A time of crisis

A butterfly flaps its wings in Wuhan, China

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THE COVID[1] PANDEMIC is first and foremost a human tragedy. At the time of writing, there have been more than 1.5 million confirmed cases and more than 88 500 confirmed deaths. As we all become increasingly numb to these large numbers, we need to keep reminding ourselves that behind each of those numbers is a human story.

As the weeks pass, the depth of the economic devastation and full impact of the virus and its containment measures will be revealed. For those who argue that human lives come first and economics second, the evolution of the economic fallout into a humanitarian crisis will become increasingly clear.

The Covid pandemic is a unique event that is unprecedented in modern times. Consequently, we must be careful, as deeply frustrated citizens, when we harshly judge the decisions made by governments. Although life is always more uncertain than we like to acknowledge, in this case there is just so much we don't know. We have had 15 calls with epidemiologists since early February. The most striking outcome for us has been not what we know about the virus, but what we don't – with a last count of 14 important unknowns.

If you don't have the answer to the most basic questions, such as how seasonal the virus is, whether it can be transmitted by aerosols (and not just droplets), and whether or not those infected gain immunity, how does a government make the impossible choice between suppression strategies over the alternative – pursuing herd immunity?

How does the government of a low-income country, without a social safety net, manage the balancing act of controlling the virus and keeping the economy going, especially since these are fundamentally competing interests? In some of these countries, will the all-in damage to society of a national lockdown exceed that of simply letting the virus run its course? How do you even measure these things?

Countries have managed the epidemic in very different ways. This matters enormously, for both the long and the short term.

Due to the lack of any immunity or treatments, governments have resorted to 'non-pharmaceutical interventions' to limit the spread of the virus. These range from targeted measures such as large-scale testing for the virus, isolation of infected individuals, contact tracing of people with whom they have come into contact, and quarantining people who have been exposed to the virus; to more indiscriminate measures such as social distancing. The most extreme form of this is restrictions on the movement of all people via regional, or even nationwide, lockdowns.

[1] Note from the authors: for simplicity we have used the term Covid to describe both the virus ('SARS-CoV-2') and the disease ('COVID-19') caused by the virus.

The choice of which measures to implement, and when, has varied across countries. First prize is the early use of targeted measures, which, if executed well, reduce the need for more heavy-handed and indiscriminate measures later. This is the path taken by most of Asia (China, Hong Kong, Singapore, South Korea and Japan). Responses differed, but the region has, to date, handled the epidemic very well and consequently has added to our conviction that Asian equities offer great value. The region benefited from:

- the experience it had with the outbreaks of SARS in 2002/2003 and MERS in 2015;
- more compliant societies (often with less civil liberties); and
- superior surveillance capabilities and very digitised societies (for example, in China, the QR code on your smartphone will change from green to red if someone you have been in close contact with subsequently tests positive).

South Korea and Singapore have thus far avoided the extent of lockdowns seen across much of the world by acting early (crucially important given the exponential transmission of the virus). They also deployed widespread testing, contact tracing and quarantine measures in a very effective manner.

China was initially slow to react, and therefore had to implement a combination of the measures used by Singapore and South Korea, and some drastic restrictions on the movement of people in the affected areas. All three countries have thus far controlled their outbreaks, with much fewer cases per capita than some hard-hit western countries, despite having been nearer to the initial epicentre of the pandemic. Across Asia, freedom of movement is improving, and economies are slowly recovering.

The main reason for Asia's success is that they acted early and with the full gamut of targeted interventions, especially the widespread testing of suspected cases. Countries that do not, or cannot, do something similar are at risk of much more extensive outbreaks. The cruel feedback loop is that the worse the outbreak becomes in a country, the exponentially more difficult it becomes to control. And as it overwhelms the healthcare system, the worse the disease's infection fatality ratio is likely to become.

This has left many countries with seemingly little option but to enact unprecedented restrictions on the movement of people. The US is a great example of this. It squandered its many advantages and is likely to prove a case study of government failure in crisis management:

- Being further from the epicentre, it had more time to take decisive action early on.
- Although wealthier than South Korea (with a roughly 50% higher GDP per capita on a purchasing power parity basis) and with deep institutional knowledge of the control of infectious diseases, it failed to roll out the necessary testing, contact tracing and quarantining processes.

The US is now seeing rapid growth in case numbers. This has left it with little option but to use lockdowns to contain the outbreak. As we write, three out of every four Americans are now under orders to stay at home, causing significant disruption to everyday life and the economy.

