Market Commentary

Q2 2020

Markets rebound sharply as many countries start easing lockdown restrictions

The COVID-19 pandemic and its ongoing uncertainty continued to dominate global news flow in the second quarter. The pandemic has spread across most countries and at the time of writing, there were more than 11 million confirmed infections and more than 500 000 deaths. In South Africa, the number of confirmed cases is more than 200 000, with more than 3 000 people having lost their lives. Notwithstanding the escalation in the number of cases, many countries have started to ease restrictions, allowing for more economic activity. More people have resumed their normal duties, albeit at a slow rate as governments try to find the delicate balance between rising rate of infections and the "cost" of restrictions on economic growth.

Global stimulus supports markets

Many of the major benchmarks bounced back strongly in the second quarter from the multi-year lows reached in March. The unprecedented downturn in global economic data has largely been shrugged off by stock markets as investors look towards a post COVID-19 world.

Many economics reports published earlier in the year tried to predict whether the world will experience a 'V or U' shaped recovery from the pandemic. The World Bank's Global Economic Prospects Report forecasts that the global economy will decline 5.2% in 2020 before gradually recovering 4.2% in 2021. Global equity markets appear to have experienced a 'V-shaped' recovery. The MSCI World Index rallied 19.5% in US dollar terms, from being down 20.9% in the first quarter. Importantly, the sheer magnitude of the liquidity injection that has been provided by central banks across the globe, however, has certainly offered support in this regard.

In the US, the Fed's balance sheet soared past $7 trillion compared to just more than $4 trillion at the start of the year. In addition, the fiscal stimulus package issued by the US government – which is expected to amass to well over 10% of GDP – may also have provided market participants with some hope of a strong rebound in economic activity in the future. The S&P 500 Index has erased nearly all of its March losses. It gained 20.5% for the quarter and is now down only 3.1% for the year-to-date, from being down 19.6% in the first quarter. The resilience of mega cap stocks such as Microsoft, Apple, Amazon, Alphabet and Facebook – which represent roughly 20% of the S&P 500 – have emphatically propelled the rebound in the S&P 500.

Domestically, "lockdown stocks" push the local equity market higher

Similar to the stimulus provided by global central banks, the South African Reserve Bank (SARB) bought more than R30 billion of bonds in April and May, and cut interest rates by 150 basis points in the second quarter. This brought the repo rate to 3.75%, its lowest level in more than two decades.

The lower interest rate environment provided much needed support to the equity market and the JSE ALSI returned 23.2% for the quarter in rand terms. The sheer weight of Naspers and Prosus in the JSE All Share Index – accounting for almost a quarter of the total stock market – also helped spark a recovery in the performance of the local stock market as the "work from home" movement gathers momentum. Lockdown restrictions have supported online gaming and streaming services, which are driving internet usage even higher.

The performance of resources has also been important for the recovery of the JSE due to the resilience of gold – elevated by low real rates in the US and the safe-haven appeal among investors – and platinum group metal (PGM) prices. The resilience in PGM prices, particularly palladium and rhodium which are used in automotive catalytic convertors, continued to benefit from efforts to reduce global carbon emissions, particularly in China and the Eurozone. Gold companies soared

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68% in Q2 while platinum stocks rallied 62%. Also worth mentioning is Sasol, the best performing share in the second quarter, which gained 258% after losing 80% of its market value in the first quarter.

Dilution fears as capital-raising bids line up on exchange

The first signs of the impact of COVID-19 are clearly visible – nine large JSE-listed companies have indicated that they intend to raise more than R17 billion as they look to shore up balance sheets, reduce debt or make possible acquisitions. We have seen far more announcements over the past few months than we saw the same time last year. This has been the norm on a global level too. Raising capital is one of the reasons equity markets exist, but there are risks involved for investors.

> *"If a rights issue is launched and everyone follows their rights, then there is no dilution. But if a company does a rights issue and you don't believe it is the correct decision, but other shareholders pass it, then you get diluted if you don't follow it."* *– Duncan Artus, newly appointed CIO at Allan Gray.*

Bonds now junk but foreigners buying again

The turmoil in global financial markets, and the sudden plunge in oil prices wreaked havoc in fixed income markets across the globe. SA government bonds did not escape the pain, as we lost our last remaining investment grade-rating from Moody's in March. However, like equities, SA bonds have recovered from the March lows.

By way of an example, the nominal yield on the 10-year SA government bond was trading north of 12% at the height of the sell-off in March before falling by almost 3% in the second quarter to finish just above 9%. As yields fell, the ALBI posted a 9.9% return in Q2 and 0.4% for the year to date. Foreigners returned to our markets – after selling a record R64 billion of government bonds on a net basis in the first five months of the year, foreign investors bought R5 billion of SA debt in June.

> *"Outflows were wildly overestimated" – Nishan Maharaj, Head of Fixed Interest Investment at Coronation Fund Managers*

SA government bonds remain attractive relative to peers. The credit default swap (CDS) spread seems to suggest this – SA government debt is trading at a higher spread relative to countries of a similar credit rating. This spread reflects the price that investors must pay to insure against a country defaulting on its debt and indicates the market's perception of the creditworthiness of a sovereign issuer. On a real yield basis, SA also looks attractive. The table that follows shows that longer-dated bonds are pricing inflation closer to the upper end of the SARB's target band.

