EFFECTUS
CAPITAL MANAGEMENT

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Effectus Capital Management (Pty) LTD • FSP Number: 50016 • Registration Number: 2015 / 280719 / 07

Effectus Capital Management (ECM)

By Grant Nader

Monthly Newsletter August 2020

August was another positive month for global markets, particularly the US and tech once again. Key questions we are asking ourselves:

- Have markets priced in too much?
- How is the recovery playing out so far and what lies ahead?
- What are key economic indicators telling us?
- The impact of low rates, inflation and lost 2020 earnings?
- Will there be an unwind of the Covid-19 earnings tailwinds for some companies?

Nobody likes a cocky market

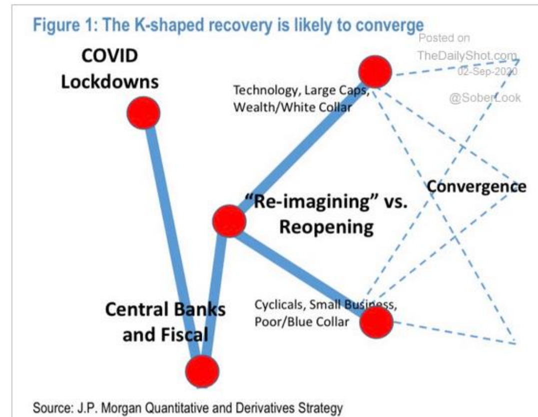
Markets become dislocated when traders and newer investors (especially Millennial margin traders) forget that markets can move both up and down from one day to the next and that margin funding is not actually free money.

The trajectory of the moves in certain market leaders have become unsustainable and a healthy correction is not only due, but necessary for a healthy functioning market. After five continuous positive months, a reality check is welcomed.

The question now becomes is this a healthy correction or is it the start of something deeper?

What's up with the recovery?

It is critical to assess not only the sustainability of the recovery but the path it may take. Once school of thought that is growing is that of a **K-shaped recovery**, whereby some laggards catch up and some do not. Some leaders push on and some mean revert. Some companies are on a new, structurally lower path and others will give back some of the boost provided by the pandemic. We frame our own thoughts on this further on.



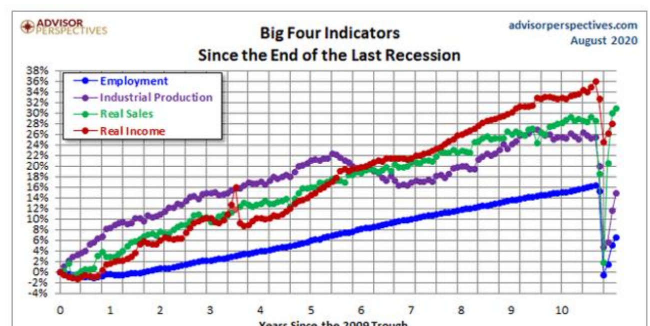
The haves and the have-nots

South Africa is likely to be a subject to the K shaped recovery too. Certain economies have been far better off than others (such as China and developed markets) and this uneven recovery profile is likely to persist.
The gap between the haves – being countries with enough fiscal and monetary stimulus, and the have-nots – countries with limited resources and burgeoning debt, is likely to be exacerbated by the pandemic for years to come.

Economic signals

Some key economic indicators continue to point to the positive momentum. Globally, **ISM and PMI** surveys have on average remained positive in August.

The chart below shows some key economic indicators: Employment, Industrial Production, Real Sales and Real Income. These graphs certainly are tending towards a V-shape however, they are still a fair way below previous highs.



Notably **port, rail and trucking data** in the US and China have shown growth. Retail has been better than industry in line with our readings on the consumer and the tendency of businesses to reduce inventory we have seen thus far.

