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INTUITION

SPECIAL EDITION: LOCKDOWN, DAY 11

- **The asset management team answer some common questions**

HARVARD HOUSE

We understand your need for FINANCIAL INTEGRITY

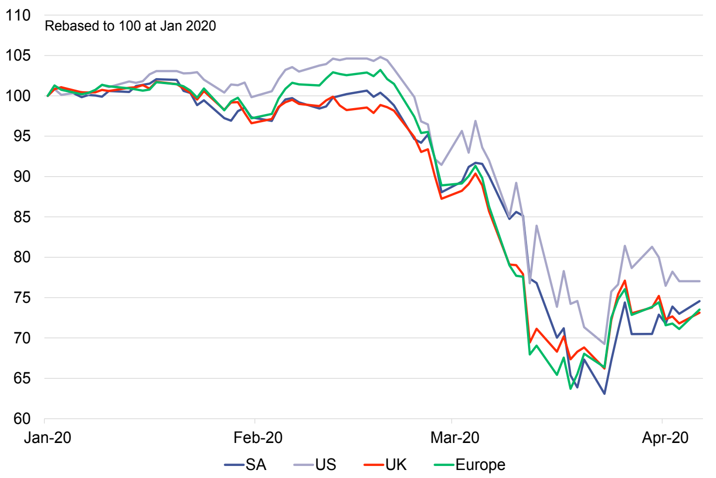
Client statements have been distributed and the picture is bleak. Please summarize what is driving the price action and what "the market" is telling us?

Within the space of just a few short weeks, the global economy has been plunged into one of the most severe recessions in living memory. The difference is that this recession is self-induced – it is as a result of governments around the world restricting the free movement of people, and the ability of businesses to operate normally, in an effort to curb the spread of the virus, and in so doing, prevent a collapse of their respective healthcare systems.

The two charts below help to understand the reaction of markets to this unprecedented event:

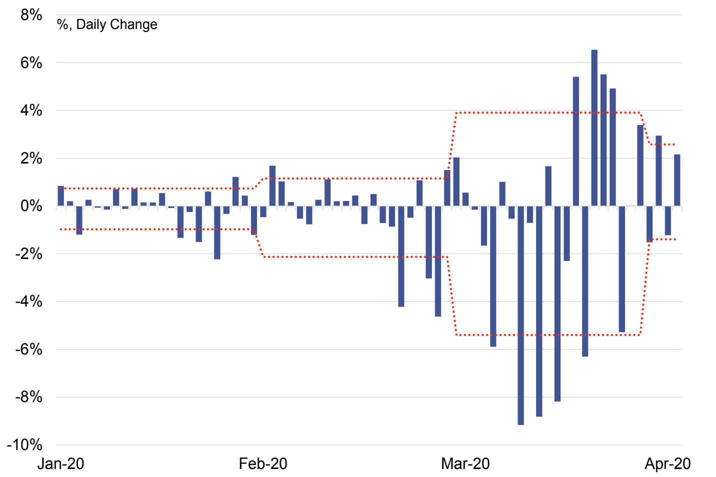
1. The left-hand chart shows that this has truly been a global event. Markets around the world have moved in tandem with each other. The JSE has performed exactly in line with its peers.
2. Secondly, the weakest point for our market was on the 23rd March, in line with the trend for the US and UK. Markets around the world have rallied over the past ten days.
3. Part off this recovery has been fueled by the actions of governments and central banks to limit the damage. Commonly referred to as "Alphabet Soup" because of all the acronyms used to describe the various bailouts, they have been wide-ranging and extensive, and mostly to ensure that markets have sufficient liquidity and solvency to prevent a second round of economic collapse, akin to what happened during the Financial Crisis. This has largely been successful. Fear about a huge wave of corporate and banking failures has largely subsided.
4. A familiar question is why are markets rallying when the news continues to deteriorate? It all comes down to the trend in new infections. Markets have already priced in a recession. The only thing that they don't know is the duration thereof. Indications that lockdowns are achieving the desired purpose of reducing cases points to a scenario of a very sharp, but relatively short, recession. Hence, markets, being forward-looking in their nature, are discounting an end to the severe lockdown phase, and a gradual resumption of economic activity.
5. The right-hand chart shows the daily volatility of the JSE – i.e., the price movement each day (blue bars), and the standard deviation of that volatility for each month (the red lines.)
6. As we know, the year started on a benign note. The global economy was expected to recover post the Trade Wars of 2019. Daily movements were small. February saw a rise in daily volatility, partly due to angst ahead of our own Budget, and then Covid-19 driven at the end of the month. March saw daily volatility rise to a whole new level – with wild swings in both directions.
7. We have only had 4 trading days so far in April, but it is clear from the chart that the level of volatility is falling. Daily market movements are becoming less severe, but there are still swings in both directions – i.e., a positive day followed by a negative day, and

