Tackling the frequently asked question - How are financial markets faring well when economies are shrinking?

Morningstar Investment Management South Africa

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For Financial Advisors and their Clients

The seeming disconnect between the performance of financial markets versus that of economies across the globe has left many investors scratching their heads. We often get asked how is it possible for financial markets to increase in value, but the economy is shrinking?

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 started to reopen, many investors have been left scratching their heads – the recoil in financial markets painted a very different picture from the economic outlook.

It is not surprising that markets experienced some of the sharpest falls in asset prices during the first quarter of 2020. The JSE All Share Index lost more than 30% from the start of 2020 until 23 March 2020. What was surprising to see was the speed of the recovery hereafter – since 23 March 2020 (the bottom of the sell-off), the market is up more than 70% (as at February 2021) making COVID-19 seem like a mere short-term disruption.

The economy, however, tells a very different story, with one of the largest contractions in GDP ever recorded, coupled with sky-high unemployment numbers.

How are financial markets flourishing when economies are falling apart? 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 2020, 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).

If one looks at every company listed on the South African stock exchange (the Johannesburg Stock Exchange or JSE), the majority of companies are not reliant on the South African economy to generate earnings. These are companies with business interests that are either predominantly outside of South Africa or entirely outside of South Africa.

In fact, 69% of the revenue generated by the top 40 companies listed on the JSE was generated from outside of South Africa for the 2019 calendar year[2]. In essence, when you are investing in the South African equity market (as represented by the Top 40), only 31% of company revenues are reliant on the South African economy[3].

This is possible due to the fact that some of the largest companies on our stock exchange are dual-listed companies. In other words, these companies are listed on more than one country’s

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

[2] Source: Ninety One Asset Management as at 31 May 2020

[3] Source: Ninety One Asset Management as at 31 May 2020

stock exchange. For example - the BHP Group is listed on the London Stock Exchange as well as the Johannesburg Stock Exchange. While the BHP Group used to have operations in South Africa, currently the company does not generate any earnings in South Africa.

There are many similar examples on our stock market and most of these companies carry larger weightings in the index. We call these rand hedge shares. In short, if the rand weakens, it is a benefit to own these shares as they generate earnings in offshore currencies. So, as an investor, you are hedging your currency exposure even though you are investing in a South African listed equity.

Local government and economy

In contrast with forward-looking equity markets, Government GDP numbers are backwards-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

Investors too often redirect their attention away from the destination to the journey when faced with a lot of outside noise. Much like in other walks of life, we can lose focus, making us susceptible to capitulation or giving up at the moments when fortitude and resolve pay off most.

Patiently allocating to assets that will help you achieve your financial goals should remain key. So, if you catch yourself getting down about the state of our economy, or speculation around government policies or trying to predict what is next, always remember why you are investing in the first place.

There's no doubt that the current market conditions are unsettling. It is at these moments that we would discourage investors from making changes that could harm their ability to reach their financial goals. It is often during these difficult times that we have the greatest opportunity to add value for our clients, acting rationally when others struggle to do so.

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