The state of the **US (and Chinese) consumer** remains healthy

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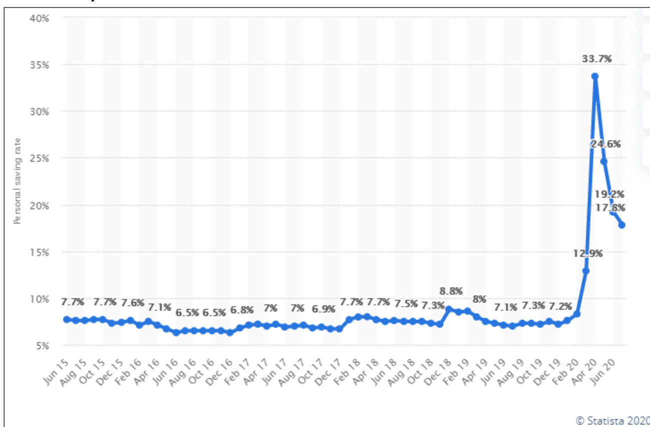
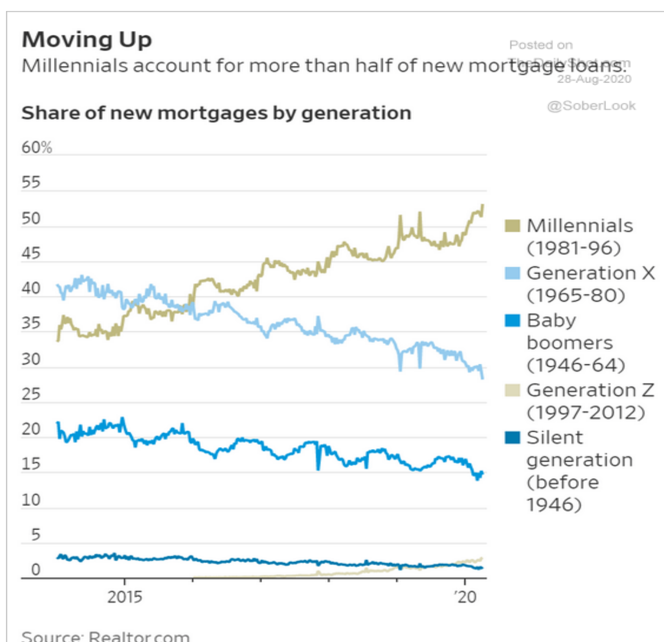
In July 2020, the personal saving rate in the United States amounted to 17.8 percent, down from a high of 33.7 percent in April but it remains at very high levels historically. This is an indication of the uncertainty and fear people have felt, but it is also a potential tailwind as confidence returns and the savings rate declines. A healthy consumer will be key to sustained economic recovery in the consumption-led US economy.



The **housing market continues to be indicative of a** growing economy. Historically low mortgage rates have improved the affordability of home ownership. We are seeing a similar effect in South Africa with surprising strength in the housing market.

The increased affordability coupled with the reduced requirements to commute (thanks to WFH) make living in the suburbs a more viable and attractive option than living and working in the cities.

What makes this trend even stronger is that is being driven by the largest and increasingly wealthy generation the world has seen in the form of the **Millennials**.



US Unemployment has dropped to 8.4% from a high of close to 15%, but we think this improvement rate will slow.

Corporate Interest rates and bond yields

Corporate bond spreads remain tight, indicating that cheap liquidity remains available. We have not yet seen a weakening of these spreads in the recent sharp pullback which typically accompanies a real risk-off move. Admittedly though, this market is being distorted by central banks.

Inflation, the Fed and lower rates for longer

The FED inflation target revision to an average rather than a hard line in the sand means that inflation can trend above the 2% for some time without being outside of their mandate. The amended wording gives the Fed more freedom to act without adding any new constraints.

Inflation is all about expectations

Most emerging market investors understand the risk is that of changing expectations around expected inflation levels. Once business and consumers expect inflation to be high, it becomes a self-fulfilling prophecy and very difficult to slow down without the pain of the interest hiking handbrake.

However, the effect of the **deflationary forces** at play globally (ageing demographics coupled with rapid technological innovation) can be seen in the deflation Europe and Japan have been subject to for the past 10 years at least, despite massive monetary easing. Another major inflation driver is the unit cost of labour. Given that this was not causing inflation at sub-4% unemployment, it seems unlikely to put pressure on employers in the Covid-19 world as unemployment is currently above 8%.

