Market Commentary

Q3 2020

COVID-19 debt becomes payable… global economy remains in crisis but markets have recovered

"COVID-19 has triggered a global crisis like no other – a global health crisis that, in addition to an enormous human toll, is leading to the deepest global recession since the second world war" – World Bank Group Flagship Report

The numbers are brutal with massive falls in economic output, many firms having closed permanently and thousands of jobs lost. The world is now "paying the bill" for a pandemic that has tragically claimed more than 1 million lives.

Increasing concerns around a second wave of infections and the absence of a vaccine are dampening hopes of a speedy global economic recovery.

Domestic economic data remains poor, despite easing restrictions

The nationwide lockdown that started on 27 March deepened the slump for the local economy. Local GDP shrank an annualised 51% in the three months to June, compared to a revised 1.8% contraction in the first three months of the year – this was the steepest decline since 1990. On an annual basis, SA GDP fell 17.1% y/y in the second quarter after recording growth of 0.1% y/y in the first quarter of 2020. It is worth noting, however, that South Africa was already in a technical recession before emergence of COVID-19.

On the employment front, SA lost 2.2 million jobs in Q2, sending the unemployment rate, as per the extended definition, to more than 40%. The staggering decline in the unemployment rate is the first real indication of how the labour force has been affected by the pandemic. These lost jobs mean that there are only 14.1 million people employed in the country – the lowest since 2008.

Another key concern is that the number of people employed in SA has failed to keep pace with the growth in the population. This is best highlighted by the fact that the youth unemployment rates – using the expanded definition of unemployment – is now up at a staggering 73.4%.

Interest rates at a four-decade record low

In an attempt to help mitigate the economic fallout of the pandemic, the South African Reserve Bank (SARB) announced a further 25 basis points repo rate cut in July, taking the rate to 3.5% and the prime commercial lending rate to 7%. Since the start of 2020 the repo rate has been reduced by 300bps and is likely to remain at current levels, at least in the short to medium term as the SARB remains comfortable with the inflation outlook. On the flip side of the coin, economic growth remains tepid and the SARB is mindful of the need to attract and retain foreign investment. Lower interest rates unfortunately do not support this cause.

Monetary policy alone cannot improve the potential growth rate of the economy or reduce fiscal risks. These need to be addressed by implementing prudent macroeconomic policies and structural reforms, increasing investment opportunities, potential growth and job creation.

"While it can be argued that the Reserve Bank has scope to cut interest rates slightly further, the risks associated with further rate cuts simply outweigh the potential rewards" – Kevin Lings, STANLIB Chief Economist

STANLIB

MULTI-MANAGER

IMF approves $4.3 billion loan for SA

As part of government's R500 billion fiscal relief package, the International Monetary Fund (IMF) approved SA's rapid financing instrument (RFI) to the tune of $4.3 billion. A rapid financing instrument is a low-cost loan to IMF member countries needing emergency assistance, without needing a fully-fledged programme in place. The loan comes at a very low interest rate of 1.1% and is intended to ease the "pain" caused by the pandemic. It converts to just over R70 billion. SA has received similar COVID-19 facilities from the New Development Bank ($1 billion) and the African Development Bank ($288 million).

Local bourse staged a strong recovery over the past six months

The JSE ALSI was relatively flat for the quarter, gaining only 0.7%. At the start of the quarter, it appeared the momentum built in Q2 (up 23.2%) was continuing but in August and September, news of a second wave of infections broke and local equities retreated 1.8%. Moreover, the almost forgotten trade war between China and the US resurfaced, leading to a sell-off in equity markets across the world. Despite a flat Q3, the ALSI gained 24.0% over the past six months, almost reversing all the Q1 loses. Year to date, it is down only 2.5%.

Resources remain the major driver of equity returns for 2020, up 11.9%. Within resources, it is mainly gold companies that have carried the sector, benefitting from cleaning balance sheets a few years ago and a higher gold price as investors look for safe haven assets. Looking at two other sectors, industrials are up 4.3% for the year with technology stocks (Naspers and Prosus) up 30.8%. This is not surprising given that technology companies have been beneficiaries of the pandemic as the need for people to work from home has increased demand for their services. The financial sector, on the other hand, depends largely on SA growth, has been hit hardest, losing 32.8% for the year.

Fixed income continues to outperform

The past few years have been difficult for growth assets – equities and property. Over the past five years, equities returned 4.8% and the property market lost 15.2% as measured by FTSE/JSE All Property Index. During the same period, bonds and cash have returned 7.6% and 7.1% respectively. This year is no different – bonds are up 1.8% and cash is up 4.3%, while equities and property are down 2.5% and 47.8% respectively.

Looking at the yield curve, the short end has come down with the SARB's interest rate cuts and is likely to remain anchored for the next few months as inflation remains low. This means that going forward, the high historic returns realised by investors in money market funds may no longer be there. SA's 3-month Jibar rate is currently trading at 3.4%, considerably lower than the 7.0% seen just two years ago. The belly of the curve is where most of the returns came from this year –investors who held 1- to 7-year bonds have seen returns north of 10%. The long end of the curve seemed to be pricing in SA's deteriorating fiscal position, with the SA 10-year government bond currently trading at 9.4%. Some investors argue that this is attractive considering that the SARB tries to keep inflation at roughly 4.5%.

Property remains in the doldrums

The property market has faced several blows in the past few years. It started with the collapse of the Resilient stable of companies in early 2018. This was followed by poor economic growth in SA of 0.8% in 2018 and 0.2% in 2019. While the market was digesting this, COVID-19 hit, sending the market down 47.8% this year. This performance has erased almost all its historic gains with 10-year returns now at 0.8%.

