauge at this point in time the eventual impact on economic activity and more importantly on loss of human lives. In South Africa, we have seen decisive action with President Ramaphosa declaring a National State of Disaster, how effective the measures that have been put in place in containing the spread of the virus locally will be critical to monitor.

WHAT WE ARE DOING ABOUT IT?

Equity Portfolios

For the equity asset class, it is unlikely that a slowing local and global economy coupled with lower interest rates will result in the asset class rerating. Investors will however reward earnings visibility at some point as we have seen through past crisis. The sell-down has been devoid of fundamentals and pointing to clear risk off as can be seen through Figure 5 where most of this year we have seen a clear disconnect and underperformance of gold stocks despite the rally in physical Gold. We have seen this as irrational and therefore kept our over-weight in our Gold stocks in the portfolio.

Figure 5



We have spent the last 3-4 weeks measuring and discussing potential earnings impact (from a topline, productivity (downtime due to lack of raw material) and cost basis) and the likely extent of that.

We have always maintained a quality bias within our portfolio as that is a critical tool in our portfolio construction process. This has meant that we have not instituted a significant change in our portfolio holdings. We have however taken risk off in businesses that have weak balance sheets (as in highly indebted with most of that date due in the next 12 to 24 months), revenue pressures and consequently low margin of safety (Sasol is a clear example of this, a position that we have exited). Going forward, while some stocks are showing clear value (in terms of levels that they are trading at relative to their history) what is key for us is some sort of stabilization in volatility levels before we re-enter the market in any meaningful way. Where appropriate and allowable per client mandate, we have raised cash levels to maximum levels.

Fixed Income Portfolios

Globally risk off is pronounced (Figure 6) as shown with US Treasuries yielding all-time lows (as far back as the 1990's). Locally risk premiums have adjusted firmly upwards and as a result we have seen a sharp adjustment upwards on our local Government instruments (Figure 7). Ultra-long dated instruments are now yielding c. 12-13% which are fairly attractively priced. Fixed Income assets have therefore had one of their worst months in recent history having capitulated in line with all asset classes. Going into this year we were long duration and we have continued to add to or increase opportunistically our exposure to South African Government Bonds. The biggest risk to this is if yields adjust upwards indefinitely or for a protracted period. This we believe will be dependent on the following factors:

- The duration of a global recession on the back of reduced economic activity from the Coronavirus pandemic
- The inability of our Government to deliver on fiscal tightening measures as laid out in recent announcements