GLOBAL MARKET MOVES THIS YEAR



All markets have fared equally poorly this year. Nonetheless, markets have rallied off their weakest levels, as investors react to government support and improving news about new infections.

JSE: DAILY RETURNS



Daily volatility spiked in March – both positive and negative. So far in April, volatility has declined.

Listed property has been the cornerstone of many portfolios, especially for those drawing an income. Why has this sector been more affected than "growth-orientated" shares?

In the April issue of Intuition, we discussed the listed property sector in detail, and would suggest that clients refer back to that issue for further detail on this topic. However, in a nutshell, we summarize the issues, as follows:

Property has always been considered a safe and defensive asset class, given the long-term nature of lease agreements and the steady rentals those leases generate. That status has come under significant scrutiny over this Crisis, for a few reasons:

1. Rental income is now under threat from all sectors of the property market. For retail properties, it is because of the lack of trading. For offices, it is poor occupancies and the impact on logistics remains highly uncertain given the lack of final demand and retail sales. Nonetheless, there are pockets of strength in logistics and warehousing – namely from online retailers and those requiring extra temporary storage.
   - Those landlords with retail exposure have been the hardest hit. Because malls (and therefore individual shops) have been forced to close. Some large, national retail chains have simply announced that they will not be paying rent for the foreseeable future. In addition, income is being further eroded by the portion of rent that is linked to turnover clauses.
   - If national chains are behaving in this manner, how can one expect smaller "mom & pop" stores to honour their obligations?
   - We question the legality of failing to meet contractual obligations. Our discussions with various management teams indicate that landlords are willing to be flexible, but it has to be a "quid pro quo" situation. That doesn't appear to be the case at present.

2. Concern about rental collections is raising concerns about Loan-to-value ratios (i.e. the amount of debt relative to the value of the underlying property portfolio.) Three points are relevant:
   - Rentals are weaker, and hence there is concern about the ability of companies to service their debt. Most companies have clauses in their debt contracts that state that LTV ratios cannot exceed certain thresholds. The concern is that these thresholds are breached, triggering the need for a rights issue, or worse.
   - Property valuations are by their nature a subjective exercise, taking into account numerous variables (much like the valuation of shares.) With so many unknowns, are property valuations realistic, and could they plummet, which forces LTV ratios even higher?
   - Higher LTVs in turn could force companies to sell properties at fire-sale prices, just to meet banking obligations.

   These are valid issues. Encouragingly, all role-players have joined forces to ensure that "common sense" prevails. Firstly, banks appear to be quite comfortable to relax any LTV clauses, provided debt can be comfortably serviced day-to-day. The focus will shift to Interest Cover Ratios (ICR – the higher the ratio, the more safety there is that debt obligations can be met.) This also solves the problem of volatile property valuations, as banks will not rely on them in their decision-making.

3. One way for companies to reduce LTV ratios is to retain income and not pay dividends. But legislation stipulates that companies must distribute at least 75% of their income to retain REIT status. Failure to do so results in adverse tax consequences, which would further erode value. This is valid, but the Sector has approached both the JSE and SARS to ask for a temporary suspension of this requirement until the Crisis is over.

