

# Line of THOUGHT

## ECONOMIC AND MARKET OVERVIEW

### Global

*COVID-19 and its impact on billions of lives around the world dominated news in March.*

There now seems to be no doubt that the measures taken to slow down the spread of this disease will have a significant effect on the global economy and will most likely cause a worldwide recession in the second half of 2020. Capital markets are very efficient in discounting changes in expected future cashflows from companies and, as a result, have sold off significantly from the middle of February when it became apparent that the Covid-19 pandemic had spread widely beyond China.

It is extremely difficult to produce a point forecast on the exact slowdown in the global economy. Stanlib's Economics team calculated that, if the disease is brought under control during the next ten weeks, there's a good chance we will see a strong rebound during the second half of the year. This could limit the damage to a global GDP contraction of a little over 1% in real terms. If, however, it takes longer before the current severe lockdown measures are relaxed, the global economy could shrink by between 3 and 4% in 2020. During the global financial crisis in 2008/2009 the effect was far less severe, as China still grew by nearly 10%. This helped global GDP to remain flat in real terms during that crisis. This time around they will be unable to make up for the rest of the world, as indicated in the table below:

|               | GDP Growth (%) |      | Strong rebound  | Recovery takes longer |
|---------------|----------------|------|-----------------|-----------------------|
|               | 2018           | 2019 | 2020 (estimate) | 2020 (estimate)       |
| World         | 3.0            | 2.4  | -1.2            | -3.4                  |
| United States | 2.9            | 2.3  | -1.6            | -3.2                  |
| Euro-area     | 1.9            | 1.2  | -2.7            | -6.9                  |
| China         | 6.6            | 6.1  | 0.8             | -4.4                  |
| South Africa  | 0.8            | 0.2  | -3.4            | -4.9                  |

*...there's a good chance to see a **strong rebound** during the second half of the year.*

In the United States, initial jobless claims spiked dramatically, with over 6.4 million new claims being registered in the last two weeks of March. This will have dire consequences for their unemployment rate which was at a 50 year low going into this pandemic. Small and Medium-sized Enterprises will be hit hardest as they typically don't have the same quality balance sheets compared to large corporates.

April 2020

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The fiscal and monetary stimulus announced by the world's major economies over the past month has been a global policy event without precedent in peacetime. The Financial Times reports that the increase in fiscal spending and loans in the US this year alone will reach more than 10 per cent of gross domestic product; larger than the rise in the federal deficit through 2008 and 2009. Although this is probably not as big as the financial stimulus implemented by China after the financial crash 12 years ago, most big economies could see government debt to GDP ratios rising by 10-20 percentage points.

The impact of central bank injections will be equally enormous. It would not be surprising if the US Federal Reserve's balance sheet increased by \$2tn-\$3tn this year, up from \$4.2tn at the end of 2019. The upside is that interest rates may remain low for even longer, however this form of financing can be very risky if inflation starts to rise. As it stands, there is almost no sign of inflation on the horizon, however the potential for rapidly increasing inflation rates has been building since 2008/2009. Like a taught rubber band, the release will be all the more spectacular the further it is pulled out.

In China, authorities have started to gradually lift the lockdown that started in January, however this has not been a smooth process in all instances. In many provinces it has been a phased approach and will likely take months before life is back to normal. It will, however, provide a lot of guidance to other countries as they look forward to reviving their economies beyond the current social distancing measures

### *South Africa*

*The South African Reserve Bank's Monetary Policy Committee's (MPC) second meeting for 2020 introduced the first of several monetary measures designed to assist the local economy through this crisis. The primary measure promulgated by Governor Lesetja Kganyago was a reduction of 1.00% in the repurchase rate.*

In addition, the MPC has stepped in to keep money flowing in the economy by providing lenders with cheaper access to funding and re-organising the way they inject liquidity into the financial system. These measures include the purchase of government bonds on the secondary market which, when effectuated, had an immediate positive effect on government bond yields.

This follows President Cyril Ramphosa's announcement of a nationwide lockdown of 21 days in order to slow the spread of Covid-19 in South Africa. Three weeks of very little commercial activity outside of essential services will hurt an already encumbered economy, however it does provide health services the opportunity to step up testing and preparation for increased hospitalisation. It's a tough balance to strike between health and economic risks – both of which will have a significant impact on South African consumers.

*The local  
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## *South Africa*

A silver lining is that the petrol price fell by almost R2 per liter on the back of a much-reduced oil price, this despite a significantly weaker Rand. When the wheels of the economy start turning again it will produce an essential tailwind for businesses and consumers.

Lastly, the long-anticipated downgrade of South Africa's sovereign debt rating by Moody's was announced at the end of the month. As reported before, much of this downgrade has been priced into our bond yields. Nevertheless, the Rand still took a significant beating. The local currency now seems considerably undervalued against the US Dollar, which puts it in the same boat as a whole host of other emerging market currencies.

