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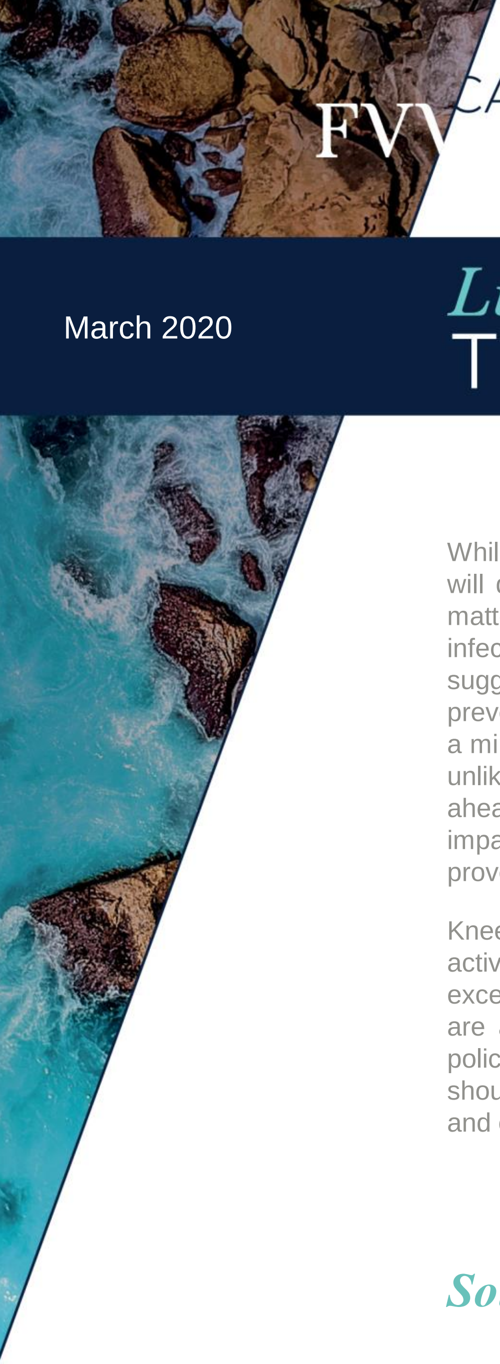
March 2020

Line of THOUGHT

ECONOMIC AND MARKET OVERVIEW

Global

In January this year the World Economic Forum published its annual "Global Risks Report". This report aims to quantify both the likelihood, as well as the impact, of risks around the world. To their credit, infectious diseases (such as the spread of the Coronavirus) made it on to the top ten list of having a global impact:



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While readers could be forgiven for thinking that this pandemic is the only factor that will drive investment performance, it's probably sensible to pause and reflect on the matter. According to medical experts, the Coronavirus, when compared to other infectious diseases, has a far higher transmissibility and lower mortality rate, suggesting it resembles more closely an influenza-like disease pattern. A vaccine to prevent COVID-19, or drugs that might help to ameliorate the disease, are likely to take a minimum of a year to identify and probably longer to definitively test, and as such are unlikely to influence the course of this current outbreak. While we see uncertainty ahead, given what we know at this point the more likely scenario is that the Coronavirus impact will have a significant effect on economic activity and company earnings, but will prove to be temporary in nature.

Knee-jerk reactions by policymakers could be a real risk should this result in economic activity being shut down for longer than warranted. The cost of policy missteps could far exceed the economic impact of the virus. The key point to remember is that earnings are a key driver of equity performance. A longer persistence of COVID19 and any policy overreaction could have a longer earnings impact on some companies. This should create an ideal environment for stock picking – astute investors will take all risks and opportunities into account when allocating capital.

South Africa

South Africa could not escape the turmoil caused by the spread of the Coronavirus. It is, however, not quite at the top of the challenges faced by the local economy.

...this should create an ***ideal environment*** *for stock picking...*

Finance Minister Tito Mboweni delivered a budget which showed good intent but is likely to be very difficult to achieve. Visio Capital reports that, following from last year's medium term budget policy statement (MTBPS), the budget did not try and hide the difficult position that the country's finances are in. However, in a change from the previous few budgets which showed a significantly better outlook than their preceding MTBPS, this time the outlook appears as bad. Positively, the focus is on expenditure cuts rather than revenue (tax) increases which could be considered more stimulatory. The expenditure reduction target depends on government's ability to negotiate lower wage increases with the public sector (trade unions). This is likely to be a very tough process though. In short, the minister seems to have done well given his opportunity set, with the focus now on implementation.

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South Africa

According to Statistics South Africa the South African economy shrank by 1.4% in the fourth quarter of 2019. This followed a contraction of 0.8% in the third quarter, which means that the economy was in recession for the last half of 2019. This is the economy's third recession since 1994, however it was not entirely unexpected following Eskom's stage 6 load shedding in December. The precarious state of local economic activity, however, seems to be reflected in the valuations of companies that depend on SA Inc. and are starting to look quite attractive from an investment point of view.

Market Performance

...fears of the Coronavirus spread ***around the world faster than the disease itself.***

Unsurprisingly, markets had a torrid time in February as fears of the Coronavirus spread around the world faster than the disease itself. Global equities lost 8% in US Dollar terms, and not even gold (down 1.2% in USD) protected investors. As was the case during the global financial crisis in 2008/2009, the only real safe haven was US Treasuries which ended the month 1% higher.

South African markets were not spared either: equities shed 9% and listed property pulled back by almost 18%. Bonds (as measured by the All Bond Index) ended the month nearly flat (-0.1%) with inflation linked bonds (+0.8%) and cash (+0.5%) the silver linings on the edge of a big dark cloud of uncertainty. Many active investors have, however, made use of this opportunity of indiscriminate selling to build positions in high quality companies which are likely to weather this storm much more effectively than their peers.