However, property companies are working tirelessly to improve their odds. They have cut income pay-out ratios to lower levels and are "cleaning" up balance sheets. Furthermore, they are selling non-core assets and exploring ways to repurpose loss-making properties for other uses. The lockdown restriction on the sale on non-essential goods meant that most tenants were unable to meet rental obligations in those months. However, since some of those restrictions were lifted, collections have improved and customers are slowly finding their way back to retail centres. Indications suggest that 2020 will be a difficult year but 2021 might be better, partly due to the low base set this year.

Global markets – sharp quarterly gains but worries remain

While SA equities struggled in Q3, Wall Street on the other hand, had an impressive run despite a challenging September. In fact, the market witnessed the best August for the Dow Jones Industrial Average and the S&P 500 since 1984 and 1986, respectively. The Dow Jones gained around 7.6% during the third quarter. Moreover, the S&P 500 Index rose almost 8.5% while the Nasdaq Composite Index increased around 11% in the same period. Globally, the MSCI World Index gained 8.0% in US dollar terms for Q3 and 2.1% YTD, from being down 20.9% in the first quarter.

The global economy continued to reopen in phases and the massive US Fed and government stimulus boosted investor optimism in the third quarter. Continued support from the Federal Reserve helped drive gains, as the central bank leaned further into the "whatever-it-takes" approach taken to support markets and the economy. After already cutting interest rates to nearly zero, the Fed said that it may keep interest rates low even if inflation runs above its 2% target level. In the UK the Bank of England voted unanimously to maintain the Bank Rate at a record low of 0.1% and the size of its bond-buying programme at £745 billion during its September meeting.

Moreover, the world's largest economy witnessed a rise in manufacturing activity in Q3 to nearly a two-year high in August owing to solid new orders. Jobs data in September showed that the unemployment rate dropped from 8.4% to 7.9%, indicating an improving economy. Encouragingly, approximately half the jobs that were lost during the pandemic have been restored and all these factors kept investors upbeat.

But stocks have struggled since the market peaked on 2 September, with that month marked by a sell-off in heavyweight technology-related stocks. People rushed to book profits, perhaps due to worries over lofty valuations and the approaching elections. The aggravating coronavirus outbreak also caught investors' attention, making them increasingly apprehensive about another round of lockdowns. The economic situation at the hands of the pandemic remains dire. Major airlines have collectively announced plans to cut some 30,000 airline workers. Investors also worried about the uncertainty surrounding an additional US fiscal stimulus package. Other worries include rising tensions between the US and China, and in the UK trade negotiations with the European Union remain in flux, with a hard Brexit still a risk.

Conclusion – an uncertain economic outlook

> *The COVID-19 pandemic has, with alarming speed, delivered a global economic shock of enormous magnitude, leading to steep recessions in many countries. The baseline forecast envisions a 5.2 percent contraction in global GDP in 2020 – the deepest global recession in eight decades, despite unprecedented policy support. – World Bank Flagship Report*

A rising case count in some major advanced and emerging market economies, together with depleted fiscal stimulus in the US and a vaccine that is still months away, add up to an uncertain outlook for the global economy.

As some pandemic job losses become permanent, the recovery in labour markets is slowing. In the US, applications for unemployment benefits remain elevated at approximately four times the level of last year. Realistically it is going to take a considerable time for the US economy, and by implication employment, to get back to the level that prevailed prior to COVID-19. Some countries are seeing encouraging virus data – especially China, from where the disease first spread. The world's second-largest economy has managed to bring the pandemic under control and get further along the road to recovery than most peers.

Locally, our economic challenges are massive. Between 2015 and 2019 South Africa achieved an average annual growth rate of only 0.8%, well below the level of growth required to generate a meaningful increase in employment, and also below the population growth. This means that GDP per capita continues to decline and is expected to fall dramatically further in 2020. The lockdown to curb the spread of the coronavirus pandemic is expected to contribute to an 8.2% contraction in gross domestic product, according to the central bank forecasts.

We need less talk and more action

With consumer and business confidence remaining at depressed levels and with the uncertain economic outlook, extraordinary steps are needed to boost long-term growth prospects. We unfortunately have "run out" of traditional policy measures to save the economy. This means that government's growth plan ("South Africa's much-anticipated COVID-19 economic recovery plan will be unveiled soon") should focus to a large extent on initiating a wide range of private/public partnerships as a means to stimulate growth and employment.

> *"Ultimately, the success of the government's growth and employment agenda will be determined not by the quality of the policy document but instead by their ability to make progress in implementing real reforms that encourage the business sector – Kevin Lings, STANLIB Chief Economist*

....and then implement the real reforms

"Specific reform commitments at the time of the October Medium-Term Budget Policy Statement will be a critical step to buttress the credibility of the reform efforts and should be followed by steadfast implementation," said the IMF's first deputy managing director and chair, Geoffrey Okamoto

Uncertainty is no friend to investment

Source Carl Richards

Lastly, the uncertain global economic outlook poses a difficult question for local investors: What should I do? Faced with disappointing returns in growth portfolios, it is a natural instinct to want to react and make portfolio changes. The short answer to the question, however, is to act rationally. Prudent investing is about cool-headed decision-making. In times of market volatility, investors should focus on maintaining an appropriate level of diversification and position their portfolios for a variety of potential outcomes. Diversification is key.

Albert Louw CFP®
STANLIB Multi-Manager: Head of Business Development
Albert.Louw@stanlib.com
www.stanlibmultimanager.com