4. Given that income distributions are under threat, investors are now questioning the rationale for holding property at all. This has ushered in another wave of selling as investors switch into alternative assets.

SA BOND YIELDS

Bonds moved sharply higher when the downgrade was announced, but have since recovered much of the weakness.

5. Property is often priced with reference to the bond market – both being income-focused investments. Bonds have been weak in reaction to the downgrade announcement, although there are well off their weakest levels, as per the chart above.

Many companies have announced a delay or cancellation of their dividend. Will all dividends disappear? How does the loss of dividends impact on our ability to meet clients' incomes?

One of the key factors that we must appreciate about this Crisis is the speed with which events changed. The virus was first detected in late December, and the first the global community really knew about it was towards the end of January. Most of February was very benign. The first case in South Africa was detected on 5th March – close to home for us given that the patient resided in Hilton. Just three weeks later, the country was in an unprecedented national lockdown. It is fair to say that the speed with which events moved caught everyone by surprise.

Against this background, it is only natural for companies to become very defensive. No company had planned for this eventuality, or the implications thereof. Hence, the first priority is to ensure you have sufficient reserves to see this crisis through – which is hard when there is little visibility as to how long the lockdown will last, or when trading can resume. Consequently, a cut in dividends is an obvious strategy that a company can take to preserve cash.

Companies have taken different routes: some have deferred / postponed their dividend to see how conditions unfold; others have cancelled it altogether. Our modelling suggests that dividends could fall by 50% - 75% over the course of 2020 – but this is very sensitive to the length of the lockdown, and the pace of the global recovery. A short lockdown should see dividend payments resume in H2 of this year, albeit at a lower level that what we had previously forecast. A longer lockdown would probably result in the majority of companies choosing to cancel dividends for 2020 altogether.

In those cases where clients rely on income from their portfolios, we have taken action to raise cash to ensure that we can meet monthly incomes for an extended period. **This does imply that income will be paid from capital – there is no other alternative.** However, in mitigation of this:

1. Some companies have already paid dividends this year, so some cash flow has already been received.
2. A high cash balance does ensure that we do not have to sell further shares into potentially weak markets to raise cash for income purposes. In this regard, we would urge clients to resist the temptation to draw extra cash from their portfolios. Higher cash balances are there to secure income, and / or provide us with cash to take advantage of weak conditions to build positions and income streams at extremely attractive levels. Extra drawdowns could force us into a situation where we are forced to sell which could do irreparable damage to your portfolio.

Are the markets, and by implication my portfolio, going to zero?

If anybody is able to paint the outcome of the next few weeks and months accurately, they will be very lucky, rather than very clever. In short, nobody accurately knows the future.

Chaotic events always bring uncertainty and no small amount of fear. We have never seen events that have had as severe an economic impact as Covid-19. Then again, we had never seen airplanes fly into skyscrapers prior to 2001. This, like that, are history-defining events that will shape the future.

There is no doubt that this Crisis will lead to some company failures. Which companies exactly, we cannot tell you for certain. A micro example is the fact that Famous Brands has withdrawn all financial support for its UK subsidiary, Gourmet Burger, for which it paid R2.1 billion several years ago. These restaurants will disappear from the UK market, but whilst the decision will hurt and have a financial impact on Famous Brands, it will ensure the survival of the rest of the organisation. There are others that will thrive and prosper in spite of the circumstances.

This is one of the reasons that we:

- Diversify portfolios among a number of shares, and
- We take profits when a single share becomes too overweight in a portfolio (even though we think it may go up further).

The fact is that every company can go bankrupt given the wrong circumstances. For every share in the market to go to zero however, would imply a complete failure of the economic system and would imply major losses in every asset class, including cash. This is purely because if the whole system fails, the banks will be unable to reimburse all its depositors, since that cash is tied up in lending and they only hold limited reserves. Governments would default on bonds since there would be no companies to pay taxes, etc, etc.

