

August 2020

# Line of THOUGHT

## ECONOMIC AND MARKET OVERVIEW

### Global

*Macroeconomic indicators published during July confirmed what investment markets pointed to in the middle of March – a significant reduction in global economic output.*

The next question is, of course, how quickly economies will recover after the global lockdown in the second quarter, as this will have a significant impact on the profitability of companies around the world. The sustainability of the recovery in equity markets will be tested as more information about economic activity is published in the coming weeks and months.

With every significant economy hit by the Covid-19 pandemic and the associated limitations on the movement of people and goods, it was no real surprise that Gross Domestic Output in the United States (as only one example) declined by 33% quarter on quarter. This was the biggest contraction since the US government began tracking such data in 1947. What's important to remember, however, is that if it's in the press, it's in the price. In addition, it's key to remember that the terrifying 33 percent figure is the economic contraction as presented at an annualised rate. i.e., how much the economy would shrink if conditions observed during Q2 carried on for a year (which is an unlikely outcome). If it's not annualised, GDP "only" declined by a somewhat less jaw-dropping 9.5 percent between the end of March and the end of June.

Tantalum Capital has previously reported that they expect a divergence in economic recovery paths. Well resourced, strongly developed and properly financed countries are likely to have an easier road to recovery than those with weak economic fundamentals, poorer medical resources and reliance on foreign direct investment. This divergence is becoming more apparent, as well as the difference between industry sectors and companies. The ongoing trade disputes between China and the United States is an example of how political differences add to ongoing tensions and will continue to weigh on market sentiment.

The silver lining is that governments around the world are keeping their feet on the fiscal and monetary pedals as central banks continue to keep interest rates low and expand their asset purchasing programs. According to RMB Global Markets' base case scenario, leading indicators point to a global economic recovery taking hold in the second half of 2020. This may, however, materialise at a slower rate than anticipated by financial markets as capacity in several industries (such as tourism and hospitality) has been permanently destroyed. They further expect precarious growth for 2021, but express concern for increased inflation due to a higher oil price and a reversal in globalisation.

So what's not priced in? A delay in the development of a vaccine or cure for Covid-19 beyond 2021, hyper-inflation and coordinated fiscal tightening by central banks around the world. Add to that the unknown political outcomes within countries (the upcoming US election, for instance) and between countries (US-China trade tensions), and investment outcomes for the rest of the year are far from certain. That will, however, not come as a surprise to investors, who will do well to remember that fortune favours the brave, and this too shall pass.

*...if it's in the  
press, it's in  
the price.*

*South Africa*

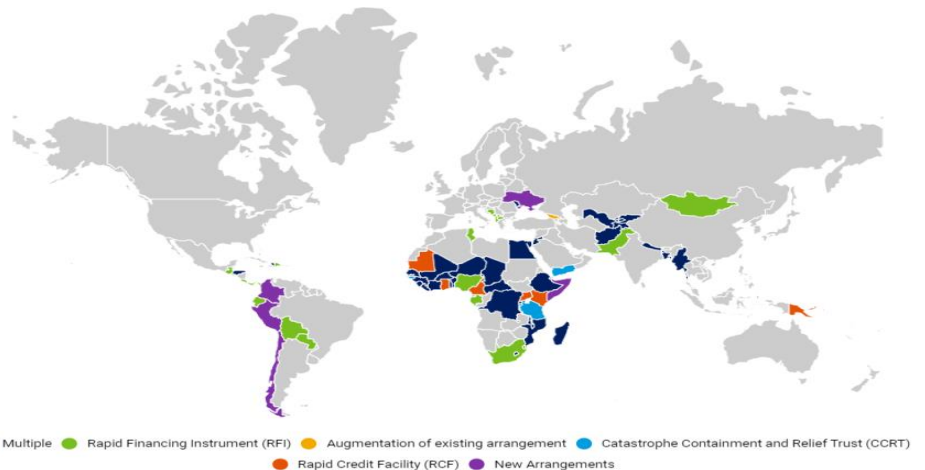
*The South African Reserve Bank's Monetary Policy Committee (MPC) announced a further reduction of 0.25% in the repurchase rate, taking it to 3.5% and the prime lending rate to 7%.*

Two of the MPC members voted to keep the rate unchanged, with three members favouring a reduction of 0.25%. It's likely that this will be the last change in rates this year as the governor reiterated that monetary policy alone cannot improve the potential growth rate of the economy or reduce fiscal risks. He added that these risk should be addressed by implementing prudent macroeconomic policies and structural reforms that lower costs generally, and increase investment opportunities, potential growth and job creation. Such steps will enhance the effectiveness of monetary policy and its transmission to the broader economy.

