icassetmanagers
Intelligent investing

07 July 2020

MEMO FROM THE CIO

As lockdowns ease, avoid following the bulls

Isaac Adomako Boamah

As lockdowns ease, the chasm between market irrational exuberance and the high level of uncertainty resulting from both the epidemiological and economic standpoint should unnerve long term investors. Global markets have rallied sharply from the panic-fueled sell-off at the end of March 2020, but the economic and pandemic reality underpins our argument for a defensive play instead of aggression.

In my maiden memo on 11th April 2020, I alluded to this: "***There are two risks associated with investing- the risk of losing money and the risk of missing opportunity. At this moment, I believe the risk of missing opportunity is high***". A bounce from the depressed levels of late March was warranted at some point, but it came surprisingly early and with more intensity than envisaged. Nothing illustrates this point better than the recently issued 5-year treasury bond that exceeded the target issuance of GHS 1.0bn by 40% at a yield of 19.25%. The same 5-year treasury bond issued on 23rd March 2020 at an interest rate of 21.75% raised only 40% of the target issuance of GHS 1.0bn. Thus far, the swing in investor mood from despair to exuberance has taken place in record time.

Does it square with the epidemiological and economic reality?

Yes, there had been something approaching a fire sale between mid-February and late March in response to the pandemic, with the prices of Ghana Eurobonds collapsing from the 104 levels to the mid 60s. Furthermore, the magnitude and the swiftness of policy response from both the fiscal and monetary sides have lifted the mood of investors. However, can one justify the magnitude of the bounce in Ghana Eurobonds prices from the mid 60s to the mid 90s over a period of three months? Also, is there a justification for the decline in local bond yields at a time when inflation has reared its ugly head from 7.8% in March to 11.3% in May? Are investors becoming comfortable looking past the pandemic and dismissing it as a one-of-a-kind and thus not fundamental?

Certainly, the answers to these questions will differ from one investor to the other. However, the root of this crisis is primarily a public health emergency. COVID-19 is a relatively fast spreading disease with long incubation period, that has a relatively high morbidity rate among the aged population. The number of COVID-19 cases when Ghana issued the first 5-year bond at 21.75% was 27 compared to the current number of 15,485 as at the time Ghana issued the recent 5-year bond at 19.25%. Have investors learned to live with the virus? If yes, how about the economic reality resulting from the pandemic?

The economic reality

In Ghana, the three main commercial hubs of the country- Greater Accra, Western and Ashanti Regions remain the epicenters of the pandemic with 90% of the recorded cases. Hence, in spite of the relaxation of some lockdown restrictions, a significant portion of the local economy is likely to operate at a lower capacity for a while unless we throw public health caution to the wind. No one captures the mood of industry better than the Secretary-General of the Trade Union Congress when he said this on May Day; "***Those that are still operating find it difficult to pay salaries, social security and taxes. One company complained about its inability to provide PPEs for its staff because of huge loss of revenue***".

The policy response from both the fiscal and monetary sides only buy us an insurance policy for the rest of the fiscal year. Ghana should sail through the rest of the year without too many pain points if the assumptions that informed the policy response do not deteriorate. Will the central bank finance government spending beyond the earmarked GHS 10bn if things deteriorate? Here's the response of the Governor, "***if the situation does not improve and it becomes protracted, the central bank will not be able to provide additional resources that will be needed***." (https://starrfm.com.gh/2020/06/bog-unable-to-support-govt-if-pandemic-prolongs-governor/).

The world is combating the greatest pandemic in a century and Ghana is witnessing the worst economic contraction of the last forty years. So, while some recovery in investor mood was not unreasonable on account of the tidal wave of monetary stimulus from major central banks, the wide swing from despair to optimism is yet to be justified. It is important to note that liquidity provided for short term relief is not the same as liquidity provided to address a solvency risk. Consequently, the more the country raises debts to meet short term liquidity needs, the more the increase in parallel of the solvency risk.

What are our investment options?

In a discussion with my boss on portfolio strategy, he had this to say, "***I agree with the sentiments- a glance at the recommendations says we are selling and reducing a lot- leads to the question, what will we have left?"***. The sentiment expressed resonates with all investors especially private pension funds that are required by law to invest 95% of their assets in the local economy. For instance, most private pension funds have approximately 70% of their assets in treasury securities- "risk free". However, given the elevated sovereign risk of Ghana, what would be left for private pension funds if they choose not to invest in "risk free" securities? This highlights the constriction in investment opportunities as more money chases fewer assets in a local market that lacks depth and breadth. Consequently, there is no surety for market correction even though treasury bonds appear overpriced.

How do we intend to position our portfolios?

Quite clearly, our investment options remain limited amid the huge liquidity supply from major central banks. In my last memo, I did indicate our intention to keep exposure to the short end of the local yield curve while adding currency protection in the shape of Ghana Eurobonds. Our strategy served us well as Eurobonds rallied by 50% from its lows in the mid 60s to the mid 90s as at the end of the half year. We do not think there is much left in a further rally, hence we intend to take profit from some of our Eurobonds positions. Even though local yields remain low, we intend to maintain our desire to buy short term securities unless the risk premium on long term bonds is compelling enough to compensate for the risk. At the moment, we are leaning towards buying local treasury bills instead of participating in the long-term market.

On the credit front, the outlook remains ominous. The battle between liquidity and solvency will become pronounced in a world that will see more debt after the COVID-19 crisis recedes. Consequently, we maintain our view that the risk-reward ratio in the credit market does not favour investors. Given the elevation in systematic risk, we intend to exit all corporate bonds in the portfolio, if market conditions permit.

While the fixed income market appears to be detached from economic reality, the local equities market is feeling the scourge emanating from the pandemic. The GSE composite index bourse has so far lost 15.8% since the beginning of the year. In spite of this, we have not changed our stance on buying stocks that can withstand six to twelve months revenue disappointments.

Despite the current legal tussle between MTNGH and its regulator, we believe that at the current price of GHS 0.59 per share the telco giant is significantly undervalued. The stock is trading at a P/E of 6.4x compared with 11.4x at the start of the year. The mobile money operator has grown its earnings consistently since listing in 2018 with FY2019 earnings exceeding the company's own projections by 10.2%. With a return on equity of 36.2% and the cost of equity of 26.7%, MTNGH remains one of the very few listed stocks with economic value (i.e. return on equity exceeding cost of equity).

Conclusion

We are now in the early stages of a downturn that will be more pronounced, in terms of public health and economic magnitude than ever witnessed over the last four decades of the country's existence. The policy response from both government and the central bank has provided short term relief to the economy. However, elevated debt levels, stretched fiscal deficits and central bank balance sheet mean that the potential for further gains from things turning out better than expected does not fully compensate for the risk of decline from events disappointing. In other words, at the current prices of assets, the odds are not in investors' favour, so avoid following the bulls.