Markets are forward looking: 2020's lost earnings

To understand the market behaviour in the face of the earnings disaster that is 2020 we looked at a simplistic 10-year DCF valuation of 2 equal growth stocks with some basic assumptions.

One stock has zero earnings in year 1 (Covid) while the other does not. **Keeping all else equal, the key observation is that the difference in values from year 1's lost earnings is only 2%.** Admittedly this impact is greater in stocks with higher growth rates and in low-interest environments such as we are seeing now.

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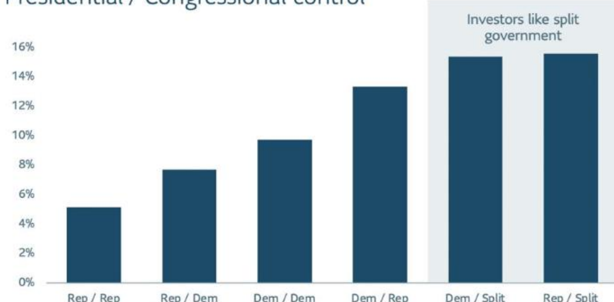
Shares	100									
Earnings in year 0	1500									
Growth rate	15%									
Terminal growth	0									
Period (t)	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Cash flows	1 725.0	1 983.8	2 281.3	2 623.5	3 017.0	3 469.6	3 990.0	4588.5	5276.8	99155.8
Discount rate (r)	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
Present value	1 625.5	1 761.5	1 908.9	2 068.7	2 241.8	2 429.4	2 632.7	2853.0	3091.7	54745.2
Sum of present values	**75 358.3**									
Valuation	**753.6**									
Losing 1 years earnings										
Period (t)	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Cash flows	0.0	1 983.8	2 281.3	2 623.5	3 017.0	3 469.6	3 990.0	4588.5	5276.8	99155.8
Discount rate (r)	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
Present value	0.0	1 761.5	1 908.9	2 068.7	2 241.8	2 429.4	2 632.7	2853.0	3091.7	54745.2
Sum of present values	**73 732.8**									
Valuation	**737.3**									
Difference in value	1 626									
Difference in value as a %	**2%**									

US Elections

Experience has taught us that what the polls say and what the results say are not always the same. The election outcome is likely to be a close affair.
We do not believe the Democratic/Republican outcome is going to be as binary for the markets as some elections have been. The Democratic leadership of Biden and Harris will be more moderate than some other Democrat combinations.

However, the **real risk of a contested vote** outcome and the uncertainty that it brings is something we are taking cogniscance of in our positioning.
A shared outcome between Republicans and Democrats across the various levels of parliament are traditionally market friendly.



Source: Bloomberg, SLC Management

The Dollar weakness remains a point of major interest. A weak dollar is beneficial to many emerging markets for several reasons such as:

- Dollar denominated debt becomes cheaper to service
- Imported inflation is lower
- Commodities, which are priced in Dollars, become more affordable and the price tends to increase with dollar weakness.

How much can the USD weaken? We have pointed out previously that the USD has been strengthening against other major currencies for several years now as the combination of higher economic and corporate growth and higher real interest rates (among other things) supported capital flows and the currency.
The US fiscal and monetary stimulus explosion through this crisis has closed the gap between Europe, Japan and the UK, justifying the weakness.

The longer-term outlook will once again be driven by relative real rates, economic growth and terms of trade. As long as the gap in these factors exists the potential for USD weakness will ultimately be limited in our view.

Tech earnings and the Covid-19 endowment

The trillion-dollar question is to what extent the tech windfall that came from the Covid-19 fallout is sustainable and what is mean reverting.
Given the rally in some of the tech shares, earnings mean reversion will carry with it significant risk in certain high-flying tech names.

We have said before: we believe a good portion of this Covid endowment will be sticky and represents an acceleration of what would have been future growth rather than a temporary bump. This is not likely to be uniform and needs to be assessed on a case by case basis.

A recent PWC Global CEO survey found that certain Covid trends are more likely to stay. **Remote collaboration and automation** are top of the list.