In the UK, the government initially proposed a strategy of gradual restrictions to allow for herd immunity to build up in its population. It then swiftly changed course, adopting strict social distancing measures when it became evident from epidemiological modelling that their initial strategy could quite easily overwhelm their healthcare system. The UK subsequently entered a three-week lockdown on 23 March.

Both the US and the UK wasted precious time and squandered an opportunity to respond to the virus in a manner much less damaging than the measures they have ultimately been forced to take.

Developing countries, most of which are in earlier stages of their outbreaks, face substantial challenges. Although they have the benefit of younger populations and a slight head start in preparing for the virus' arrival, in many instances, these countries are unlikely to have the resources to carry out mass testing of suspected cases as well as other measures, such as contact tracing and isolation/quarantining at the necessary scale. Many also have high disease burdens, and healthcare systems that are more fragile and have less spare capacity to absorb the added burden from a flood of Covid patients.

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As such, developing countries have fewer tools available and may be more inclined to resort to heavier-handed tactics, and sooner in their outbreak timelines. For example, on 24 March, India declared a three-week nationwide lockdown of all 1.3 billion of its citizens, despite having only around 500 confirmed cases of Covid at the time. This is a staggering move by the world's second most populous country.

It is also an unfortunate reality that many developing countries don't have the ability to implement the unprecedented fiscal and monetary stimulus being deployed in many developed countries. The >

citizens of these countries are, in general, less able to insulate themselves from the economic fallout that measures such as lockdowns will unleash. And, regarding the question of social unrest, although lockdowns may be effective in developed countries, one has to question whether this is possible in the more cramped and unsanitary conditions of many emerging nations.

Sadly, unless their demographic advantage turns out to be material, many developing countries are likely to see significant damage from a public health and economic perspective. Some may have little option but to prioritise their economies and choose the herd immunity route that the UK abandoned.

HOW THE PANDEMIC IS LIKELY TO PLAY OUT

Many decisionmakers around the world are now grappling with what happens next. The first point we should make here is that no-one knows how this will play out. Anything could happen. The only way, therefore, that we can think about it is probabilistically.

Lockdowns in most countries could well go on for longer than their initial three-week goal (for context, the lockdown in Wuhan lasted for two months and is only now slowly unlocking). Prolonged lockdowns are likely to be ruinous for the global economy though, and many are now asking if the remedy is not worse than the disease? The conundrum is obvious; if restrictive social distancing measures are relaxed too far or too fast then, as has been seen in past pandemics, there will be second 'waves' of infection. There is no easy way out.

The ultimate exit is a vaccine; this will provide the necessary herd immunity to protect the global population, especially the most vulnerable within it, without having to rely on them having been infected with the virus itself. There are currently a few dozen vaccine candidates in development, some already in clinical evaluation in humans. There is a high probability that an effective vaccine will be developed; the problem, though, is how long it will take.

Vaccine development timelines are typically measured in years, not months, with the average vaccine taking eight to 10 years to develop. There are numerous measures being implemented, as well as unprecedented amounts of capital available, to compress this significantly. Experts are relatively confident that there will be, with a bit of luck, a Covid vaccine within 18 months. It will take some time to scale it to a global level. There are newer vaccine technologies that are being looked at that could yield a vaccine sooner than this, although they are relatively unproven in humans and their likelihood of success is lower (and regulatory scrutiny is higher) than traditional vaccine approaches.

There are also numerous existing drugs (for example, antiretrovirals used in HIV patients) that are currently being examined for 'repurposing' as a treatment for Covid infection. They have the benefit of already having been approved by regulators for treating other diseases, so, if effective against Covid, they could be approved and rolled out rapidly. These treatments will not prevent infection, but only treat it and, in so doing, reduce the need for hospitalisation – they are only a stopgap, we will likely still need a vaccine.

A few of these drugs have displayed promising results in lab and animal studies, and some even in small-scale human clinical trials, but more trial data is required before we will know for sure if any of them will work. This data should be released in the weeks ahead.

If one or more of the above treatments prove effective, it could materially change the current status quo. But it is not a given that any will be successful; drug research and development is an endeavour with a notoriously high failure rate. If none prove to be a game-changer, then the only light at the end of the tunnel is a vaccine.

UNLOCKING THE LOCKDOWNS

Must we all now sit at home for 18 months waiting for a vaccine? This isn't an option. Most likely we will see a period of rolling restrictions on movement that snap on and off when certain triggers (e.g. total case numbers or rate of ICU bed utilisation) are breached. We wonder whether societies have the endurance this would require. The economic and social costs will likely be staggering. Conversely, allowing the virus to spread unfettered would almost surely be a public health disaster and carry with it its own social and economic costs. Barring a breakthrough on the treatment front near-term, there is seemingly no obvious way to break this impasse.

