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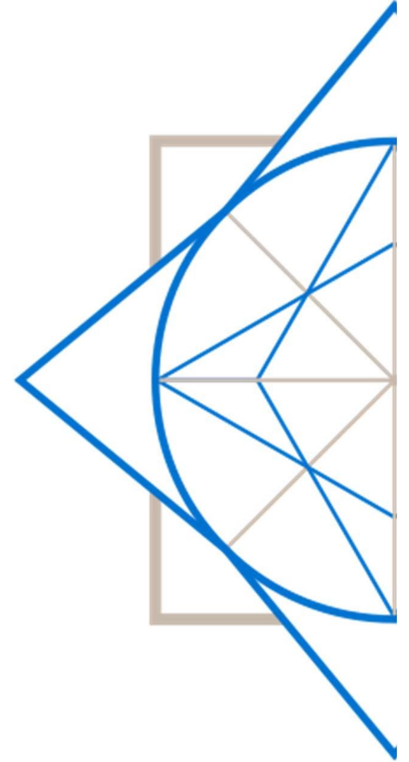

Quarterly Market Commentary

Q1 2020

We would like to reassure all our clients and partners that we are fully operational during this time of crisis and hope that you and your families are staying safe and well. If you have any queries, please do not hesitate to contact us at any time

COVID-19

The global and local market reactions to the COVID-19 virus has dwarfed all other market related events in recent years. What started as an international health crisis has now developed into a global economic crisis the likes of which may well surpass that of the global financial crisis in 2008/09.

We do not consider ourselves experts regarding infectious diseases and the management thereof, we therefore take this opportunity not to discuss the virus itself but rather to discuss both the possible economic impact that may be attributable to it, as well as the mechanics driving the negative returns in the market. We have excellent independent macro-economic minds at our partners (BCA Research) assisting us with unpacking the global data while one of our local partners (ETM Analytics) is giving us real perspective on the impact on the Rand and financial and capital markets.

As countries scramble to contain the spread of the virus, equity markets reacted quickly to the perceived impact on economic growth, driving equity prices down significantly, at one stage causing the biggest weekly drop in the S&P 500 since 1929. The drop in equity prices caused the price of safe-haven assets such as the USD, Gold, and bonds to rise sharply, but as equity prices continued to drop, many traders started facing margin calls on their positions and became forced sellers of their liquid “safe” assets. This forced selling caused the rather rare circumstance where nearly all asset prices, risky or not, were highly correlated and falling together. This event is what is generally known as a “Market Crash”.

The Organization for Economic Co-operation and Development (OECD) recently estimated that for every month that a country remains in “lockdown”, the estimated economic output growth of said country will decline by 2%. As an illustration, South Africa currently has a growth outlook for 2020 of 0.5%, if the lockdown continues for a full month, the OECD estimate would result in a GDP contraction of (1.5%). Many governments are faced with very tough decisions having to weigh up the loss of human life against the long-term economic costs of their attempts to contain the viral outbreak. The lockdowns have been balanced by substantial and coordinated efforts by governments and central banks to stimulate the global economy on a broad scale, more on this later in the report.

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SA Market Overview

Much of the good news that we started the year with has been completely overshadowed by a singular "black swan" type event. COVID-19 shook and continues to shake the market in a way that hasn't been seen since the great depression (90 years ago). While it is likely that the central bank has done enough to avoid a depression-like spiral, a resulting severe and extended recession will be dire for all emerging markets, including South Africa. The sheer number of businesses that are likely to close their doors permanently will have a knock-on effect on the already dwindling employment in our country and the lockdown will have many more economic effects, some unknown. The government measures taken are necessary to avoid the potentially enormous and painful human cost of the virus. One cannot discount that for many, especially in impoverished communities the economic slowdown will be dire. We know that in times of economic crises, all asset classes (bar a few) become more correlated and this spiral affects everyone. It is not surprising that cash is again king as it was the only major asset class (barring gold) to have a positive return over the month and indeed the quarter.

Loadshedding

Before the virus fully impacted us in the first quarter we saw another persistent bout of load shedding in South Africa, the experience reached a peak in early March, when an abundance of sea life in the form of jellyfish swarms clogged the water pumps used to cool the nuclear reactor at Koeberg nuclear power plant, forcing the authorities to shut down generation at the plant for close to a week. The shutdown of Koeberg as well as the already strained power grid resulted in nearly a third of the national generation capacity affected, leaving many South Africans in the dark. At the same time there was long overdue good news, the government recently approved miners and resources companies to produce their own electricity if they have the capacity, which is a great leap forward in the process of procuring private power utilities in our country, which many believe will solve much of the electricity generating issues.