Figure 6

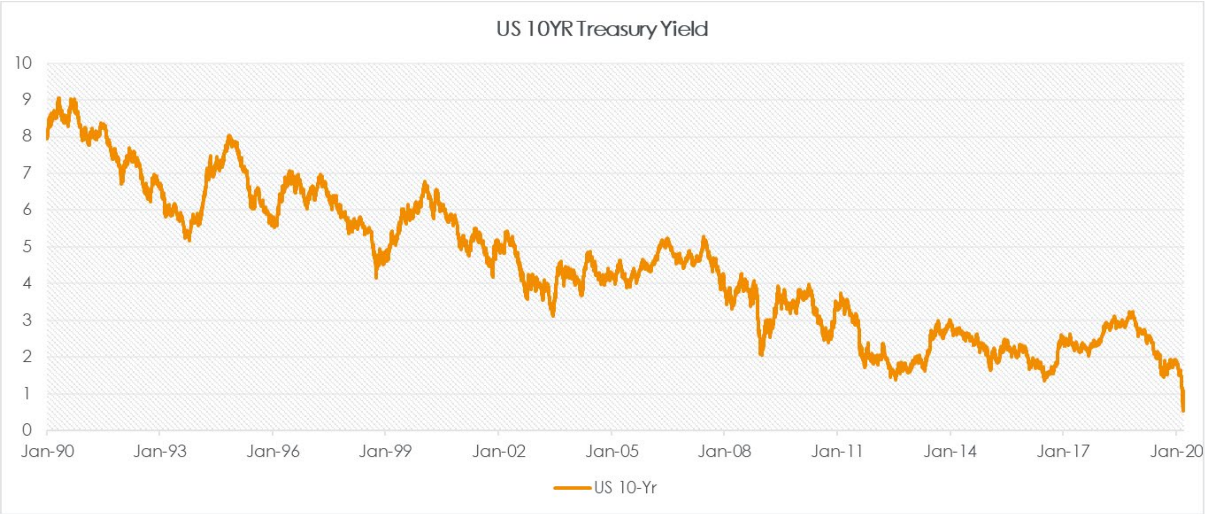
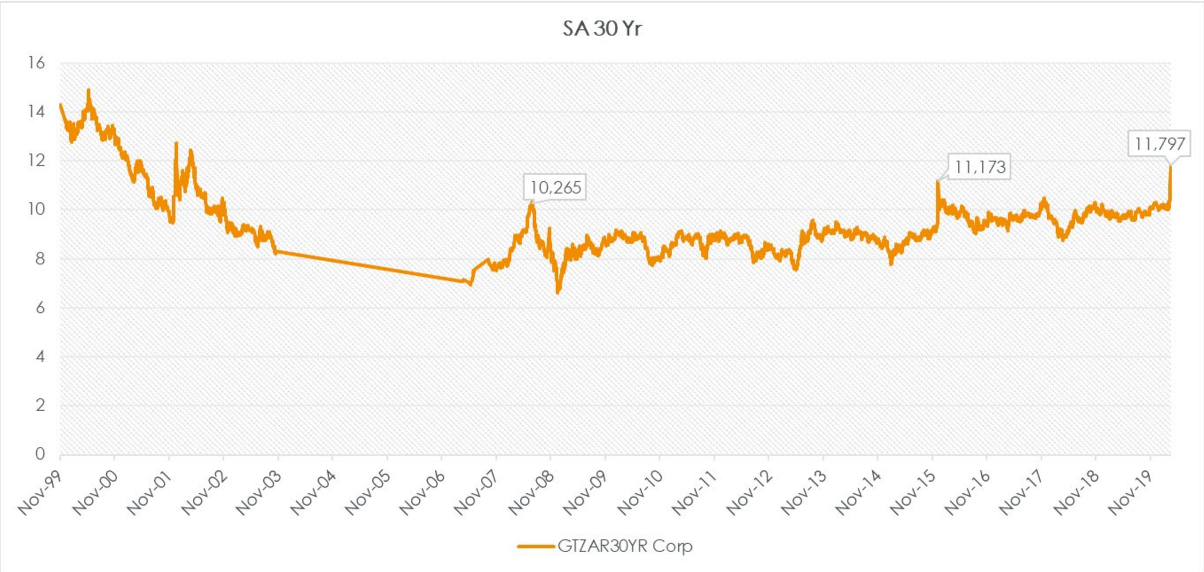


Figure 7



We have been opportunistically reducing our credit exposure over the last 12-18 months by not rolling over our positions as we did not believe that spreads were compensating sufficiently or providing the margin of safety needed. Locally we have not seen credit spreads collapse or even adjust in any significant way given the nuances of our market which does not re-price credit assets or mark-to-market unless there is a clear trade on the back of it or new issuances. On the back of this we do not expect efficient spread widening within the asset class unless there is a clear allocation out of the asset class over this period or a large default. Our holdings are concentrated in high quality companies with strong balance sheets – therefore strong cash/ capital positions and low leverage.

QUESTIONS THAT WE WILL NEED TO THINK ABOUT OVER THE COURSE OF THIS YEAR-

We are still in the eye of the storm and where things settle is still very uncertain. Our focus on delivering risk adjusted returns through market cycles is key for us and therefore we will continue to build diversified portfolios with a high-quality bias. As we move into the second quarter and the rest of the year it is important that we keep a tab on the level of increase in infections and the consequent economic and humanitarian los on the back of that. We will also be asking ourselves key questions to ensure we do not become complacent in these extreme market conditions, some of these include-

- What are the direct and indirect risks within our portfolios?
- How severe is the fiscal impact on the back of a macro slow-down?
- Does the South African Government continue to deliver on key initiatives to strengthen our macro position (privatization etc.)?
- Does the current emphases' cause a shift in consumer behaviour or spending patterns and what businesses are on either side of this equation?