The lockdowns won't end the pandemic, but they will buy us time. Much will depend on which countries use the time well. Those that use it to build the infrastructure and processes needed to contain future community transmissions and to win citizens over will come through this immeasurably better.

WHAT DOES THIS ALL MEAN FOR SOUTH AFRICA?

The spread of the epidemic to South Africa sparked a market crisis that has felt just as serious and

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existential as the Global Financial Crisis (GFC) did in 2008/2009. For a few days, South Africa was the only major country in the world to have announced Covid suppression measures without the requisite fiscal and monetary emergency measures that any modern economy requires if it is to survive an economic full stop of this nature.

At work we found ourselves, for a brief period, having to navigate a simultaneous paralysis of four systemically important markets (the interbank, the repo rate, and the corporate and government bond markets).

Nonetheless, as stressful as financial markets have been over the last few weeks, we are bracing ourselves for greater difficulties ahead. South Africa is a fragile place, making for a difficult road ahead:

1. **A long list of obvious vulnerabilities,** namely high levels of poverty that compel people to work through illness; densely populated townships; large numbers of people with compromised immune systems; a dependence on crowded public transport; a limited social safety net; and, finally, the onset of winter (notwithstanding uncertainty of how seasonal the virus is, winter isn't good for respiratory diseases).

2. **A public healthcare system that was already failing.** We have watched with dismay as some of the world's best public healthcare systems have been overwhelmed by Covid and forced into rationing their healthcare facilities.

3. **Enforcing the lockdown.** Enforcing a lockdown in South Africa feels to us to be a fundamentally impossible task, given limited means of enforcement and crowded living conditions (how do you ask someone that lives five people to a room not to leave that room for 21 days?). For people on the poverty line, bulk-buying food isn't an option – they need regular use of public transport to buy food and to collect social grants (which, unfortunately, were due a few days into the lockdown).

4. **Use of the lockdown period.** As mentioned, the lockdowns won't stop the pandemic, but they will buy us time. In the case of South Africa, we question whether government has the funding and the organisational structures needed to procure the requisite number of ICU beds and ventilators, and to build the testing, contact tracing and quarantine infrastructure that it will need if it is to successfully release society from its lockdown.

5. **Managing the epidemic after the lockdown.** Aside from our doubts that we lack the testing, contact tracing and quarantine infrastructure to execute on a national scale, the bigger question is probably: with so many people on the breadline, would we have the societal endurance for such a prolonged fight against the epidemic anyway (while we await a medical breakthrough)?

6. **The economy and government finances were on a knife-edge before this.** This is the one that worries us the most. In contrast to the healthy growth that most of the rest of the world was enjoying, South Africa has been in recession for some time. Job losses, fiscal deficits and government levels of indebtedness were all at alarming levels to start with. As a consequence, we simply don't have the financial wherewithal needed to absorb and counter the coming economic and humanitarian fallout. Will this end up dwarfing the Covid crisis? Is the cure worse than the disease itself? It's a question we too ask ourselves every day...

WE SIMPLY DON'T HAVE THE FINANCIAL WHEREWITHAL NEEDED TO ABSORB AND COUNTER THE COMING ECONOMIC AND HUMANITARIAN FALLOUT.

This is not to say that South Africa has no chance in fighting this:

1. We have the precious headstart of time as the virus took longer to hit Africa. This is crucially important when you are fighting an exponential growth curve. Recent research tracking infections confirm this, with South Africa stacking up well against other countries (almost entirely because of the early and decisive actions taken).

2. We have a very young population by global standards (fatality rates are very low for people under the age of 50).

3. Our hospital bed/population ratio stacks up well against international peers.

4. We have been encouraged to see the government acting more decisively of late (perhaps because the crisis has made it easier to put aside the worst of its paralysing factionalism). There even appears to be a determination to use this crisis to drive through some of the structural reforms that South Africa desperately needs.

5. The public and private sectors are working well together to fight this, something that we never really got right in the past.