Moody's Downgrade

After much anticipation and delays, the ratings agency Moody's, on Friday 27 March, elected to downgrade the credit rating of South African sovereign debt to below investment grade, while many feared that this would be disastrous for the South African bond market, the downgrade proved to be well priced in by the market. Evidence that the downgrade turned out to be a non-event can be found in the fact that on March 30th, the treasury had a record oversubscription at a bond auction, proving that the demand in the high yield space outweighed the low returns offered in the investment grade universe, aligning with the long standing theme of a hunt for yield by international investors.

SA interest bearing market woes

During the market downturn in March, investors flocked to traditionally safe assets, this meant that many investors were seeking to sit in cash, but the enormous demand for cash soon meant that there was no more liquidity left in the market and investors attempting to sell their positions suddenly had no bids on their assets, this was a problem across the globe, but more to the point, the South African fixed income market dried up significantly, with credit spreads widening immensely as investors became willing to sell at any price in order to stockpile a cash position. The SARB made a quick and correct decision to cut the benchmark repurchase rate by 1% to 5.25%, thereby reducing the cost of borrowing and aiding both companies and consumers. In addition, they stepped in to guarantee buying government bonds adding much needed liquidity in the short term. This short-term liquidity crisis resulted in all but bank deposits taking temporary losses as SA's big banks were all downgraded by the ratings agencies and credit spreads widened.

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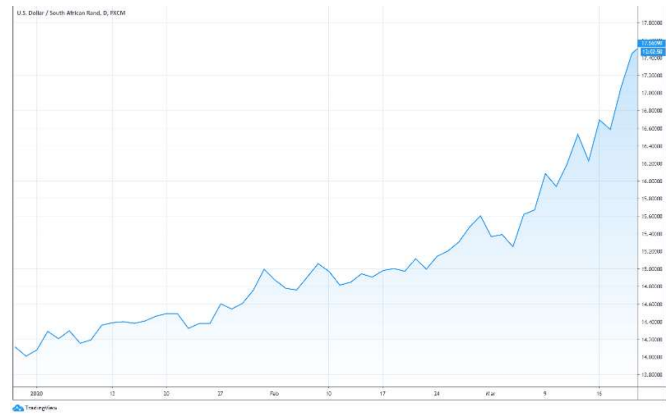
ZAR depreciation

The Rand saw one of its worst performing quarters in Q1, losing close to 22% against the USD over the three-month period, with 12% of these losses happening in March. The significant weakness was mainly a result of the strong risk off sentiment due to the spread of the COVID-19 virus and the expected negative effects of this on the global and especially emerging market economies. The Rand did however underperform most of its emerging market peers, likely a result of the significant idiosyncratic risks related to our fiscal position. The Rand is (at the time of writing) trading at close to a 35% discount to fair value vs. the USD based on purchasing power parity, a undervaluation of this magnitude has historically been unsustainable in the medium term, which suggests evidence of a Rand rally sometime in the not too distant future. The graph above shows the USD/ZAR exchange rate over the quarter.



Inflation

South African inflation creeped up over the quarter increasing to 4.5% in January and then 4.6% in February. This was mainly driven by increases in the food and beverage section of the inflation calculation. The consensus is that these increases are short term, as the plummet in oil price is very likely to decrease cost of goods across the economy, especially in the transport sector. In the current market environment, economists are less worried about inflation, as thoughts shift toward the possibility of a global deflationary environment (driven by both lower demand and overcapacity and the effects that such an event could have on companies and other market participants.

SA Government and Central Bank Response towards COVID-19

The South African government has been praised for its' swift and decisive measures to contain the spread of COVID-19. On 23 March, President Cyril Ramaphosa announced that a 21-day lockdown period would commence at midnight on 26th March in an effort to "flatten the curve" in South Africa and in order to ensure that our already frail healthcare system can cope with the expected influx of clinical cases. The lockdown would entail immediate suspension of all non-essential services and a mandatory stay at home policy, in which citizens are only permitted to leave their place residence to conduct essential shopping and healthcare needs. While these measures are sure to have a devastating effect on the economy, when weighed up to the human cost of not reacting, the economic cost should be bearable albeit painful to endure.

