Private Capital Advisers

Market Update – Extraordinary times in markets

Extraordinary times in markets

At the start of last week I wrote,

"The market correction at the end of February has taken us back into Fair Value and Cheap territory for most asset classes. This is a time to be fully invested - even though it may feel uncomfortable. This is what long-term investing is all about."

What an understatement. Today that statement is even more true. This is a time to be buying not selling.

Friday the 13th and Monday the 16th

After 40-plus years in the industry, you think you have seen it all. And yet, Friday the 13th March was like nothing I have ever seen. The Australian market was down close to 10% in the morning and then rallied 14% in the afternoon to end the day 4% up. Apparently, it was the biggest intra-day turnaround in Australian sharemarket history. The New Zealand market did much the same but closed before all the ground was made up, while the US market exploded up by almost 7% in the last hour of Friday's trading. And, then came Monday 16th - the Australian market fell 9.5% with the S&P500 off 12%. These are massive moves - efficient markets don't do this. Even inefficient markets don't do this!

We are in uncharted territory. However, on reflection, we always are. Every bear-market is different. Different causes, different speed, different depth.

Every bear-market is different

My first day at work in the investment industry was in February1976 - just out of secondary school. My job was to copy all the stock prices from the newspaper and to update our 250+ stock charts by with a Rotring pen and Letraset. While I didn't witness first-hand the horrors of the 1974 bear-market (-53% in Australia with the leaders, BHP and the banks falling 70% to 80%), my older colleagues would grow ashen faced as they described it. I could see it in the charts I was updating. It felt like I was there.

Then came the 1980-82 bear-market which seemed to go on forever. In 1987 the bear-market was over in a matter of weeks although the scars remained much longer. The tech-wreck was a straightforward matter of avoiding the grossly overpriced US market loaded with tech stocks. The Global Financial Crisis was terrifying as there was a real possibility we were witnessing the collapse of the global financial system.

And so, while reflecting on how different this bear-market feels, I have realised that each bear-market has been different and terrifying in its own way. However, what is the same in each case, is that valuations provide a very clear guide about what we should do. The simple question we need to ask over and over again is “what impact will all this have on long-term company earnings?”

Long-term Earnings Per Share

It is farrelly’s view that the impact of coronavirus on EPS in ten years will be modest.

Companies will need to re-think the diversification of their supply chains. This is already happening. No longer will everything be produced by the most efficient, low-cost producer. Costs will rise, a little. Some of which will be passed on to consumers, some of which will reduce profits. But even a 10% hit to long-term profits will only reduce expected returns by 1% per annum over the next decade. Cheap assets are still cheap.

Impact of a recession

Over the course of the past week, our assessment of the possibility of a recession has gone from distinctly possible to highly likely. Now, while recessions clearly have short-term impacts on EPS, longer-term impacts tend to be minor unless we have large scale corporate failures and large scale capital raisings at depressed prices - particularly by the banks. Neither seems likely at this point.

Our expectation is that corporate failures will be low. The level of corporate debt is not excessive worldwide, interest rates will remain very low and the banks are unlikely to take an aggressive approach with corporates who fall behind on their payments. Governments may step in to help here as well - although the form that will take is not yet clear.

The banks - particularly in Australia - are extremely well capitalised and have the majority of their lending exposure to residential property. What some have touted as a weakness will become a strength. The banks will have an increase in corporate loan losses, but these are likely to be modest and temporary.

Valuations remain sound

The Tipping Point Tables are a sea of green. Expected returns at 10 to 12% per annum are a long, long way ahead of expected returns on secure assets. Even if our earnings growth forecasts are vastly over-stated, returns from equities and commercial property will be much better than returns from bonds or TDs. For long-term investors this is a buying opportunity.