South Africa's application for a USD 4.3 billion loan (around R75 billion at the time of writing) from the International Monetary Fund's Rapid Financing Instrument program was approved in July. Together with other foreign loans and government debt issued in foreign currencies so far this year, it just about covers the South African government's planned foreign debt borrowings for the year. In its announcement of the loan the IMF highlighted fiscal consolidation, improving governance and operations of state-owned enterprises, preserving the SARB's inflation mandate, and the implementation of specific reform efforts at the time of the Medium Term Budget Policy Statement (MTBPS) in October.

To put the R75 billion into perspective it's useful to know that the SA government currently raises R8.6 billion every week in the nominal and inflation linked bond markets. R75 billion therefore equates to about two months of current fund raising and, at an interest rate of 1.1% and a repayment term of five years, it has a beneficial effect on the country's debt servicing costs. It's only the fifth time that SA has borrowed money from the IMF, with the previous instance as far back as 1983 when foreign disinvestment was at its peak. As the chart below shows, South Africa is certainly not alone in knocking on the IMF's vault, but we would do well to find better company soon:

*...it has a beneficial effect on the country's debt servicing costs.*



Source: International Monetary Fund

## Market Performance

Despite poor economic data, global investment markets continued to perform well in July with most broad asset classes delivering positive returns in their base currencies. Against this risk-on environment the US Dollar fell to its lowest level in over two years (when measured against its main trading partners) and gold surged ahead, setting a record high.

Visio Capital reports that the strong investment demand for gold supported the basic materials sector of the JSE (up more than 9% in July) and helped the broader South African equity market to end 2.6% higher for the month. It means that the FTSE/JSE All Share Index is back in the green when measured over a year (1.6% higher than 12 months ago). However, it lags other emerging markets which, in Rand terms, have added nearly 30% over the same period.

After a very strong rebound in June, the listed property sector came under pressure as incoming company updates suggest that an earnings recovery is not likely anytime soon. Prospects of structural change in demand for listed property (eg. office space and the shift towards on-line shopping) continue to weigh on the sector resulting in weak performance and increased volatility which negates some of the benefits of the higher income stream that the asset class traditionally has offered. It ended July 3.9% lower, taking the year to date return to nearly -45%.

As mentioned earlier, resource companies did very well in July and on the back of a strong bounce in the Chinese economy have now added 15% year to date. This is in stark contrast to companies that depend on the South African economy for their revenue growth: financials are more than 30% lower than at the start of the year. This may yet prove to be one of the sectors where the greatest opportunities exist.

MARKET INDICES <sup>1</sup>		30 July 2020		
(All returns in Rand except where otherwise indicated)				
	3 months	12 months	5 years	
SA equities (JSE All Share Index)	10.8%	1.6%	4.6%	
SA property (S&P SA Reit Index)	7.7%	-46.9%	-11.2%	
SA bonds (SA All Bond Index)	6.4%	4.2%	7.4%	
SA cash (STeFI)	1.4%	6.8%	7.2%	
Global developed equities (MSCI World Index)	4.7%	29.5%	14.8%	
Emerging market equities (MSCI Emerging Market Index)	9.4%	28.5%	13.1%	
Global bonds (Bloomberg Barclays Global Aggregate)	-3.0%	29.6%	10.6%	
Rand/dollar <sup>2</sup>	-7.3%	20.1%	6.2%	
Rand/sterling	-3.5%	28.8%	2.6%	
Rand/euro	0.1%	27.6%	7.6%	
Gold Price (USD)	16.5%	37.6%	12.4%	
Oil Price (Brent Crude, USD)	71.3%	-33.6%	-3.7%	

1. Source: Factset

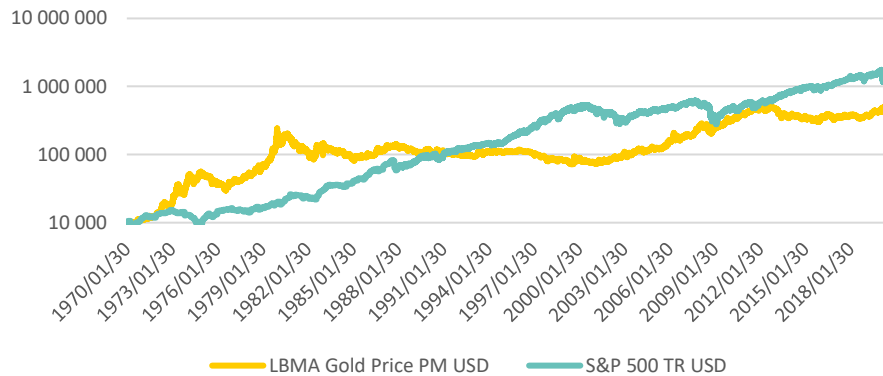
2. A negative number means fewer rands are being paid per US dollar, so it implies a strengthening of the rand.

