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Economic Snapshot February 2020

- All-Share Index: 57,576.93, up 0.86 YTD.
- USD/ZAR: R15.03 per dollar after recent growth outlook downgrades by Moodys and Coronavirus outbreak.
- South Africa 10Y Government Bond yield: 8.91%, opened at 8.21% on January 2nd.

(Data: Bloomberg; Google finance; www.worldgovernmentbonds.com)

LOCAL HIGHLIGHTS & LOWLIGHTS

- SONA address described as lukewarm, complaints again about no clear or detailed plans around the promises. All eyes now on budget speech by Tito Mboweni.
- Reserve Bank signals second rate cut likely in 2020 to stimulate economy. Good news for borrowers, but not good for investors and pensioners in safe assets.
- USA has removed RSA from the list of nations that can receive preferential trade benefits.

GLOBAL EVENTS OF NOTE – Coronavirus

- Outbreak declared pandemic by WHO.
- Subsequent travel lockdown, extended Chinese new year and movement restrictions severely affecting many industries, growth forecasts generally revised downward of all major trade partners.
- Global oil demand forecast to fall by 435,000 barrels a day

FOCUSED COMMENTARY: Valuation of equities (part 1)

Equities (commonly referred to as shares) are normally top-of-mind when people hear the word "investments". This may be the case because the companies that have shares listed on exchanges are often household names, and everybody knows somebody that made a lot of money at some point from buying shares. But knowing a few company names is often where it stops, and only a fraction of the people I personally know are willing to make a call on an intrinsic value of a share, or if it is a good time to buy a share.

The most basic foundational principle of valuation is that owning a share means partial ownership of a functioning business, and that this ownership means entitlement to the future earnings and profits of the said business. The traditional models assume that you will rather hold the share and receive dividends. These models therefore start off by getting a present value of the wealth that will be unlocked by an investment. It is important to note that when you buy a share, you are implicitly believing that the business will exist forever, and therefore have to somehow find a way of valuing a stream of cashflows that will continue into perpetuity.

The present value of an infinite stream of future dividends is one of the most widely used methods of valuation. It is so popular, that companies that pay no dividends are sometimes even valued in this way by means of assumptions around how the dividends would look like if it were paid.

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The Dividend Discount Model (DDM) and the Gordon Growth Model are two widely used present value models, with both assuming not just the payment of dividends, but also that the dividends will grow from year to year.

Multi stage models are also used if estimates of short-, medium-, and long term earnings growth rates are made. The model then looks as follows:

$$P_0 = \underbrace{\sum_{t=1}^{t=n1} \frac{EPS_0 * (1+g_a)^t * \Pi_a}{(1+k_{e,hg})^t}}_{\text{High growth phase}} + \underbrace{\sum_{t=n1+1}^{t=n2} \frac{DPS_t}{(1+k_{e,t})^t}}_{\text{Transition}}$$

$$+ \underbrace{\frac{EPS_{n2} * (1+g_n) * \Pi_n}{(k_{e,st} - g_n)(1+r)^n}}_{\text{Stable growth phase}}$$

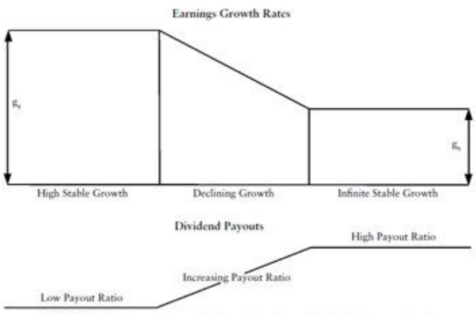

FIGURE 13.5 Expected Growth in the Three-Stage Dividend Discount Model

Source: Online Valuation Chapter, Page 24 to 26

To read a simple example of the GGM and some of its shortcomings, please visit Example: GGM. While these models are not perfect, they present a suitable starting point for valuing an investment.

OUR QUOTE FOR THE MONTH:

I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful.. ~ Warren Buffett

Newsletter compiled by Dr Rousseau Lötter (Senior lecturer @ Department of Statistics and Actuarial Science, University of Stellenbosch)

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