Figure 1. Tipping Point Tables as at 16 March 2020

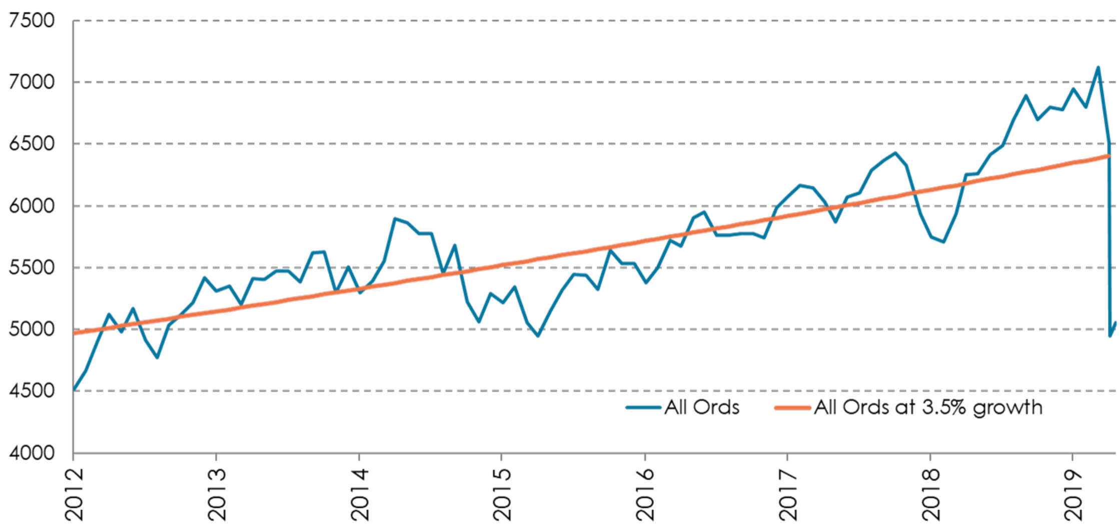
Australian Equities			Developed Market Equities			Emerging Market Equities			A-REITs		
All Ords 5,058.2	10 yr F'cast return	Status	FTSE DM 249.507	10 yr F'cast return	Status	FTSE EM 549.4	10 yr F'cast return	Status	ASX REIT 1216.4	10 yr F'cast return	Status
10500	1.4%	Overpriced	470	1.9%	Overpriced	1025	1.7%	Overpriced	2600	1.4%	Overpriced
9500	2.7%	Fully priced	450	2.3%	Fully priced	975	2.3%	Fully priced	2400	2.4%	Fully priced
9000	3.4%	Fully priced	430	2.9%	Fully priced	925	2.9%	Fully priced	2200	3.5%	Fully priced
8000	5.0%	Fair value	410	3.4%	Fully priced	875	3.6%	Fully priced	2000	4.7%	Fair value
7500	5.9%	Fair value	390	4.0%	Fully priced	825	4.3%	Fully priced	1900	5.4%	Fair value
7000	7.0%	Cheap	370	4.6%	Fair value	800	4.6%	Fair value	1800	6.2%	Fair value
6750	7.5%	Cheap	350	5.3%	Fair value	775	5.0%	Fair value	1700	6.9%	Cheap
6500	8.1%	Cheap	330	6.0%	Fair value	750	5.4%	Fair value	1600	7.8%	Cheap
6250	8.7%	Cheap	320	6.3%	Fair value	725	5.9%	Fair value	1500	8.7%	Cheap
6000	9.3%	Cheap	310	6.7%	Fair value	700	6.3%	Fair value	1450	9.2%	Cheap
5750	10.0%	Cheap	300	7.1%	Cheap	675	6.8%	Fair value	1400	9.8%	Cheap
5500	10.7%	Cheap	290	7.6%	Cheap	650	7.3%	Cheap	1350	10.3%	Cheap
5250	11.5%	Cheap	280	8.0%	Cheap	625	7.8%	Cheap	1300	10.9%	Cheap
5000	12.4%	Cheap	270	8.5%	Cheap	600	8.3%	Cheap	1275	11.2%	Cheap
4750	13.3%	Cheap	260	9.0%	Cheap	575	8.9%	Cheap	1250	11.5%	Cheap
4500	14.2%	Cheap	250	9.5%	Cheap	550	9.5%	Cheap	1225	11.9%	Cheap
4250	15.3%	Cheap	240	10.0%	Cheap	525	10.2%	Cheap	1200	12.2%	Cheap

Markets over-react. This is no exception

Figure 2 below shows how Australian share prices have moved since 2012 when our analysis suggested that share prices should grow at 3.5% per annum on average over the next decade. The orange line shows what would happen if share prices travelled in a straight line - which, of course, they don't. They over-react.

What we can see is that the share prices tend to vary around that expected long-term trajectory. When markets get overly optimistic prices rise above the line and, when fear reigns, prices tend to be below the line. When utter panic sets in, prices can fall well below our target. Last week was an example of utter panic.

