

Why the world could end but probably won't

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Stepping back from the frustrations of lockdowns, the growing toll of human tragedy, and the unhelpful daily twitter feed of President Trump, are investment markets actually behaving rationally?

The current volatility in equity markets is driven by a change in future earnings estimates of the companies that make them up. As the price you pay today is to own a share of those future cashflows, naturally, when the prediction is that these will fall, so the share price of a company falls. This is known as a market clearing mechanism and is nothing unusual. Yes, the scale and speed of the downturn this time has caught most of us off guard, but so will the recovery if history is a reliable guide.

So, what makes us reach this conclusion?

Well, first, most major governments and central banks around the world have acted quickly and 'gone large', to coin a phrase from a well-known burger restaurant. This increases the odds of a materially positive economic outcome over the next two years. Secondly, and most importantly, the pandemic is a temporary stop in global growth and not a permanent one. Therefore, companies will recover earnings at a point in the future, the question is when and what will these be?

Now this is where things are indeed different this time to most previous downturns. Previous downturns such as 2008 were sharp but they were also synchronised on the downside and to the upside. A problem that started in the US mortgage market had implications globally but once this problem was rectified by the authorities most economies rebounded in a synchronised way and this led to more certainty about future cashflows, therefore equity markets rose strongly and rapidly.

This pandemic has major implications for the prospect of a synchronised global economic upturn and will also have lasting impacts on how goods are procured in future (more on this second point in another Thought). The only way global economic growth can rebound in a synchronised way is if a mass-produced vaccine is available within the next few months. This would allow the lockdowns to stop globally and economic growth to rebound quickly, supercharged by the stimulus enacted by governments and central banks.

This is unlikely, however, based on recent scientific reports and therefore a slower, more gradual economic rebound is more likely globally until such a vaccine is developed. It is important to note that this scenario creates more opportunities for investors, and we see this as a very positive outlook, albeit only from an investment perspective, given the terrible price that is being paid by many around the world. Good companies, with strong balance sheets, will take advantage of this global change and should take market share from less well-run businesses. This will increase their market share and reduce competition, increasing their ability to increase margins.

Since 2008, the investment environment has been one where the size of the economic pie has not been growing evenly but good companies have identified changes in trends and taken advantage of them to increase market share. In the next cycle, we expect some of the leadership to change, but the opportunities, locally and globally, will emerge. Being selective will be more important now than ever before and we believe our approach will generate very strong real returns for investors over the coming market cycle. We just can't predict when.

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