MANAGING INVESTMENTS THROUGH THE CORONAVIRUS MARKET SELL-OFF

PRUDENTIAL INVESTMENT MANAGERS

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Following our President's announcement last night of a nationwide lock-down, South Africa now joins many countries around the globe in an attempt to mitigate the impact of the Coronavirus on our country and its citizens. Prudential had already implemented measures to allow the full functioning of our business remotely, and as a company and individually the effort to 'flatten the curve' of infections is forefront of mind. The negative impact of the Coronavirus has made itself felt in nearly every corner of the globe, taking a heavy toll on human lives, economic growth prospects and financial markets.

Uncertainty prevails for now

These are uncharted waters where the near-term result of the interaction between global lock-down with massive monetary and fiscal stimulus is uncertain. There are echoes of the Global Financial Crisis (GFC), but unlike then, this is not at the outset an issue of leverage and irresponsible lending. Further, policy action has been swift thus far, which would give reason for cautious optimism - but acute market volatility is the outward manifestation of the uncertainty.

I'm sure many unanswered questions rattle in your minds: 'For how long?', 'How much stimulus and when will it work?', 'Will the world ever be the same?'. We don't know the answers to these questions because no one does. Jerome Powell, Chairman of the US Federal Reserve, said as much on 3 March when they implemented their first 50-basis point emergency rate cut (and since have announced a great deal more). What we do know is that markets are in many cases priced more cheaply than they were at the worst of the GFC and the risk of generating a permanent capital loss through selling extraordinarily cheap assets has never been higher.

"Risk-off" and forced liquidations overtakes fundamentals

All types of assets, including many traditional safe-haven assets like gold, have been hit by the wholesale selling, which we believe is largely attributable to forced liquidation by many leveraged investors needing urgent liquidity. Price action has thereby become divorced from market fundamentals as margin calls and investor redemptions have forced managers to sell their most liquid assets, a phenomenon that may also be a factor in driving our own government bond yields to almost 20-year highs. Moves have been exacerbated by shifts in investor risk preferences and a shortening in investment time horizons and selling of "risk assets" has been widespread. US Investment-Grade and corporate bonds, US high-yield bonds and of course all emerging market assets have sold off relentlessly in the panicked "risk-off" environment. The US dollar as the global reserve currency has benefitted from its safe-haven status along with the rapid US monetary response; while emerging markets have unfortunately been on the receiving end of this.

Below are the returns recorded by each asset class for the year so far to 20 March 2020.

ASSET CLASS	YTD PERFORMANCE AS OF 20 MARCH 2020 (% TOTAL RETURN IN RANDS)
SA Equity (FTSE/JSE Capped SWIX)	-32.3
SA Property (All Property Index)	-46.9
SA Bonds (All Bond Index)	-13.6
SA ILBs (FTSE/JSE ILB Index)	-11.1
SA Cash (STeFI Composite Index)	1.5
Global Equity (MSCI ACWI Index)	-13.0
Global Emerging Markets (MSCI EM Index)	-9.5
Global Bonds (Barclays Aggregate Bond Index)	21.1
Global Property (FTSE EPRA/ NARIET Global REIT Index)	-25.5
Rand/US dollar (price move)	-25.6

Source: Morningstar

South Africa has been among the worst hit because our rand, bond and equity markets are among the most liquid. **Please see our new video "Global View on Coronavirus Market Sell-off" which specifically addresses our views on the global sell-off by Marc Beckenstrater, Lead Portfolio Manager of our Prudential Global Funds at M&G Investments (UK).**

Getting worse before it gets better

The ultimate severity of the global economic downturn can probably only be gauged once the virus is contained and global society returns to some form of normality, but its humanitarian and economic impact can hopefully be mitigated by the numerous measures governments around the world have been taking. The second quarter will undoubtedly witness GDP declines more severe than anything seen in the post-war environment. Forecasts of US Q2 GDP are being revised lower precipitously, and the President of the St. Louis Federal Reserve, James Bullard, recently cautioned that a GDP number of -50% q/q annualised is not implausible.