Figure 2 : ASX All Ordinaries price growth vs 3.5% pa steady growth



Source:ASX, farrelly's analysis

farrelly's expectation is that, over time, prices will work their way back towards the orange line. Of course, there are no guarantees, but if our fundamental assumption that the Coronavirus will cause only modest long-term damage to company earnings is correct, then that is where prices will head, eventually.

The volatility will go away, but probably not any time soon

The economic impacts of the Coronavirus will be with us for at least another six months and, perhaps, 18 months. There will be many more announcements along the way, some containing good and some bad news. The economic numbers are likely to be awful and will cause large falls when they emerge. However, in between times, we will get major rallies as investors reassess the value on offer. The net result is that we could see much lower prices, or we could be close to the bottom. We just don't know.

Nonetheless, to put the recent volatility in perspective, for all the ups and downs this year, both the US and Australian markets are down 26% since the beginning of the year. These falls are nasty, but not unusual. The damage seems much larger than that. I believe that the reason is that the volatility has been so high - the moves have been very large and very fast.

Historical bear-markets table updated

Two weeks ago, we produced this table which we can now update. There were question marks in the "Length of next bull market" column. These can now be filled in at 11 years. The "Valuations at the peak" of the 2009-20 bull market can also now be included. They range from Overpriced in the case of the US, to Fair value in Australia and Cheap for UK and Japanese equities. The first time in 50 years where we have had major bear-markets starting when markets are rated as Cheap.

Figure 3: Bear markets (1968 to 2020)

Australia - All Ords Index				
Peak	Trough	Fall	Length of next bull market[2]	Valuation at peak[3]
Jan-70	Nov-71	-35%	1.2 yrs	Overpriced
Jan-73	Oct-74	-54%	6.1 yrs	Fully priced
Nov-80	Mar-82	-37%	5.6 yrs	Fully priced
Oct-87	Feb-88	-44%	1.5 yrs	Overpriced
Aug-89	Apr-90	-35%	17.7 yrs	Overpriced
Dec-07	Feb-09	-51%	11.1yrs	Overpriced
Feb-20	????	????		Fair value

Japan - Nikkei 225				
Peak	Trough	Fall	Length of next bull market[2]	Valuation at peak[3]
Dec-72	Dec-74	-31%	15 yrs	Fully priced
Dec-89	Jul-92	-70%	1.1 yrs	Overpriced
Aug-93	Jul-95	-30%	1.1 yrs	Fair value
Aug-96	Sep-98	-44%	1.5 yrs	Overpriced
Mar-00	Jan-03	-43%	4.2 yrs	Overpriced
Mar-07	Jan-09	-59%	11.2yrs	Overpriced
Feb-20	????	????		Cheap

US - S&P500				
Peak	Trough	Fall	Length of next bull market[2]	Valuation at peak[3]
Dec-68	Jun-70	-29%	2.6 yrs	Overpriced
Jan-73	Dec-74	-43%	12.8 yrs	Overpriced
Oct-87	Dec-87	-27%	12.8 yrs	Overpriced
Sep-00	Feb-03	-43%	4.7 yrs	Overpriced
Oct-07	Feb-09	-52%	11.1yrs	Fully priced
Feb –20	????	????		Overpriced

UK - FTSE All Share Index				
Peak	Trough	Fall	Length of next bull market[2]	Valuation at peak[3]
Jan-69	May-70	-34%	2.3 yrs	Fully priced
Aug-72	Dec-74	-71%	12.8 yrs	Overpriced
Sep-87	Nov-87	-34%	12.1 yrs	Overpriced
Dec-99	Mar-03	-47%	4.6 yrs	Overpriced
Oct-07	Mar-09	-44%	11.0 yrs	Fully priced
Feb-20	????	????		Cheap

Notes: 1. Bear-markets are falls of 25% or more; 2. Time is from trough to next peak; 3. Overpriced: negative forecast Equity Risk Premium (ERP_f), Fully priced: ERP_f less than 2.5%pa, Fair value: ERP_f between 2.5%pa and 5%pa

Now the question marks relate to how far this market will fall before it bottoms out - or indeed if we have already seen the bottom in the extraordinary trading seen on Friday the 13th.

We don't know the answer. On one hand, we know that there is a long time to go before the medical crisis is over and that this market reacts violently to bad news. On the other hand, the falls have already been quite significant and much bad news has been discounted. Only time will tell.

What we do know is that valuations are attractive. The chances of long-term investors earning returns well in excess of Term Deposits over the next five to ten years are very, very high.

Tim Farrelly
PCA Investment Committee Member

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