How are financial markets flourishing when economies are falling apart?

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For Financial Advisors and their Clients

It goes without saying that we live in extraordinary times. The South African economy had never faced such an abrupt cease in trade and/or economic activity as with the commencement of the nationwide lockdown on 27 March 2020. The same can be said for other economies around the globe. As economies start to reopen, many investors have been left scratching their heads – the recoil in financial markets painted a very different picture from the economic outlook. How is it possible for financial markets to increase in value, but the economy is shrinking?

It is not surprising that markets experienced some of the sharpest falls in asset prices during the first quarter of 2020. As can be seen in the below graph, the JSE All Share Index lost more than 30% from the start of the year until 23 March 2020. Also apparent in the graph is the speed of the recovery thereafter – since 23 March 2020 (the bottom of the sell off), the market is up more than 40% (as at 31 July 2020) making COVID-19 seem like a mere short-term disruption.

The economy, however, tells a very different story. A 30% contraction is predicted in second-quarter gross domestic product (GDP) (on an annualised basis) and unemployment is expected to surge to 35%.

JSE All Share index price movements if R100 was invested on 01 January 2020

Source: Morningstar Direct as at 30.06.20. Forecasts are not a reliable indicator of future performance. For illustrative purposes only.

Let's have a look at financial markets in more detail, more specifically the equity market.

Equity market

The equity market is forward-looking and prices of stocks/shares/bonds (any listed liquid instrument's) are determined by the supply and demand of investors. Investors that are buying these instruments are expecting positive outcomes looking forward. Sellers, on the other hand, expect the price of the stocks/shares/bonds to decrease in value.

So how do you know if you should be buying or selling? Ultimately, you need to consider the value of the company. The intrinsic value of a company can be estimated by taking its future expected earnings and discounting the future cash flow with an appropriate discount rate to ascertain what the value of those future earnings are worth now (or at the time one buys the listed equity).

The factor that has changed most notably in the above equation is the significant drop in interest rates - not only in South Africa but globally as well. With interest rates decreasing with 3% since the start of the year, the discount rate being used to calculate the worth of future earnings is now significantly lower. This will result in future earnings being worth more today than before the interest rate cuts.

When the economy is slowing, the South African Reserve Bank (SARB) cuts interest rates to stimulate financial activity. This benefits businesses in that they enjoy the ability to finance operations, acquisitions, and expansions at a cheaper rate, thereby increasing their future earnings potential, which, in turn, also leads to higher share prices.[1] The reduced financing cost also increases future earnings figures.

Companies also have control over aspects that contribute to the current value of the company. Companies can use times of uncertainty as justification to cut their cost base and in doing so increase their bottom line/earnings. In other words, the leaner operational costs will result in higher expected future earnings.

In short, market crashes reset valuations of listed companies and provide investors with the chance to invest into opportunities that might not have been available, or an even an option previously due to prices being too high. This 'opportunity' buying cycle subsequently drives up market prices.

The last factor that can't be ignored, and one that is especially important in the South African landscape, is that listed companies that sell products offshore are not reliant on how the South African economy performs. These shares are more broadly known as Rand Hedges (with the weaker Rand also working in their favour).

[1] Source: https://www.investopedia.com/investing/how-interest-rates-affect-stock-market/

Local government and economy

In contrast with forward-looking equity markets, Government GDP numbers are backward looking. GDP is the value of goods and services produced/rendered in a country during a certain period. It provides a snapshot of a country's economy, and it is used to estimate the size of an economy and its growth rate.

Due to stringent lockdown, rules in South Africa, several sectors came to a complete standstill and, therefore, did not contribute to growing our GDP rate. As an example, in South Africa, GDP numbers are highly dependent on mining, agriculture, manufacturing and construction (to name but a few) – most of which had to halt operations for quite some time. In addition, many of the companies that contribute to our GDP numbers are not listed entities but rather privately held and/or small business.

Unemployment is another number that has a different effect on economies when compared to listed companies. When a company retrenches employees it immediately lowers the expenses of the business and can potentially grow earnings (if income is unchanged) but the opposite is true for an economy. When someone is retrenched and they can't find an alternative job, they move from being paid by a company to being paid by the economy and thus increasing the expenses of the government.

In closing

The sustainability of the equity market rally remains to be seen. For investors, it would be prudent to look beyond the overconfidence and optimism of the current equity rally as well as the pessimism of the second-quarter economic data. The most relevant indicators are to be found in company operations, specifically earnings from listed companies. In the end, that's far more insightful than equity market exuberance.

[1] Source: https://www.investopedia.com/investing/how-interest-rates-affect-stock-market/

Risk Warnings

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[1] Source: https://www.investopedia.com/investing/how-interest-rates-affect-stock-market/