## *Market Performance*

Global financial markets had one of their worst and most volatile months in decades as the Covid-19 virus spread and economic, as well as human, costs mounted. Visio Capital reported that the market sell-off was widespread as investors made a "dash-for-cash" in order to increase liquidity. This was particularly evident when traditional safe haven assets such as gold also sold off at the height of the panic.

The poor market performance ensued despite central banks' decisive policy action and governments' announcements of some of the largest economic relief packages in history. Quarter-end demand masked some of the extreme moves during the month. At their worst point, indices of SA equities, nominal bonds, inflations-linked bonds and the property index were down 30%, 27%, 25%, and 48%, respectively.

The bond market was particularly hard hit, having its worst month since August 1998 and the second worst on record, as foreigners sold approximately 6.5% of their SA bond holdings and market liquidity dried up to a level not seen since the introduction of primary dealers for government bonds in 1998.

The domestic property sector, struggling under the pressure of years of over-valuations, has been hit particularly hard by the latest economic crisis. The "defensive" nature of the property sector (due to the index's high exposure to offshore REITs eg. Nepi ) failed to provide any protection despite a 12% depreciation in the rand.

Global equities also struggled, however much of their fall was negated for South African investors by the 12% depreciation of the Rand against the US Dollar. On a fundamental basis, South African equities, bonds and the Rand look very cheap.

*The upside is that the price of fuel in South Africa dropped by nearly R2 per liter*

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| MARKET INDICES <sup>1</sup><br>(All returns in Rand)  | 31 March 2020 |               |             |
|-------------------------------------------------------|---------------|---------------|-------------|
|                                                       | 3 months      | 12 months     | 5 years     |
| SA equities (JSE All Share Index)                     | -21.4%        | -18.4%        | -0.1%       |
| SA property (S&P SA Reit Index)                       | -50.9%        | -51.9%        | -13.4%      |
| SA bonds (SA All Bond Index)                          | -8.7%         | -2.9%         | 5.2%        |
| SA cash (STeFI)                                       | 1.7%          | 7.2%          | 7.2%        |
| Global developed equities (MSCI World Index)          | 1.0%          | 11.6%         | 12.2%       |
| Emerging market equities (MSCI Emerging Market Index) | -2.4%         | 2.3%          | 8.1%        |
| Global bonds (Bloomberg Barclays Global Aggregate)    | 27.3%         | 29.0%         | 10.9%       |
| Rand/dollar <sup>2</sup>                              | 27.7%         | 23.8%         | 8.1%        |
| Rand/sterling                                         | 19.5%         | 17.8%         | 4.2%        |
| Rand/euro                                             | 24.8%         | 21.0%         | 8.5%        |
| Average South African Multi-Asset High Equity Fund    | <b>-13.5%</b> | <b>-10.4%</b> | <b>0.9%</b> |
| Average South African Multi-Asset Low Equity Fund     | -7.3%         | -3.2%         | 3.6%        |

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

## Commentary – Beauty is in the eye of the beholder

“Cecil Graham: What is a cynic?

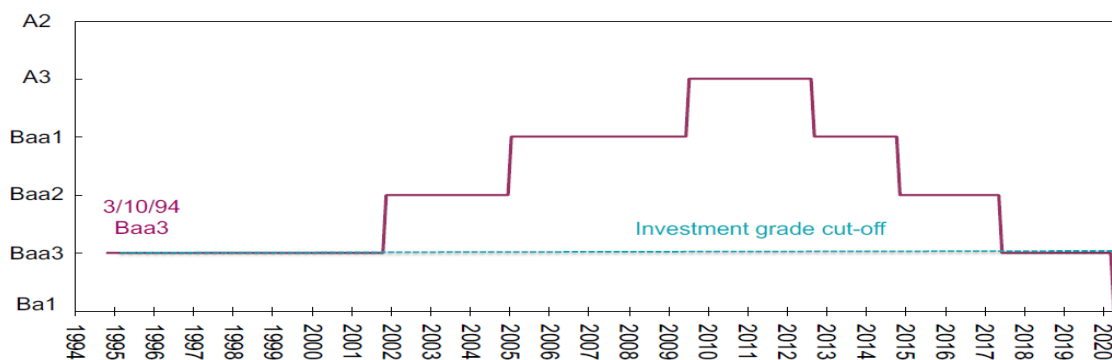
Lord Darlington: A man who knows the price of everything, and the value of nothing.”

Oscar Wilde (from Lady Windermere’s Fan)

Late on Friday 27 March 2020, Moody’s announced that they had decided to downgrade South Africa’s sovereign credit rating from investment grade (where it has been since they started rating us in 1994) to sub-investment grade:

South Africa sovereign credit rating by Moody’s

### Rating history



Source: Stanlib and Moody's Investor Services

...being right  
 is much  
 harder than  
 being  
 outrageous

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## *Commentary – Beauty is in the eye of the beholder*

This has various implications for the issuer of these bonds (the South African Government) as well as the owners of these bonds. As it stands, the government has around R2.2 trillion worth of outstanding bonds, with foreigners owning a portion of about R800 billion. Not all of these bonds will have to be sold when South Africa exits the FTSE World Government Bond Index at the end of April, however indications are that another R100 billion will need to be sold by investment portfolios which are not allowed to hold sub-investment grade bonds. Contrarily, investors who look for higher yields (and as a result must take on higher risk) will look to buy these bonds to enhance the risk/return profile of their portfolios. The exact quantum is not known but some of the supply will happily be taken up once these bonds hit the markets.

