EFFECTUS
CAPITAL MANAGEMENT

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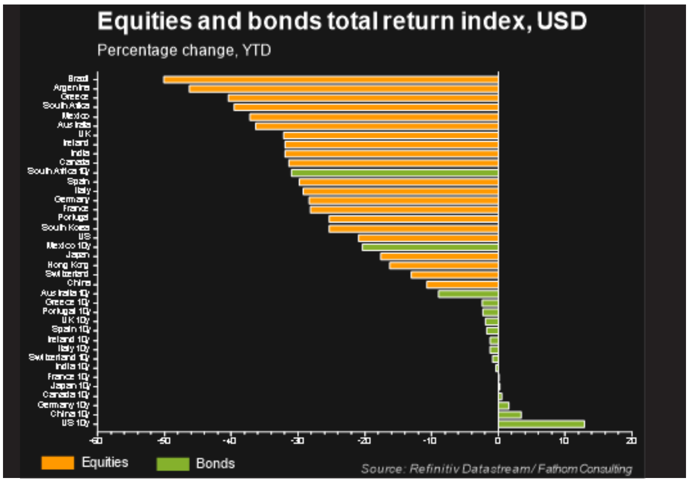
Its tough to summarise the kind of quarter it has been

BY GRANT NADER

The overall macro-economic landscape of the past 3 months is completely overshadowed by Covid-19 and its impact on the now shell-shocked global economy. While we certainly did not foresee the Covid-19 outbreak, we were cautious about some of the global exuberance heading through January and thus defensively positioned, highlighting the PGM stocks as an example of some of the froth prevailing at the time. This served us well through the quarter.

The oil-price collapse and finally getting the overdue downgrade are possibly the only other meaningful conversations to be had outside of Covid-19.

In South Africa the benchmark Top40 index finished down just less than 20% for the quarter, despite the currency weakening by over 27%. The only index recording positive returns was the gold index. On the other side of the coin, losses were led by property, industrials, financials and general retailers.



The carnage was replicated globally with developed and emerging equity markets getting equal treatment, the S&P500 finishing down 23.7%, well off its record high.

We have written about the winners and losers through the evolution of the pandemic and during the course of the Government enforced shutdowns. We have also detailed how we have navigated our investment strategy.

A brief summary of our investment approach to date:

We have avoided exposures to:

- Discretionary, highly cyclical sectors, such as clothing retailers and the related property companies
- Resources, which are highly dependent on the global growth cycle
- Banks who will incur significant increases in credit loss ratios should enforced shutdowns last longer than expected
- Life and health insurers who will bear the brunt of a blowout in healthcare and death benefit payouts
- We have invested mainly in:
- Non-discretionary 'sectors such as food producers and food retail
- Gold (as a risk and inflationary hedge)
- Sectors that stand to receive a net benefit from enforced or voluntary changes in worker and consumer behaviour (such as e-commerce, online entertainment, cloud-based collaboration enablers etc)
- Pharma and biotech companies poised to benefit from spiking demand for treatments, vaccines and related medicines

What we know for certain:

Medically - never has the world been as well equipped as it is today to deal with a crisis such as this. We firmly believe science will find a solution sooner rather than later.

Economically - despite all the stimulus and best efforts, many companies are likely to shut their doors for good.

Of critical importance now is to try and understand the long-term impact of the virus, at what point is enough downside priced into the market. To accurately make these assessments a lot of information is needed but not yet available.

Looking ahead to Q2 and beyond

Our focus has now turned to the future of the world post-Covid-19 crisis and the questions that will eventually need to be asked and answered

What is the lasting impact of the negative capital formation as some savings and income are permanently lost? When the shutdowns are over, this reduced capital base will lower the future recovery potential. Emerging markets will be the hardest hit as they have the least personal and fiscal resources to support their economies and people.

Which companies will survive and what sort of recovery will they have? Who survives and who does not is the key to successfully taking advantage of this major correction.