The Reserve bank also responded swiftly, opting to cut the repurchase rate by a whopping 1%, after most market participants only expected a cut of 50 bps. This caused a brief rally in the asset markets, only to be undone by the worldwide risk-off mood controlling the markets. All in all, most market participants are expecting more policy action, both monetary and fiscal, but only time will tell how these will be implemented and how effective these policy levers will be.

Also gratifying is the level of public and private sector cooperation and consultation with some of the wealthiest families in SA, Oppenheimer; Rupert and Motsepe each donating to schemes to small businesses and vulnerable employees.

The Banks are offering corporate, company and consumer loan repayment holidays and even SARS are offering tax payment extensions. On the political front virtually all opposition are either supportive of government action or silent.

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Global Market Overview

Global markets were decimated by the COVID-19 induced selloff, sending all perceived risk assets plunging. The S&P 500 saw its worse daily return since Black Monday in 1987, not on one occasion but on three separate days in March. Safe-haven assets such as the USD and US treasuries soared, with the US 10-year yield reaching its all time low of 0.25%, this is a likely reason why the global bond indexes showed such strong performance in the quarter as US government bonds are heavily overweight in these indexes. Government and Central banks have done their absolute best to support the economy during these trying times and have often seen positive results thus far. It remains to be seen whether the current stimulus will be enough, and it is more than likely that we will see more action in due time.

Brexit

After more than three and a half years of waiting, Britain finally left the European Union at midnight 31 January 2020. This comes after years of infighting in the UK parliament, as well as the broader British society. While Britain is no longer an EU member state, the country will still be part of the EU customs union and single market until the end of the transition period in 31 December 2020. This means that the UK will no longer have any voting rights in European parliament but must comply with EU rules and regulations and contribute to the EU budget during this period. This implementation period is put in place to allow trade to continue unhindered while official terms of trade can be negotiated. With COVID 19 impacting everything expect to see extensions the transition period.

US Iran military conflict

Late last year the tensions between the US and Iran picked up, reaching a fever pitch after a US civilian contractor was killed in Iraq by Iranian backed rebels. The US military reacted swiftly via an unmanned airstrike targeting a convoy of vehicles near Baghdad International airport. Later it was confirmed that the convoy was transporting Major General Qasem Soleimani, a high-ranking official in the Iranian Islamic Revolutionary Guard. The tension sparked worldwide panic at the possibility of a global conflict erupting from the show of force, yet after a few days of high tension, both militaries took a step back and tensions eased.

US China Trade talks

Early in the year the US and China agreed to a “phase-one” trade deal, reducing the major geopolitical risk of 2019. The deal is widely considered to be a temporary truce rather than a long-term reduction in risk, which is evident in the terms of the agreement, which would see China double its’ imports from the US over the next two years. The deal was likely struck as President Trump is facing re-election and wants to run on a strong economic ticket; thus, a negative trade conflict did not bode well for his voter support base. All in all, the combination of Brexit being concluded and the US-Sino trade conflict coming to an end, the reduction in geopolitical uncertainty was market positive and sent global risk assets to new highs early in the quarter.

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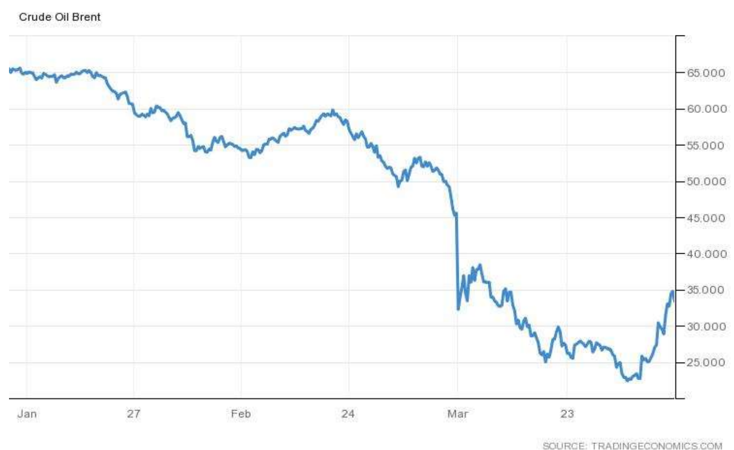
US Democratic Party Primaries