Global unemployment will surge as companies seek to cut costs and conserve cash in order to come through 'The Stop' intact. Debt relief, lower rates, forbearance from landlords on rents, suspension of mortgage payments, direct payments to workers who have lost their jobs and many other initiatives are all being implemented around the world. The West's playbook is combining the best of the responses from the GFC with new and innovative thinking. China has led the way: Wuhan city in China, once the epicenter of the pandemic, is a good example of the possible future for the rest of the world given the significant slowdown in transmissions and relaxation of some restrictions there, although it is still early days.

South Africa has been potentially fortunate that our government has been able to learn from other countries preceding ours in dealing with the virus, in terms of both a response to the pandemic and aggressive economic stimulus. More needs to be done and details are still lacking as to how schemes will be funded and implemented, but there can be no doubting the seriousness of the response. However, we know that these measures do take some time to work. Some damage has already been done and more will yet unfold.

It is this uncertainty that is not allowing financial markets to find a "correct" value at which to price risk, making it impossible to know when asset prices of all kinds will stabilise. This is not a classic 'risk off' event along the lines of 9/11, the Invasion of Iraq or Nene-gate; there are real fundamental effects on company earnings and balance sheets, on rental incomes from property, on credit ratings, on consumer incomes, on government debt and on bad loans for banks - and no country, sector or asset class will be left untouched. However, whilst attempting to hold on to this reality, it is vital to appreciate that this is not a permanent state of affairs. Assets are being re-priced as if growth will not return, or at least not for a prolonged period, and that 'The Stop' will endure. History suggests otherwise; Spanish Flu that killed an estimated 50 million worldwide in 1918/19 didn't stop a huge global stock market rally in the 1920s, and more recently, the post-GFC world saw five years of extraordinary growth in company earnings and global equity markets. Absent hyper-inflation or nationalisation of assets, losses will be temporary unless you have divested from risk assets and fail to share in the recovery when it comes.

Continuing to actively manage our client portfolios

Practically, as the financial market fallout from the Coronavirus has worsened, Prudential has continued to actively manage our client portfolios, positioning them to both help mitigate losses and take advantage of potential opportunities to add value where possible.

It's important to note that our portfolios are able to absorb some level of market shock due to the manner in which we construct them. Prudential has always been a risk-cognisant manager. We appreciate that not every investment idea turns to gold and that positions must be scaled and diversified appropriately. We diversify across asset types, geographies and currencies. We limit exposures to any one stock or corporate bond all because there is an acute appreciation that we do not know the future, and unexpected events can and do occur.

As recently as two weeks ago there was no forecaster suggesting US GDP might fall by 10%, 20% or 50% (q/q annualised) in Q2 – now there are many. Financial markets humble participants regularly. Argentina has defaulted now seven times over the century; it didn't stop them issuing a 100-year bond just a few years ago and many global investors taking that up. Memories are short and desire for outlandish returns has left markets exposed once again.

Complicating risk control in the short term is the fact that in a crisis the correlations of assets rise. Multi-asset portfolios comprising a diversified set of stocks, sectors, markets and countries whose returns would not normally move together, have now become highly correlated. Everything is tarred by the same broad brush; specifics matter less than loss aversion. "Sell it", "hedge it", "abandon ship" are heard often right now; but these are not actions that can create long-term value for clients.

Taking a long-term view

At Prudential our process looks forward beyond five years. It is a "look to the horizon" view that seeks to avoid staring at the storm breaking all around us, while instead asking the critical questions of who will be the long-term winners, who has the balance sheet to weather the turbulence, who owns real assets, brands or intellectual capital that will have enduring value. In this crisis, it is probable that some companies with high levels of debt may fail, even with monetary and fiscal help. Our analysis therefore doesn't ignore the demand destruction that is unfolding around us, it is simply that our core investment focus is not what presents right in front of our noses. It is beyond that - past the current turmoil and into calmer waters where fundamentals will once again begin to operate.