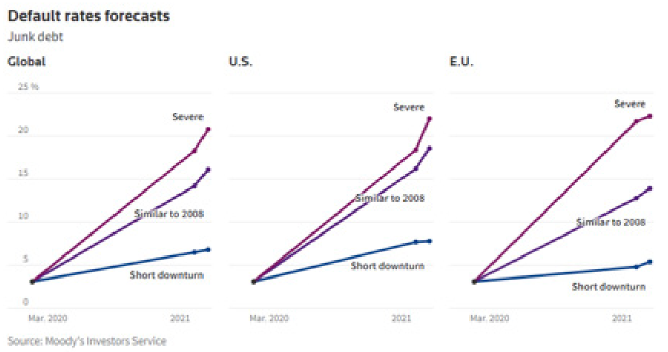
What shape will the global recovery have?

Consensus is leaning towards a U shape, but one cannot ignore the risk of and L or W shaped recovery. This is of course a key question in the 'has the market bottomed' call.

Are the stimulus measures enough?

Developed markets have been willing to go above and beyond, moving with speed and unity as they deploy historic levels of fiscal and monetary support.

The US Fed's financial commitment to lower grade debt purchases is another significant positive in stemming the potential domino effect of weaker companies failing. Unfortunately, the rest of the world may not have the same level of protection.



The much debated MMT is now essentially in effect. What are the long term unexpected consequences of this live MMT experiment? Will the world remain in a prolonged deflationary spiral or will this trigger an inflationary spiral in a world struggling for growth?

It is estimated that Emerging Markets collectively need about $2.5 trillion in monetary and fiscal support to fully manage this crisis. It is not clear that they can get this. This means that the base from which their economies reset will likely be lower in relative terms than developed market peers. After all an economy that shrinks 10% in year 1 year needs to grow at over 11% in year 2 just to reclaim the initial GDP in year 0.

South Africa

It is clear the shutdown cost of R13bn per day in SA comes at a great cost. The balance between economic loss and human loss needs to be carefully balanced as both have long-term implications for the wellbeing of South Africans in the form of unemployment and a further shrinking economy. Leadership over the next 6-12 months will prove critical to the future outcomes.

Our already vulnerable fiscal position heading into this crisis has us on the back foot. We will emerge with higher debt, higher unemployment and likely lower growth. Government has limited resources available to support businesses and we question whether our stimulus efforts will be enough. Many small businesses cannot survive more than 30 days with their doors closed. The real long-term consequence of this being that a business that closes is gone forever as opposed to a business in survival mode that can reopen and re-employ people quickly.

It is not all doom and gloom and there are some positives to be found:

- Clear, strong leadership from government for the first time in many years
- The potential for forced implementation of the structural changes that are long overdue and justification for some of the hard decisions we haven't been able to make thus far as money is channelled only to places most in need (e.g. cut the ties to SAA)
- Effective collaboration between government and the private sector
- The longer-term boost of a significant fuel price cut
- The fact that the downgrade has finally happened perhaps means we can move past this Damocles sword and focus on more pressing economic issues
- There is a balanced path out of this as demonstrated by several countries thus far (South Korea, Singapore, Germany, China)

The strongest SA businesses will survive, but we are concerned of a domino effect on the economy should we see numerous smaller businesses shut their doors, hitting banks, consumers and consumer facing businesses.

When is normal, what is normal and how deep will the scars be?

In a post-Covid world we need to ask, has the market priced in enough downside? Or have they potentially priced in too much? What will the return to normal look like? We believe it is industry and country specific as the recovery rates and resumption of 'business as usual' will differ across every industry. For example, clothing versus automotive sales…how deep will the scars run and will the consumer focus on repairing their balance sheet ahead of durable non-essentials such as cars and luxury items?

It is likely that the younger generation will bounce back more quickly, resuming social interactions, travel and leisure. It may not be the same for the older generations. Post the GFC, the fear of investing in markets and property meant many ordinary people missed out on 10-year bull markets.

What are some of the long-term structural changes we expect to see?

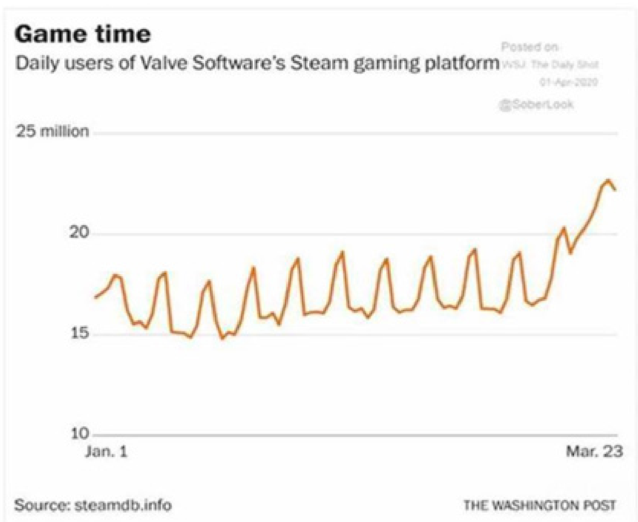
- De-globalisation as companies move more key parts of their supply chain closer to home reducing the risk of future supply shocks, this will also mean:

1. Increased demand for 3D printing as part of supply chain reconfiguration
2. Increased demand for industrial and service robots

- Accelerated e-commerce adoption by older generations of users such as the baby boomers
- Accelerated online food delivery adoption
- Accelerated streaming content consumption, particularly gaming and e-learning
- Accelerated remote/work from home adoption, cloud service usage and related cybersecurity requirements
- Accelerated autonomous vehicle adoption as people shy away from crowded public transport, accelerated drone delivery implementation is likely as well (avoiding unnecessary human contact)
- Increased innovation in healthcare solutions
- Increased AI integration in every facet of the economy, especially healthcare
- Faster adoption of online payment technologies, (global grant programs, contactless payments, ecommerce, MMT will all increase demand and need), including cryptocurrency such as bitcoin which is trusted by millennials

While we expect the massive increase in some of these to mean-revert, we believe there will be a fair amount of user stickiness that will remain.

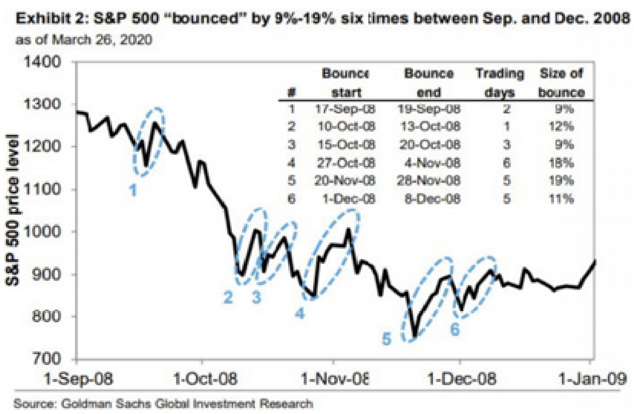
7. Video game streaming:



This may not be the new normal but there will be lasting benefits for services such as online gaming.

Other factors to consider

How and when will the oil crisis be resolved? The US shale industry has been a big driver or growth and employment over the past 10 years and a resolution is vital given the double whammy of a supply and demand shock the oil market is facing.
US-CHINA tensions to escalate again, perhaps post-election. It's clear that China handled this crisis poorly to say the least and it has been to the detriment of the rest of the world. China may emerge from this crisis far stronger than before on a relative basis and there may yet be some push-back from the US and perhaps rest of the world. Along with this we expect increased defence and cybersecurity spending.
As we move into earnings season, company outlook statements and plans for mitigation and risk management will be important indicators for the outlook.
Market volatility is likely to remain for some time and further sharp bounces and sell-offs are to be expected, as we witnessed in 2008-2009.



#	Bounce start	Bounce end	Trading days	Size of bounce
1	17-Sep-08	19-Sep-08	2	9%
2	10-Oct-08	13-Oct-08	1	12%
3	15-Oct-08	20-Oct-08	3	9%
4	27-Oct-08	4-Nov-08	6	18%
5	20-Nov-08	28-Nov-08	5	19%
6	1-Dec-08	8-Dec-08	5	11%

Source: MarketWatch

In Conclusion

There is no economic model for this. We as investors need to avoid recency bias, assuming the future will look like the past and the world will never be normal again. Many of the Covid related trends will reverse with time and the more bad news in the headlines, the more likely markets will begin to see past this. Looking beyond the short term and the obvious, there will be great companies trading at very attractive prices that offer the potential for outsized returns.

We expect that opportunities offshore will be greater than those in South Africa as we have discussed above.

We have no earnings visibility and we do not know how long it will take to resolve the threat of the virus. As such, preserving capital in this never seen before environment is our first priority and the second is to find opportunities for long term alpha. For now, we remain defensively positioned with a view to taking advantage of the opportunities that arise to buy great companies or great secular growth stories at attractive prices.