WISE FUNDS

Buy toilet paper – sell shares

Eleven years ago today world stock markets began to recover, several months after the collapse of Lehman Brothers brought the banking system to its knees. Today, stock markets are once again in free-fall as the coronavirus Covid-19 races round the world, bringing economic activity to a shuddering halt.

Events are moving at a pace that's almost impossible to keep up with. In just a week, the number of affected countries has risen from 50 to 85, detected cases from 35,000 to over 110,000 and the death toll to 3,800 from less than 1,000.
It seems that now's the time to lay in emergency supplies of dry pasta, tins of beans, long life milk, and of course plenty of toilet rolls.

This short blog will attempt to answer two questions – whether the market's response to the unfolding situation has been appropriate in view of what we know and don't know, and what the Covid-19 crisis might look like in retrospect, say in two years' time.

Coronavirus in retrospect

With the benefit of hindsight, we will know – and will possibly already have forgotten, what we don't know now - how long the pandemic lasted for, what the death toll was and which countries were least and worst affected. We already know that the outbreak appears to have been contained in China, where 3,887 new cases were announced on February 4th, 139 on March 4th, and just 40 today, and it may be that the rate of new infections in South Korea has peaked. But worldwide, Covid-19 is spreading, and very rapidly. The full trajectory can only be guessed at.

In hindsight, it will be clear which policies worked and which didn't, which countries coped and which didn't. The damage caused will vary from one country to another. Factors include whether a country is in the northern or southern hemisphere, what proportion of the population trust the health authorities and are prepared to do what they're told, how quickly governments react, how much testing is done, whether sick pay arrangements are effective or not, and whether the coming of spring will make any difference.

Covid-19 will have been the only truly global pandemic in living memory, but there is no guarantee that it will be the last. However, the next one may not be quite such a gigantic media event.

In two years' time we will know the full effect of the virus on economic activity. We are already seeing a multi-dimensional shock affecting both supply and demand. Chinese factories closed due to lockdowns, sickness and workers being unable to return from home after the lunar New Year. Closer to home, sporting events are being cancelled or played in otherwise empty stadiums, travel arrangements are being cancelled or deferred, the roads are noticeably emptier – and we are only in the early stages.

Could this activity-shock lead to an outright recession? Yes – a recession is two consecutive three-month periods in which economic activity contracts. There have been recessions before, and the one that may be about to occur would likely end once people regain confidence that normal movements can be undertaken safely. The word 'recession' has taken on sinister undertones over the last few years and is often referred to these days as 'the R word'. This is because it is over a decade since the last recession – the only one many investors remember – came to an end, and because that one, lasting from 2007-09, was unusually brutal. There can be mild recessions, though few people can remember one.

A coming recession – if such it is – might consist of few months of lower activity followed by a pick-up once the all-clear is sounded. However, those would probably be months of sharply lower revenues for companies in the leisure and travel industries, some retailers, estate agents, construction and home improvement companies, and of pain for anyone made redundant by businesses desperate to reduce costs.

The recovery in share prices which began eleven years ago today was kick-started in large part by the reduction of interest rates to previously unknown levels and the policy, known as QE, of supporting the price of government debt. Today, it's generally agreed that these policies have run their course. Interest rates can't be cut much further because they're close to zero already. An emergency half-percent cut last week in the US, which has the most scope among the larger economies to cut interest rates, was met with disdain in financial markets. Other policies will be needed to help challenged businesses through this difficult time, which could include tax cuts and subsidised sick pay. But then the spectre of moral hazard could arise – should governments interfere with capitalism's natural process of creative destruction by propping up the weak at the expense of the strong? If they don't, there will be bankruptcies – the airline Flybe's recent descent into administration was hastened by the Covid-19-related slump in demand. If they do, they will be accused of propping up zombies. Whatever governments do or don't do, there will be fatalities in the corporate sector – leaving empty spaces which the stronger survivors will expand into. These companies may be identified in advance as ones with able managements who are wasting no time in responding to the situation and have balance sheets strong enough to withstand prolonged periods of impaired cash-flow.

Will everything return to normal afterwards?

At a guess, yes – and no. Apart from causing the demise of companies that might have survived otherwise, the coming crisis is likely to accelerate trends that are already happening, such as the growth in home-working and internet shopping, and the speed at which companies cut costs. Another permanent change may be in the way companies look at their supply chains. Companies whose businesses consist of re-selling products imported from one or two suppliers in China must be feeling vulnerable today in a way they didn't a few weeks ago, and the stock market is busily factoring supply-chain risk into their share prices. The long-time consensus view of globalisation as an all-round good thing has been questioned in recent years. The process of de-globalisation or 're-shoring' may accelerate, too.

Has the market's response to the coronavirus crisis been appropriate?

The current panic began a couple of weeks ago when the news that the virus had appeared in Italy and South Korea turned it into potentially a global phenomenon, rather than a purely local Chinese one, and has continued as the virus has jumped across borders and new cases have multiplied.

What's happened in the markets in the last couple of weeks is a major risk-off event, akin to what we saw after the 9/11 attacks in 2001, in the early stages of the Euro crisis (2011) and in the weeks following the Brexit referendum (2016). At these times the headlines can be relied on to scream at us how much value has been wiped off world stock markets. We're never told when the value gets wiped back on, which tends to be a more gradual and less newsworthy occurrence. This asymmetric reporting has now been enshrined in regulation, Fund managers are obliged to write to investors each time their funds fall by 10% in a three-month period, but not when their funds go up.