In the short term, given the magnitude of the sell-off, our portfolios have unfortunately also reflected the reductions in value. Nothing has been immune, especially not in an emerging market like our own. Price has driven price as investors liquidate simply because the market has fallen. This is presenting outstanding long-term investment opportunities, but with the storm raging and considerable uncertainty as to when it will blow itself out or what the landscape will look like once it's dissipated, market participants remain in a "risk-off" frame of mind. As I discuss below, with our eye to the horizon we have been tentatively adding to certain assets and stocks, while maintaining our focus on risk positioning and the long term. It is a process that has served us and our clients well and we remain committed to it.

Following are more detailed comments on how we have been managing our house view client portfolios in the past few weeks.

Reducing global equities in favour of local assets

We have been overweight in global equities for some time now. Global equities were already more expensive than SA equities prior to the downturn, and have fallen less than the local market. On top of this, the rand has depreciated by over 20% against the major currencies. We have taken advantage of this by reducing some of our global equity positions to buy more cheaply valued but high-quality SA equities and SA nominal bonds (therefore also buying cheap rands with expensive foreign currency.)

Remaining underweight developed market government bonds

We have been underweight developed market government bonds given the negative real yields prevailing, and their unattractiveness relative to global equities. Thanks to the flight to safety and aggressive interest rate cuts by central banks, these yields have moved even more negative. We continue to stay away from these assets and instead hold US and European investment-grade corporate bonds and selected emerging market government bonds which offer very attractive real yields. These assets have suffered as investors have sought sanctuary elsewhere, but in some cases are priced in line with the worst of the GFC conditions.

Buying selective SA equities

The SA equity market was already trading at a very attractive price-book value ratio of 1.5X before the Coronavirus hit markets, and we were therefore overweight SA equities in our portfolios. It has now fallen to 1.0X, some 20% cheaper than it was during the GFC. Even though the recent sharp pull-back in prices has hurt our portfolios, we think this provides a once-in-a-generation opportunity to acquire selected good quality domestic stocks that we are now taking advantage of. **Watch more about our view on SA equities and our response in our new video "Equity View on Coronavirus Market Sell-off" by Ross Biggs, our Head of Equity.**

Although some SA companies could see revenue and earnings drop in the near term as the impacts of the temporary near-shutdown of the global and local economies make themselves felt, as the crisis recedes and is brought under control we do not expect COVID-19 to materially impact the sustainable earnings or the long-term fundamental valuation of the majority of our equity holdings.

Certain equity holdings have particularly hurt our fund performance over the period, including Sasol. While we have already detailed our reasons for holding Sasol in our January "Consider this" magazine, we could never have predicted the two black swan events that have hit the company's share price so hard at the same time: the Coronavirus sell-off and the oil price war between OPEC and Russia. At this stage we are not selling our exposure, which is now quite small in our portfolios, since we think there is a large potential upside.

We have been using part of the proceeds from our offshore equity sales to buy up exposure to certain SA stocks at excellent valuations as local share prices have fallen to levels even lower than those seen during 2008. We are being careful to choose high-quality businesses that we know can survive reduced earnings and cash flows for an extended period, since it is unclear how long the Coronavirus uncertainty will continue to impact consumer behavior and economic growth. The market has almost indiscriminately sold off all companies to a level, in some cases, where they're being priced as if they were about to fail in the coming months. However, there are many high-quality SA companies with sound business models and strong, well-capitalised balance sheets that have also become very cheap in this sell-off, where we do hold positions. We are confident that these positions should add above-market value to our client portfolios over the next five years.