PORTFOLIO POSITIONING AND CONCLUDING THOUGHTS

Notwithstanding a barrage of bad news since the *client note* (18 March) we wrote almost three

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weeks ago, I'm sure it would surprise many to hear that most markets have given positive returns since then (S&P +5%, the JSE Capped SWIX Index +13% and the All Bond Index +2%), although not enough to prevent some of the worst returns in decades. In times of crisis, the market always acts as an efficient discounting machine, hence the ruthless manner in which the Covid tragedy has been priced into risk assets, with all sorts of records broken by the extent and the speed with which markets collapsed in February/March.

Many clients have asked us whether one shouldn't prioritise preservation of capital in these uncertain and trying times. This is a difficult question to answer, regardless of what we think the right answer is. This is not an easy time for anyone. Tragedy surrounds us all. Every stakeholder in our society (citizens, business, government) faces unprecedented uncertainty as they watch their incomes dwindle and their balance sheet stresses build. In times like this, watching one's life savings get hammered is a galling experience.

The temptation to give in to one's emotions is enormous. But to do so would be a big mistake. Investing is always an exercise in conquering one's emotions. In times of bad news, asset prices will almost always be low. The primary objective of investing is to own more when prices are low and to own less when prices are high. As tempting as it is to 'go to cash', we do not believe that this is the right answer. As tragic as the Covid epidemic is, we will come out the other side. And when that happens, most economies will benefit from pent-up demand, unprecedented fiscal and monetary stimulus, and record-low oil prices. Markets are likely to rally when we all least expect it. Will it be a medical breakthrough (which could happen at any time)? Will it be the point of peak infections? Will it be the lifting of lockdown? Who knows?

A long time horizon has been the cornerstone of Coronation's success of many decades. Every crisis we have lived through (and the list is getting long!) has presented an outstanding opportunity for those investors prepared to take the long view. We currently find ourselves swimming in stunningly cheap assets. We have been astounded by some of the long-term opportunities that have been on offer in the last few weeks. The list of stocks, in both domestic and global markets, that our analysts believe offer more than 100% upside (to their underlying intrinsic value) is a long one. This valuation process has been updated for our entire universe of stocks, fully capturing our best estimate of the economic downturn, and the path dependence that companies with stretched balance sheets often experience in times of stress.

Although positions will vary, the following key features are common across our fund range:

- **In our multi-asset class funds, we have moved from an underweight to an overweight equity position over the last two weeks.** We have closed out the puts that protected us from the worst of the early declines and bought some equity exposure at lower levels. Notwithstanding this, we don't feel that we have reached the point of capitulation quite yet, and we have therefore put cash aside to buy in more meaningful size, should that point come.

- **We believe that *both* domestic and global equities are attractive to any long-term investor.** This is in contrast to our view throughout 2019, where we felt that global equities were fully priced.

- **The current turmoil is providing a unique opportunity to buy high-quality stocks at great prices.** This is the case across both domestic and global markets, and we have taken advantage of it across all our equity mandates. It is not often that one gets the opportunity to buy great businesses, with excellent management teams, at low prices. We are confident that these stocks will give investors good risk-adjusted returns, even if the tough economic environment endures. As an example, the Coronation Houseview Equity Fund currently has a 77% exposure to high-quality companies. This is the highest it has been in 20 years.

- **In multi-asset class funds, we have held, and even increased, our domestic bond holdings.** These now offer double-digit yields. The risks are clearly high, given worryingly high levels of government indebtedness, but we think this is compensated for in yield.

- **We remain concerned by thin credit spreads in the local fixed income market.** Elsewhere in the world, credit spreads have blown up, as investors who were reaching for yield are being forced to price in a significantly higher risk of default. In South Africa, the market is thinly traded, and limited re-pricing has happened. If the market does become stressed, we would actively look to deploy cash into attractively priced credit, be it new issues or credit that has to be sold in the secondary market. The GFC provided a once-in-a-lifetime opportunity to do just that. We hope to get that chance again.

EVERY CRISIS WE HAVE LIVED THROUGH HAS PRESENTED AN OUTSTANDING OPPORTUNITY FOR THOSE INVESTORS PREPARED TO TAKE THE LONG VIEW.

- **Developed market bonds.** We remain extremely negative about this asset class. We are very uncomfortable with government levels of indebtedness and we question whether future generations will ever be able to repay this level of debt.

- **Inflation.** We have become concerned that the very long-term consequence of all this fiscal and monetary stimulus will be monetary debasement. We have all lived through two decades of declining inflation. Most central bankers have never experienced inflation. Their jobs have become one of stimulating economies and bailing markets out of crises. The risks feel very asymmetrical to us and we think it makes sense to avail oneself of long-term inflation protection, even if it is not something that is likely be rewarded in the next year or two. ✚