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Making sense of current market conditions

The current market volatility is understandably causing investors much stress. Andrew Lapping examines the impact of coronavirus and the drop of the oil price on our portfolios and offers clients some perspective.

Global asset prices are under extreme pressure as investors rush to perceived safe-haven assets in the face of a global economic slump brought on by the coronavirus. Even large companies with strong balance sheets have fallen sharply, for example BHP is down 37% from January highs. Companies with highly geared balance sheets have generally fallen over 50% in the last few weeks.

There is little doubt that coronavirus will spread around the world and cause a sharp economic slowdown. Given the current case number growth rate, it seems peak infections may occur within five months and subside quickly thereafter. The direct impact on asset valuations could potentially be a single year of lost earnings. For a company trading on 15 times earnings this would indicate a 7% price fall. If businesses lose in a single year what they would have normally made, this indicates a 14% price fall is appropriate. The downside scenario is if the coronavirus economic slowdown causes a far greater rolling recession as in 2009.

Businesses that can survive a year of no cash flow should hold up well; this does not apply to companies with substantial financial leverage. Fortunately, most South African businesses do not have heavy debt loads, unlike many in the US, which have geared up to buy back shares. The obvious risk in our portfolio is Sasol. Sasol took on R145bn of debt to build a chemical plant in Louisiana. A US$35 oil price puts the balance sheet under considerable strain. As of 6 March, Sasol accounted for 2.5% of the Allan Gray Equity Fund, 1.9% of the Allan Gray Balanced Fund and 0.9% of the Allan Gray Stable Fund; this was prior to the share falling 47% on 9 March. We think Sasol is undervalued at R87.50 per share – but the debt load makes the company a risky investment proposition. Ironically, the outlook for the oil price is the best it has been in a long time. US oil production growth has plateaued in recent months and at these oil prices US production will slow sharply as the industry is cash flow negative at US$50, let alone US$35. US shale oil is not the only production source facing declines – the capital starvation of the past five years is beginning to bite in several jurisdictions. I think the current Saudi/Russian strategy is the right one for a strong stable market in the long term. (Saudi Arabia and Russia seem to have decided not to defend a US$60 oil price and rather let low prices drive US shale oil producers into bankruptcy and therefore stem supply).

The recent price falls have created very exciting buying opportunities. We are buyers of equities and South African Government debt. Numerous companies are trading at free cash flow yields of over 10% and we have not seen expected total returns of this magnitude since the early 2000s, when South African shares were extremely out of favour, and the global financial crisis of 2007/08, both of which proved to be exceptional opportunities to invest in equities.

I realise it sounds hollow to say now is the time to invest given the recent underperformance of our funds and the consistent outperformance of cash over the past five years, but the rewards of investing at times like this in the past have been substantial. As contrarian investors we invest in assets that we believe are trading at a discount to their intrinsic value, the recent price action has widened those discounts.

Commentary contributed by Andrew Lapping, chief investment officer, Allan Gray