We cannot forecast how long market volatility will last. We suspect it may be elevated for quite some time. News flow will determine the markets daily direction as investors grapple with (and exploit) events around the Virus. We are however, pretty convinced that Governments will act to save economies – actions taken so far exceed those made during the GFC, and therefore reinforce this view. Business will recover and thrive after a period of supressed profits and balance sheet repair. This will cause a strong revaluation and resumption of dividends. Consequently, we have no fear that any portfolio is going to zero, and would consider capitulation as a long-term destructive action to your investments.

How would you advise an investor to look at his portfolio at this point?

The temptation, right now, is to give into one's emotions when looking at your current portfolio value - we would caution against this. As alluded to earlier, the World is reeling from the unknown impact and duration of the Corona Virus – so fear is driving markets and this is clearly reflected in share prices. We are constantly being reminded of negative news on the TV, radio & our phones which only heightens our negative and confused emotions about the present.

During periods such as these, one needs to remind oneself that:

1. The original investment was not made for the present, but rather for the long term,
2. Share prices are forward looking and the market is extremely efficient in pricing in bad news. On the 19th March (the weakest point intra-day), the JSE's Top 40 Index dropped to 34,239 points during the day – only to close that same day at 34,696. It then proceeded to recover to 40,738 (a gain of 19%) by 31st March, yet no one would have known this trend by simply studying their latest statement.

We are not suggesting that the worst is over, but merely illustrating how wild the moves are currently – "irrational" may be a more apt adjective. This is not the time to make irrational decisions.

The mood in our country was dealt a further blow when Moody's downgraded us into 'Junk' territory at the end of March. The temptation to give into our emotions has thus been amplified, especially for South African citizens. It is therefore worth remembering that client portfolios are not solely reliant on the performance of the local economy – they never have been, nor will be in the future. For many years, we have advocated a "barbell" strategy which simply means that your portfolio is exposed as much to global, rand-hedge earnings as to local earnings. Furthermore, it is diversified

across many different industries – such as telecomms, technology, banking, mining and property - depending on the mandate. Currently, the market is pricing in a near-worst case scenario for both local and global earnings due to the global lockdowns – the scale of which is unprecedented in history – which makes near-term forecasting impossible.

However, when the global economy recovers (and it will) those global shares and earnings will be the first to react. Markets are likely to rally when one least expects it. To reiterate earlier comments, missing that early recovery by being too conservative risks irreparable damage to the portfolio. Coupled with this are the opportunities that present themselves in times of crisis, where high quality shares are mis-priced and caught up in the turmoil, often unfairly so. Furthermore, our mantra that "a Company is not a Country" means that for every share in your portfolio, there is a unique business and management team, who are experts in that specific industry, tasked with restoring that business to growth regardless of the country-specific challenges.

We have raised cash holdings across portfolios to ensure that we have the ability to add to current or new opportunities and take advantage of these shares when the tide does turn. The duration of negative news and speed of recovery are unknown. Consequently, when looking at one's portfolio, investors need to apply context, calmness and above all, remain committed to the long term until such time as dividends and earnings recover - which they have done after every single prior global crisis in history.

What is your perception of what lies in store for investors over the coming months?

The answer to this question has been broken down into two sections:

1. Economic growth cycles:

The SA economy was already in a structural decline after the so-called “10 Lost Years” of the Zuma Administration. The Budget Speech in February 2020 revealed some hard facts. Estimates for GDP growth were lowered substantially, as were forecasts for weaker tax revenue. Government’s huge wage bill will need to be addressed – one proposal is to offer 0% wage increases next year.

Although the downgrade to our sovereign credit rating came after COVID-19 started its infectious nature, the criteria for a downgrade have been well communicated in the past. These criteria include our escalating Debt to GDP ratio, Eskom’s structural impact on the economy, unemployment etc. Unfortunately, the lockdown period has exacerbated the impact of all of the above: companies have not been able to trade; staff have been retrenched or suffered reductions in their salaries; Government has been forced to raise expenditure to fight the virus, rather than cutting its expenditure; SAA woes have been worsened, and so the list goes on. Hence the downgrade did not come as a surprise. Furthermore:

- For the 2020 year, SA was already facing the risk of a recession.
- Globally, forecasts for economic growth for the end of 2019 and into 2020 were for a slowdown initially, but then for a gradual recovery as the Trade War subsided. However, the advent of COVID-19 will certainly result in a recession for almost every region of the World. Lockdown or variations of the concept have brought the world to a standstill.