Cynics may say that this is not good for South Africans, and in particular our government that relies heavily on the issuance of bonds, to finance our tax revenue shortfall. The fact is that Moody's view is a qualitative assessment of the fiscus' ability to repay its debt, while the market price (yield) on bonds is a quantitative take on the same conundrum. And by the looks of it, the downgrade was already priced in by the time that it was announced, due to the fact that the yield on bonds has not spiked as many commentators predicted. Part of the cushioning can be attributed to the announcement of the South African Reserve Bank that they will buy bonds in the secondary market in order to provide continued liquidity in capital markets, while not allowing yields to spike to unsustainable levels. The downgrade has also forced our fiscal authorities to explore other avenues of funding. One such measure is to approach the New Development Bank (funded by the BRICS countries) for a loan where interest rates are likely to be well below current bond yields.

South Africa could also approach the International Monetary Fund (IMF) and the World Bank. However, it is to be expected that loans from these entities would come with conditions that are not in all instances palatable to the current ANC administration, even if it is pro-business.

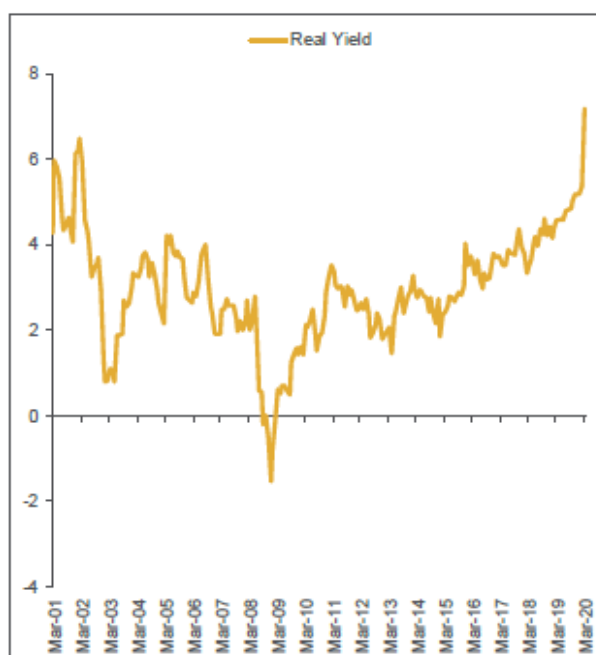
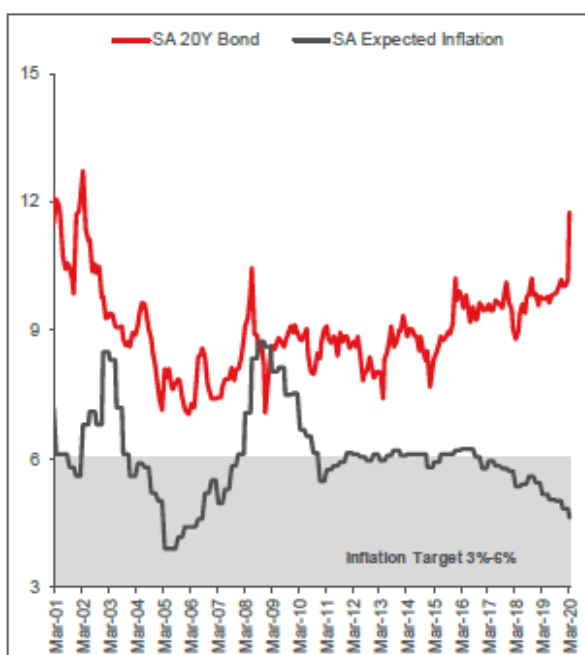
As it stands, South Africa's weekly bond auction has consistently been over-subscribed and our government is still able to raise all the debt that it requires. The economic (and revenue) impact of Covid-19 may yet increase the cost of borrowing. However, in its present form, it certainly pays to be a South African Government bondholder.

According to Prudential Investment Managers, the real yield (the gross yield less current inflation) has not been as high in the last two decades:

*...that there  
is a simple  
way to  
outperform  
even the  
consensus  
forecast of a  
crowd of  
experts*

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## Commentary – Beauty is in the eye of the beholder



This means that, in spite of the qualitative (and to some extent subjective) view of Moody's and the other ratings agencies, investors now seem to have one of their best opportunities to lock in very attractive yields on South African bonds. Beauty(-ful investment returns) certainly seems to be in the eye of the bondholder. This, alongside attractive equity valuations, should hold great potential for future returns of balanced funds.

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