	5 years	**10 years**	**15 years**	**20 years**	**25 years**
Nominal bond yield	7.0%	9.2%	10.7%	11.1%	11.2%
Less: real bond yield	3.8%	4.2%	4.6%	4.7%	4.7%
Equals: implied break-even rate	3.2%	5.0%	6.1%	6.4%	6.5%
Less: adjustment for inflation-risk premium	0.7%	0.8%	0.9%	1.1%	1.2%
Equals implied average inflation compensation embedded in nominals	2.5%	4.2%	5.2%	5.3%	5.3%

Source: Prescient Investment Managers, June 2020

The trajectory of SA sovereign debt levels remains concerning

> *"Standard & Poor's expects that government debt could hit 75% of GDP by the end of the year and reach 84.7% by 2023. A decade ago, SA's debt was at 33% of GDP".*

SA is highly reliant on external financing to fund its joint current account and budget deficit. In addition, foreign holdings of SA government bonds have decreased significantly since 2017. An unprecedented revenue shortfall of more than R300 billion is anticipated this year, and the announcement of the R500 billion stimulus package is likely to place additional strain on the country's finances.

Money market lost its attractiveness

The recent high real returns from cash proxies were a unique investment opportunity for many investors as money market investments have comfortably beaten inflation and riskier asset classes. With the repo rate dropping by 150 basis points over the quarter to 3.75%, the lower short-term interest rates suggest this has passed. Although money market returns do not reset immediately, investors can expect them to trend down towards similar levels as existing investments mature. It therefore seems likely that cash-like investments will struggle to protect real wealth over the coming years.

SA listed property sector – how a combination of high debt levels and low asset values can spell disaster

Despite SA's lockdown restrictions moving from level 5 to level 3, listed property companies and their tenants continue to face headwinds. While the All Property Index (ALPI) recorded a return of 18.7% for the second quarter, the ALPI is still down 19.8% over the three years to June 2020.

The collapse of Intu Properties' share price highlights some of the challenges faced by property companies. Intu has been battling with a R100 billion debt pile and recently asked the JSE to suspend its listing after it went into administration. KPMG has been appointed as administrator. Intu's troubles are a chill wind for SA, where the listed property sector – carrying large amounts of debt and experiencing weak market fundamentals even before COVID-19 pandemic – has been hit particularly hard by the lockdowns.

> *"Although it's easy with hindsight to tell companies to manage their debt, there is also a lot of hubris with property stocks thinking they can simply ride out the tougher cycle. Maybe you will, but maybe you won't. You always have to go into these cycles with a lot more headroom (i.e. less gearing) than you think." – Paul Duncan, Investment Manager at Catalyst Fund Managers.*

Can the local economy bounce back?

If the latest economic "baseline" predictions from the World Bank prove correct, 2020 is likely to see world recession records being smashed as the COVID-19 pandemic deals a devastating blow to global growth.

- The "deepest global recession since World War II"
- The "highest synchronisation of national recessions since 1870"
- The "first output contraction" within emerging market and developing economies (EMDEs) since 1960
- The "fastest and steepest downgrade in (global) growth forecasts" on record and "more than twice as deep as the recession associated with the global financial crisis" in 2009.

Local economic data on how the lockdown has affected the country is slowly trickling in. The monthly data readings that the country has been able to produce, despite the movement restrictions, show that the impact on the economy has been severe. More than 10% of businesses had permanently closed by the end of May and another 20% has closed temporarily.

There is concern about how the already-spluttering South African economy will bounce back, as well as how longstanding structural issues will be resolved. The SARB predicts that SA's GDP could shrink by 32.6% in the second quarter of 2020 and by 7.2% for the year as a whole. Before the arrival of COVID-19, the economy was already in crisis, characterised by a declining sovereign rating, low levels of investments, low levels of growth, an unsustainable fiscal situation, ballooning unemployment and increasing social instability. For that reason, a clear commitment to structural reform is the key, or more directly put, the only way to save the local economy.

Implementation, implementation, implementation...

The World Bank expects SA's economic growth to rebound modestly by 2.9% next year, boosted by the government's announced fiscal stimulus package. However, the bank echoed that the recovery could gain further traction if planned structural reforms are implemented, including plans to improve public investment management and to encourage greater private sector participation in infrastructure development.

Be patient – staying the course

COVID-19 has fundamentally changed our world and we worry about many things including our investment savings. Markets have been very volatile, which is to be expected as markets do not like uncertainty – nobody knows how long the pandemic will last and there is no vaccine to prevent the coronavirus disease. However, one thing is certain and that is when it comes to investment decisions, we should keep our emotions in check, despite elevated levels of the anxiety and fear.

The old saying, "it's not about timing the market, but about time in the market," has once again been proven true this year. Investors who stayed invested after the first quarter demise reaped some good rewards as markets rebounded in Q2. Research shows that those that stay invested over the long run in a well-diversified portfolio, generally do better than those that look at their portfolio every day and try to profit from turning points in the market. Patience is the name of the game.

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