So as an investor patience is the order of the day. Like all global crises previously these are mutually exclusive and we learn from them for when the next invariably comes along. But in the next crisis there is always something new. Corona has literally stopped the global economy in its tracks – there has been virtually no trade activity for a month. The question, as we have already noted, is how long will it last? The list of unknowns and uncertainties is akin to “how long is a piece of string.” Early indications suggest that the impact could be extremely severe over Q1 and Q2 of this year, before rebounding thereafter.

The table below highlights the current GDP forecasts for various economies. At a glance one can see the potential scale of the recession over Q1 and Q2 of 2020.

	Annual Forecasts (%)			Quarterly Forecasts for 2020 (%)			
Country	2019	2020	2021	Q1	Q2	Q3	Q4
USA	2.3	-5.3	4.5	-10.0	-25.0	11.0	7.0
UK	1.4	-3.7	4.1	-10.0	-30.0	50.0	2.5
Europe	1.2	-3.4	4.7	-15.0	-22.0	45.0	3.5
China	6.1	1.1	9.2	-40.8	57.4	23.9	5.6
South Africa	0.1	-7.0	5.1	-10.1	-40.4	35.0	25.0

Source: JP Morgan Global Economics

Based on current knowledge, there is expected to be an equally strong rebound over the remainder of the year. However, the scale and timing of the rebound remain uncertain. There are 3 schools of thought:

1. “V-shaped” recovery - very deep recession and quick recovery over the remainder of 2020 into the first part of 2021.
2. “U-shaped” recovery - sharp recession, followed by a period of “muddling along” with a recovery only towards the middle or end of 2021.
3. “L-shaped” recovery – sharp recession and then slower/lower growth for an extended period of time as the companies all over the world stabilize before growing again.

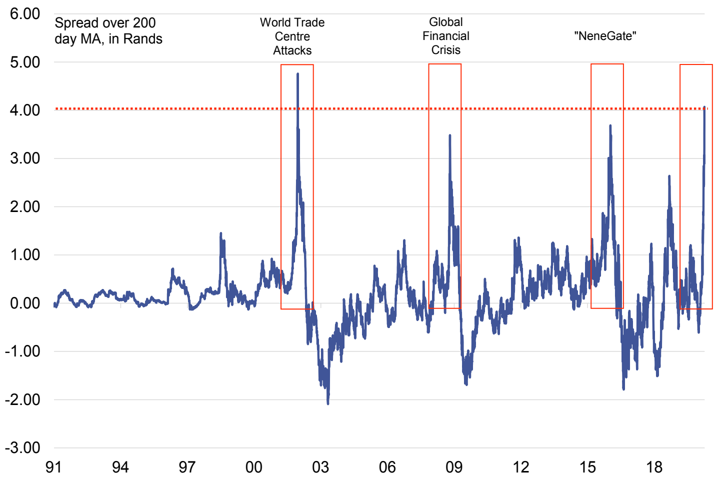
As, suggested by the table above, the consensus is currently erring towards a “V-shaped” pattern, but there is real risk that this extends into a “U” shape, depending on how events unfold over the next 3 or 4 weeks.

2. Everybody has become an expert ….

Thanks to the internet and WhatsApp, everybody has become interpreters and experts of statistics – on all topics. We would encourage investors to know and understand their “sources” when it comes to understanding how that statistic or interpretation of that statistic will impact on your long-term portfolio objectives.

Let us provide an example. The News reads: “The rand is at its worst level ever” and commentators are quick to advise investors ... get out! get out! This is not to say that the currency can’t weaken further. Of course it can. But after any period of extreme volatility, all currencies have a tendency to revert back to some form of equilibrium. This is certainly the case for the Rand. Panic and fear come first, then sanity prevails.