# Line of THOUGHT

## Commentary – All that glitters

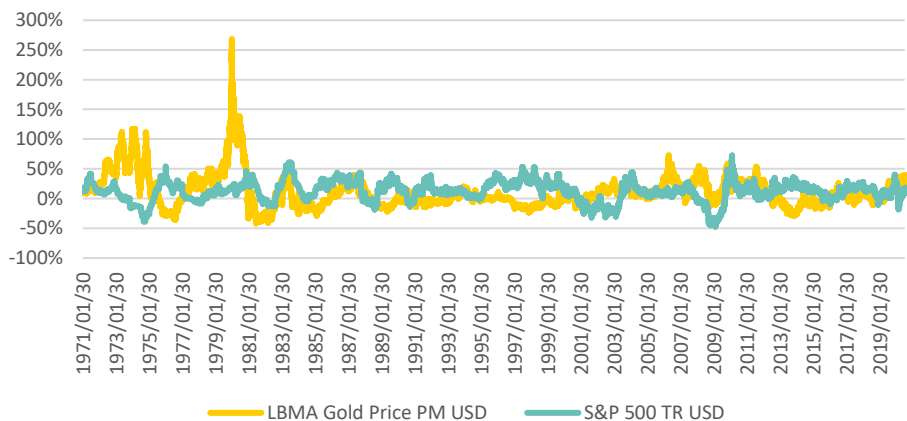
One of the top performers during this global Coronavirus pandemic has been gold. Investors (or at least some of them) have used gold as a haven during times of economic or financial crises, often to their benefit. Successfully employing the precious metal as a safety measure in portfolios implies that investors have the ability to time their entry into and exit from this asset. Over the long term gold has increased in value, but has not quite kept pace with equities (as represented by the S&P 500):

Gold vs US Equities (rebased to 10 000, log scale)



From 1970 US equities have grown by about 10.7% per annum, and gold has increased by 8.4% per annum. The former had lower annualised volatility (around 18%) than gold's 21%. It's clear, however, that these asset classes followed different journeys to get to the levels where they are today. During the last 50 years investors would have had vastly different outcomes over rolling one-year periods:

Gold vs US Equities (rolling one year returns)



Source: Morningstar

... used gold as a *haven* during times of economic or financial crises.

# Line of THOUGHT

## Commentary – All that glitters (continued)

We've now established that both gold and equities have increased in value over the last 50 years, and both are volatile asset classes. We've also shown that there are shorter time periods where, if an investor allocated to the one or the other, they could have done well by doing so. So what is the case for adding glitter to a portfolio? Or is it mere speculation that drives the price of this alluring metal?

### The case for gold

Rezco Asset Management makes a strong case for holding gold (and gold mining companies) in their multi-asset portfolios against the current economic and investment background. They note that quantitative easing continues to drive up equity markets despite a lack of fundamental earnings. The wave of (almost) free money also leads to debasement of currencies. As interest rates approached zero the incentive to hold US Dollars has diminished and the demand for gold has increased. A combination of the weakening dollar and a drop in real yields sent investors looking for alternative forms of protection, and as a result gold has started to become "monetised" again – for the first time in about 30 years.

They add that gold is a finite store of value unlike fiat currencies where central banks are continuing to print money. During some periods in the past 50 years gold also acted as a good hedge against the risk of inflation which, through the global increase in debt, is baked into the global financial system. Lastly, they suggest that some of the gold mining companies are trading at attractive price to earnings valuations and good free cash flow levels of about 20%. Fill your boots!

### The case for something else (like equities, for instance)

Depending on your source, the total amount of gold ever mined may vary somewhat, but according to the World Gold Council it's a littler under 200 000 tonnes. This would fill a cube of roughly 20 meters (the 20 meter high volume between the four bases of a baseball field). The total value of this gold would be around USD 13 trillion. For the same amount an investor could buy any of the following (hypothetically speaking):

- 8 Microsofts (with an annual dividend of USD 130 billion)
- 44 JP Morgan Chases (with an annual dividend of USD 480 billion)
- 1 000 FirstRands (with an annual dividend of over USD 1 trillion)

What is the income that an investor will receive by holding all the gold in the world? \$0. And then you still have to find a buyer to take it off your hands at a higher price than what you paid for it.

### Conclusion

Looking back over the last few years gold would have been a good investment. It would, however, not be rational to use this as the basis for your decision to buy some now. Whether it be gold, equities, or any other investment – be sure that you understand why you're holding it. This is what differentiates good investors from mere speculators.

*...gold has started to become "monetised" again – for the first time in about 30 years.*

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