Let's explore what this may practically mean? In order to remotely collaborate, companies increased their adoption and subscription of **cloud-based services and tools**. With this comes the necessary **software services** (SaaS), and with that comes the critical **cybersecurity services**. Closely allied to these are the embedded applications that allow for utilisation of **AI** and **data analysis.**

We understand the current increased utilisation in this space, but the long-term question becomes who is willing to unwind or cancel these services? Few or none is the answer, meaning this earnings windfall is likely to be sustained even if it grows at a slower rate in future.
This kind of thinking needs to be applied to each of these beneficiary companies and sectors.

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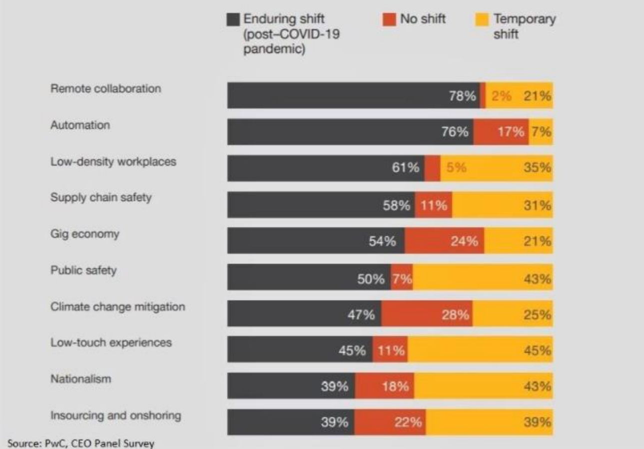


The ECM Growth and Innovation Fund investments in SaaS life-sciences and instrumentation, 5G and semi-conductors will benefit from broad based economic recovery.

Conclusion

There is pent up demand from consumers who have kept their jobs. Stimulus and liquidity remain, and economic indicators are still broadly positive.

Our base case for now is that the recovery remains robust even if it doesn't quite end up being fully V shape. The advent of a vaccine will further support a sustainable economic recovery.

We remain of the belief that market corrections are both necessary and healthy, but they do not alter the long term outlook for growth in new and innovative industries and companies.

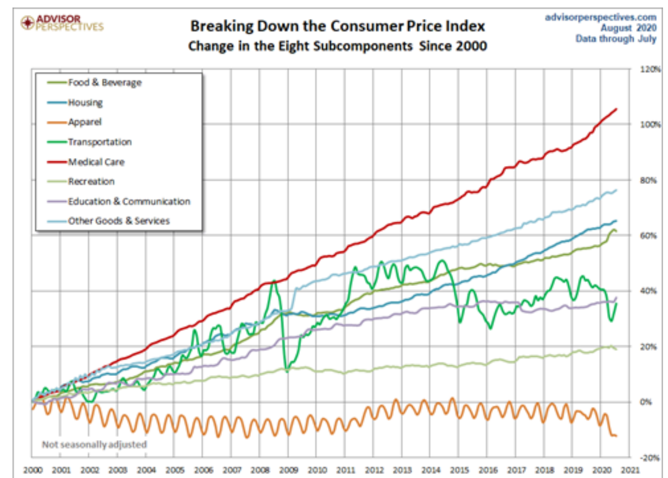
While there are potential risks ahead given the markets rally off the lows, the US elections and the potential for further lockdowns. We remain largely invested but with a defensive element into the uncertainties ahead.

Growth Technology and Innovation thought of the month

Healthcare is the biggest disruption opportunity of them all.

In 2018 the U.S. spent 16.9% of GDP on its healthcare, nearly double the OECD average of 8.8%. Current GDP is around $21 trillion making the USD cost around **$3.5 trillion**! Add to this some estimates that the cost to the US of Covid-19 could approach $600bn if enough people get infected.

This is not helped by the persistently above average inflation (see red line below)



So, the key characteristics of this industry:

- Deep structural cost base
- Massive financial value and incentive
- Significant funding available for R&D
- Major incumbents
- Highly innovative economy

All the pieces of the puzzle are in place for massive disruption and innovation. As such this is one of our key investment opportunities in the ECM Growth and Innovation Fund.