Markets are coming to terms with what could be a severe though possibly short-lasting growth shock, affecting certain sectors more obviously than others. An example is Easy Jet, an airline that operates short-haul flights within Europe, including to and from Italy. Like other companies in the travel sector, Easy Jet is already suffering from a substantial reduction in airline bookings, painful in an industry where a three-quarters full flight is an unprofitable one. Easy Jet's share price has fallen 37% since February 11th. Informa runs trade exhibitions globally. In the last few days, the Geneva International Motor Show has moved from physical to (less profitable) virtual, as has the art fair Art Basel, and others will follow. These cancellations are a direct threat to trade fair organisers, and Informa's share price has fallen 35% since January 16th.

In the short term, these substantial movements look justified. Investors with longer time-horizons will be focussing their research on whether such companies are robust enough to withstand perhaps three loss-making quarters, if they can sustain their dividend payments, whether the virus is likely to provoke a permanent alteration in their markets, whether the companies can adapt to such changes and what shape their competitors are in.

Some price movements have come as more of a surprise to us than the ones referred to above. It's interesting how the UK construction sector, universally regarded as un-investable last summer, has become defensive, outperforming the overall market by a substantial margin over the last few weeks.

The same has not been true for the much larger financial sector. Last week, Legal & General announced another record year's profits, together with their highest-ever dividend. The share price has fallen by 29% since February 14th, though not obviously exposed to the trends in travel, leisure or the supply chain mentioned earlier. What has made Legal & General's future cash-flows worth 30% less than they were a month ago? It probably isn't their market-leading pension-de-risking business. Companies' need for pension de-risking is as great as ever, unaffected by the virus. L&G have the UK's largest asset management business, and a fall in share prices translates into lower fees for them. However, L&G's assets under management include a substantial bond portfolio, and the bonds have risen in price, offsetting the shares. The company may experience increased life insurance claims, but some of the claims will be taken care of by reinsurance, and in the aftermath of Covid-19 it's likely that the demand for life insurance will go up, as will premiums. The only obviously negative factor we can think of is that lower interest rates place strain on life assurers' solvency ratios, though L&G are a long way from breaching any solvency rules, and it is improbable that any regulator would impose penalties due to breaches caused by emergency interest rates. It's also possible that investors are concerned about a spike in defaults in Legal & General's bond portfolio. This concern was a major drag on the company's share price during the 2007-9 crisis, though in the event defaults remained at a low level throughout.

The financial sector, to our bemusement, has been a major casualty in the current sell-off, despite being already very cheap, and for the most part well-insulated from the coronavirus storm. Faced with the choice between a UK government bond that gives you an income of 0.5%, and a life insurance company that invests in bonds and pays you over 8.0%, investors are unhesitatingly choosing the bond.

There is an unmistakeable whiff of panic in the air. Panic isn't always the best frame of mind in which to make rational decisions.

The price of oil

Over the weekend, OPEC (the Organisation of Petroleum Exporting Countries) and its allies tried and failed to agree on production cuts to stabilise the price of oil, which has been falling in anticipation of sharply reduced world demand. The finances of some OPEC countries are so precarious that they resist production cuts even at the risk of creating a glut. On this occasion it appears that Saudi Arabia and Russia failed to agree on deep production cuts, and the Saudis have responded by ramping up production, which exacerbated the growing over-supply. The price of a barrel (42 gallons) of Brent Crude has dropped to $35, a third of where it was six years ago.

The new price war in the oil market triggered today's turmoil in the stock markets. As might be expected, the biggest losers in the UK were the oil majors BP and Shell, both down by a little less than 20%. On the other hand, a lower oil price acts as a tax cut for consumers. Beneficiaries include airlines, haulage companies, in fact the entire transport sector, and anyone who drives a car. The shares of the beneficiaries didn't rally to offset the oil producers' woes. This somewhat counter-intuitive pattern (the losers lose, but the winners don't gain) can be explained by the fact that the price of oil is often seen as a proxy for the health of the world economy, as well as that to investors in an extreme risk-off mindset, as now, all news is bad news.

We are not selling our shares

This blog does not give advice. However, it is possible to say, as a statement of fact, that the managers of the Wise Funds all have a large proportion of their personal savings in the funds we manage, and none of us has sold a single share since the onset of the coronavirus. Indeed, we are more minded to add to than to reduce our holdings, and indeed we have done so. In ten years' time we may not be feeling too disappointed if we didn't time the bottom to the exact day.
In markets, the moment of maximum uncertainty is the market bottom. That moment is approaching rapidly.

Last August the UK market was in a tailspin caused by Brexit and the political stalemate. At the time, in a blog called 'The Eye of the Storm' We pointed to the difficulty of timing the bottoms of markets, which can only be seen in hindsight. We predicted that the UK stock market would recover long before the Brexit crisis was resolved, as turned out to be the case. It is, to say the least, frustrating that we find ourselves in the eye of yet another storm so soon after the last one.
One thing hasn't changed – we are patient, long-term investors. We will continue to develop the processes that have produced consistently good results over many years, and we will use the current market weakness to the benefit of our investors in any way we can.

Tony Yarrow

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Please note – this blog contains the views of Tony Yarrow as at March 9th 2020, and is not intended as financial or investment advice.