MARKET INDICES [1] (All returns in Rand)	29 February 2020		
	3 months	12 months	5 years
SA equities (JSE All Share Index)	-7.6%	-5.7%	2.2%
SA property (S&P SA Reit Index)	-23.8%	-25.1%	-4.4%
SA bonds (SA All Bond Index)	3.0%	8.9%	7.2%
SA cash (STeFI)	1.7%	7.3%	7.2%
Global developed equities (MSCI World Index)	0.7%	17.7%	13.1%
Emerging market equities (MSCI Emerging Market Index)	4.3%	10.2%	9.5%
Global bonds (Bloomberg Barclays Global Aggregate)	10.1%	20.7%	9.3%
Rand/dollar [2]	7.4%	11.9%	6.2%
Rand/sterling	6.0%	7.4%	2.2%
Rand/euro	7.0%	7.9%	5.7%
Average South African Multi-Asset High Equity Fund	-2.8%	0.8%	3.2%
Average South African Multi-Asset Low Equity Fund	-0.4%	4.4%	5.1%

1. Source: Factset
2. A negative number means fewer rands are being paid per US dollar, so it implies a strengthening of the rand.

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Commentary – the major benefits of offshore investing[3]

During times of turmoil in South Africa many investors are contemplating moving their savings abroad. This month we take a look at which factors investors should consider as part of the decision.

Pieter Hugo, Managing Director of Prudential Unit Trusts, says moving money offshore should ideally never be the result of a reaction to short-term changes in the local environment or a sudden depreciation of the rand. He adds that South Africans have a history of reacting emotionally and taking money offshore after the rand has depreciated significantly, often resulting in subsequent investment losses.

…South Africans have a ***history of reacting emotionally*** *…*

Rather, offshore exposure should be driven by your own investment goals and how best to achieve them within a longer-term financial plan. In general terms, including some international exposure in a portfolio has been shown to be beneficial for almost all long-term investors. Following are some of the primary benefits of investing offshore:

Diversifying helps optimize your portfolio

Diversification across countries, industries and companies, as well as asset classes and currencies, is the primary benefit of investing offshore. It reduces the risk of a portfolio for the same expected rate of return, resulting in a more "optimal" portfolio by spreading risk across many different investments. At the same time, offshore equities help reduce the risk inherent in the local equity market, which is among the world's most concentrated: between 2005-2012 the resources sector comprised over 30% of the FTSE/JSE Top 40 Index, rising to over 45% at the peak of the resources cycle in 2008. Today IT giant Naspers (and sister company Prosus) makes up over 20% of the Top 40 Index.

Gaining exposure to growth opportunities

The stocks listed on the JSE represent only 1% of the world's total listed equity market capitalisation – so if you only invest in South African equities you are missing out on 99% of the global equity universe. There are many fast-growing industries under-represented on the local exchange such as pharmaceuticals, bio-technology and alternative energy. There are also many world-class companies in which to invest. Living in an emerging market like South Africa, it can be very beneficial to diversify into developed markets, which are often driven by different macro factors, can offer more stable growth, and provide hard-currency exposure to a wide variety of sectors. At the same time, rapidly expanding emerging markets like some Asian economies also offer lucrative growth prospects, giving your portfolio a higher probability of generating better returns than those confined to the domestic market.

3. Adapted from an article published by Prudential Investment Managers

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Your offshore exposure ***depends*** *very much on your* ***long-term investment goals.***

Helping you reach your offshore goals

If you spend significant time outside the country, or buy lots of imported goods, or if you want to retire abroad or send your children to schools outside South Africa, higher-than-average offshore exposure could prove invaluable. Investments in hard currencies like US dollars, euros, sterling and yen act as protection against a depreciating rand (which is likely to remain the long-term trend given South Africa's higher inflation rate versus developed markets), and other South Africa-specific risks. This effectively ensures you match your longer-term offshore "liabilities" with equivalent assets.

At the same time, it is not advisable to use offshore investments to speculate on currency movements (a notoriously difficult task), but rather to ensure a globally diversified portfolio.

Acting as a safe haven

For those who are concerned about political or social instability in South Africa, having a portion of an investment portfolio offshore helps mitigate the associated investment risks and can help ease investors' worries, making them more likely to stay invested for the longer term and avoid panicking and selling their investments at the wrong time. However, sentiment-driven investing should be avoided: you should rather always follow sound investment principles and a long-term plan to determine whether, when and how much to put offshore.

How much should you invest offshore?

Your offshore exposure depends very much on your long-term investment goals. Generally, the offshore portion of your portfolio will be larger the higher your targeted investment return (and therefore the higher the risk required). For example, if you have a more aggressive return target of inflation+7%, you would tend to need between 35%-40% offshore. A return target of inflation+6%, meanwhile, is more in line with a typical "balanced" fund with around 30% offshore. Finally, a more conservative target of inflation+2%-3% would generally dictate offshore exposure of only 10%-20%. These are guidelines, however; the exact portion should be appropriate for your own long-term requirements and is probably best discussed with your financial adviser.

Keep in mind that Regulation 28 of the Pension Funds Act only allows a maximum offshore exposure of 30% (excluding Africa), plus an extra 5% in Africa (outside South Africa) for funds approved for retirement purposes. Yet investors who hold SA equities are also gaining offshore exposure through local companies with offshore operations: over 50% of revenue from JSE-listed companies comes from outside South Africa. So Regulation 28-compliant funds are likely to have effective offshore exposure of more than the 30% (+5% Africa) permitted.