British American Tobacco (BAT) is our largest current active position. Tobacco tends to be more defensive in downturns – and has so far proven to be so in the current sell-off. While the group is carrying more debt than previously (since the acquisition of Reynolds), we remain of the view that BAT's cashflow is robust enough to fund a handsome dividend (dividend yield of around 8%) and repay the debt over time. All businesses will suffer disruption as a result of the virus, and BAT could well encounter problems in manufacturing and distribution of its products, but many of the outlets at which cigarettes are sold remain open (even in countries that are implementing lock downs). BAT was inexpensive going into the crisis and currently trades on a forward P/E of 8X, which feel is attractive relative to other "defensive" stocks.

Naspers (and Prosus) are our largest holdings in our house view funds. Both these stocks derive the majority of their value from their direct and indirect stake in Tencent – the Chinese internet and media giant. Internet/e-commerce businesses may prove more resilient in the initial phases of the Coronavirus crisis, as users continue to use if not increase the services they offer. Tencent has one of the most valuable platforms in China and while some of its revenue streams may suffer (such as advertising), we think the overall business will hold up better than the average South African company. While Tencent trades on a high valuation (that has not deteriorated significantly during the crisis), the discounts at which Prosus and Naspers trade relative to Tencent have certainly opened up.

Property holdings have fallen

Even though we had good stock selection alpha in this sector in 2019, listed property has been one of the largest detractors from our fund performance in the past year. This is despite the fact that we have been tactically underweight this asset class for some time now due to the uncertainty surrounding corporate earnings prospects given the depressed economic environment in South Africa. We have been holding selected, well-valued companies with stronger balance sheets. As property stocks have sold off more than other asset classes, the property weighting in our multi-asset portfolios has fallen relative to other asset classes. We have been comfortable with this reduction, as the risks around property company earnings have worsened given the deterioration in the economic outlook. Prospective returns on some quality stocks will be outstanding but as with general equities, those who have gone into this episode with higher leverage and weaker balance sheets will struggle and may not survive. Stock selection is critical, as is careful portfolio construction and risk control.

Increasing our low-risk bond holdings

We were already modestly overweight SA nominal bonds in our house view portfolios at the beginning of the year, when longer-dated maturities of 15-20 years were offering very attractive real yields of 4.5-5.0%. This was well above our long-run fair value assumption of 2.5%, and we were happy to own bonds at these levels. Now these bonds are giving investors a real yield of nearly 8.0% on a medium-term view, an extraordinary prospective return in an environment when inflation is below 5.0%. A weak economy means inflation is also not likely to be a significant risk factor for some time to come. We have been adding to our active bond positions out of cash (in portfolios where sufficient cash permitted) and out of the reduction in our offshore equity holdings.

We were neutral in **inflation-linked bonds** (ILBs) prior to the market downturn and continue to be so even as ILBs have also suffered in the sell-off and now offer very attractive prospective real yields of over 5.0%. While these are very attractive real yields on offer, we believe better value exists in SA equity and nominal bonds: both have the potential to offer more attractive returns over the medium-term and are much more liquid.

A concluding thought

In my 30 years in financial markets I have seen events of unprecedented value destruction such as the Japanese equity market implosion in the early '90s, the Russian default, LTCM's failure in 1998, the Emerging Markets collapse, the Dot-Com bust and the Enron default, and then witnessed the first global recession for over 70 years with the GFC. But as I have termed it, 'The Stop' is without precedent. Investors are understandably panicked. However, while it is very hard to stomach the reduced portfolio values we've experienced over the last month or so, we're taking advantage of this rare opportunity, where valuations are now 20% lower than at the time of the GFC, to buy attractively priced, high-quality assets. Of course we don't yet know how much this virus will ultimately impact global and South African growth, and there is likely to be more volatility ahead before things improve. However, we do know from experience that it is impossible to call the bottom. We also know from experience that buying quality assets at these current attractive valuations has produced well above-average returns going forward, and that this is likely to be the eventual case for this downturn as well. In the meantime, we urge you not to make any significant changes to your portfolios based on sentiment. Rather, consult with your financial adviser and try to take a long-term perspective, as difficult as it may be.