RAND REL TO ITS 200 DAY AVERAGE



Most assets tend to revert to some form of equilibrium after a period of extreme volatility. The rand is no exception.

Finally, and as alluded to in earlier answers, we must accept that volatility is the new norm. Volatility in share prices will remain for an extended period of time. To see share prices falling 25% or even more during a day is becoming increasingly common. The same applies on the upside. For shares to rally 10%/15% in a morning session is not out of the ordinary. Unfortunately, volatility lends itself to panic. What do others know that I don't know? Often the answer to this question is "nothing." Volatility is created by the mixture of erratic views from a wide pool of investors, each with a different objective. Once again, please refer back to April's issue of Intuition for a recap on this issue. Our advice, as then is not to panic in any direction. Think your objectives through. If you are worried, let us help you by providing context and background.

Should I be investing new money now?

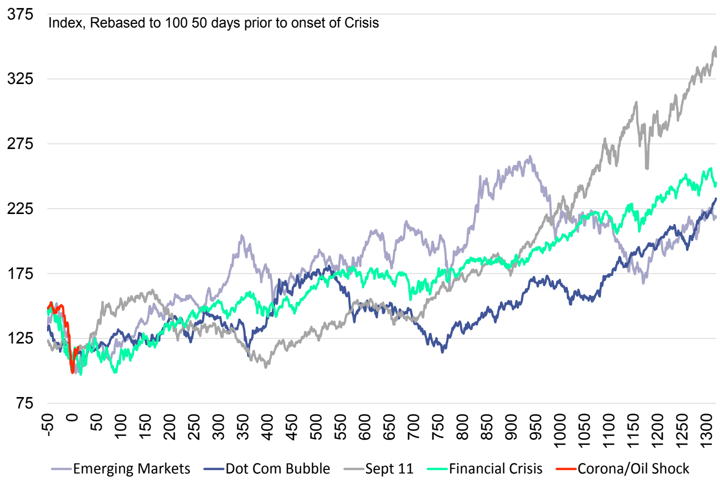
We have had a number of conversations with clients asking whether now is a good time to invest new cash? The answer is a typical economist's one: "yes" and "no".

Yes - from the perspective that history will prove this event as one of those rare buying opportunities that will perfectly illustrate the expression "buy when there is blood in the streets". There are many cases where valuations have become extreme, and are unlikely to last. It is possible however that there may be a lot more volatility in the weeks ahead so we would be judicious with the application. One of the greatest unknowns about events of this nature is the extent of the collateral damage – i.e., how distress in one area feeds through to distress in other, seemingly unrelated, industries – and the propensity for further "left-field" shocks. An example currently is the oil industry – where there is a dual, and coincident, impact from both the Covid-19 disaster (a dramatic decline in demand for oil) coupled with a simultaneous political issue (Saudi initiative to drive smaller players out of the market.) If either issue was the sole issue, market reaction would have been orderly. However, the simultaneous eruption of both has caused severe distress from which some companies may never recover.

Hence the "no" element to our answer. No, we don't think it is time to just buy blindly. Caution is warranted until you are better able to establish what is good value. Everything looks cheap now, but not everything may be quality in the new normal we will shortly face.

Having said all that, IF you have cash that you want to invest, we urge investors to add it to your portfolio account as soon as possible. There is no possible way that we will be in a position to call every investor who wishes to inject new cash to tell them when the time is right. When confidence returns, it will come quickly and we will need the cash to be immediately available if we are to act.

MARKET FALLS AND RECOVERIES



This chart is a reminder that markets fall, but they also recover. It highlights the trend of various crises in the past – from 50 days prior to the onset of the crisis to 5 years thereafter. Invariably, these occasions do provide lucrative entry points.

Given the prevailing circumstances, the speed at which conditions are changing, and guidelines from Government on social distancing, our Insight seminars will be postponed until further notice.

Please RSVP to Clare Mitchell on 033 3302164 or clarem@hhgroup.co.za.

Topic:	**N/A**
Natal Midlands	
Date:	N/A
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opposite entrance to Midmar
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	N/A
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

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