The Democratic Party primary election started in the quarter, with Bernie Sanders taking a surprising early lead. This was short lived however as centrist candidate and former Vice President, Joe Biden took a convincing majority of the votes on super Tuesday, a single day on which over a third off all democratic party delegates are up for grabs. This is especially important when considering that a total of 1357 delegates are decided on this day and a candidate only needs 1991 delegates to ensure the party nomination for President. Primaries have now been postponed due to COVID 19 priorities but, it looks more than likely that Joe Biden will be nominated as the democratic presidential candidate when the new convention date is released. Polls currently show an election between Trump and Biden as “too close to call”. The COVID-19 pandemic and its effects on the US economy will likely be more negative for Trump’s re-election chances, as he is or was running on a strong economic ticket that is quickly evaporating.

Oil market share conflict

After the oil price reached multi year highs in January on the back of US-Iran military conflicts, a breakdown in talks between OPEC+ members driven by a market share dispute between the Kingdom of Saudi Arabia and Russia led to both countries flooding the market and ramping up production. This resulted in the price of Brent oil dropping as low as $25 per barrel. This fight has continued to a point where global oil storage is nearing capacity, with pipelines filling up and production continuing, estimates show that if an agreement is not reached soon, the oil price may dip below $20 per barrel. Estimates also show that with the current storage at capacity, a significant cut in oil production of 3.7 million barrels per day would likely only have the oil price recover to around $40 per barrel by year end. At present it seems that Saudi Arabia, Russia and the US (the world’s largest producer before this collapse) will agree to cut production significantly and investors can expect further high volatility and a muted oil price for some time to come. The Graph above show the YTD price movement for Brent crude oil in USD per Barrel.



Global monetary easing & stimulus

While it is important to recognize that the only things that are most likely to solve the current pandemic is widespread treatment and self-isolation (or social distancing) the reaction by central banks across the world must be commended. The wave of coordinated stimulus (5% of global GDP) has done exactly what is needed in the current economic crisis, which is not to jumpstart a possible recovery, but more importantly to ensure that there is adequate liquidity for markets to function. There have been rate cuts from every major central bank with the US effectively cutting rates to zero and the ECB cutting further negative. The true wonder is the speed at which fiscal stimulus has been approved, which usually lags quite a bit behind as there is usually a lot of red tape. The main stimulus package to focus on is the $2.2 trillion package by the US government, which includes $350 billion in guaranteed loans. (Other major fiscal stimuli are included in Addendum A).

One very key difference between the current AID packages and those during the Great Finance Crisis is the implementation of what is called “Helicopter Aid”, where governments provide financial support more directly to consumers rather than almost exclusively via the banking system. They are providing salary support, lower pay-as-you-earn taxes and cash payments for employees laid off due to COVID – 19 related issues.

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ANNEXURE A

Current fiscal policy responses in reaction to COVID-19

COUNTRY	STIMULUS PACKAGE DESCRIPTIONS	BN LOCAL CURRENCY	BN USD*	GDP**	% OF GDP
AUSTRALIA	- First package : A$ 17.6bn. - Second package: A$ 66.4bn.	84	50	1376	4%
BRAZIL	- A package of emergency measures worth nearly R$150bn.	150	30	1847	2%
CANADA	- C$10bn credit facility for distressed businesses. - C$1bn COVID-19 support. - C$107bn targeted at businesses &households - C$52bn in direct support, C$55bn in tax deferrals. - C$17bn stimulus package announced by Ontario including C$10bn tax deferral	70	48	1731	3%
CHILE	- A $11.7bn package of emergency measures aimed at saving jobs and protecting small businesses	9750	12	309	4%
CHINA	- CNY448bn increase in local frontloaded bond quota (from 2019 Q1). - ≈CNY300bn net UCIB issuance increase (2020 vs 2019). - CNY116.9bn to combat COVID-19. - Increase in budget deficit ≈2% of GDP. - Social credit growth (total) will be normalized.	2885	404	14140	3%
FRANCE	- €45bn to invest in and support SMEs and health-care systems. - €300bn in government loan guarantees. -Setting up a $4bn rescue package	49	53	2707	2%
GERMANY	- €156bn in debt to finance higher social spending. - €600bn rescue fund including 400bn guarantees. - KfW was authorized to lend up to €550bn to boost liquidity	356	384	3863	10%
GREECE	- A package of nearly €10bn.	10	11	223	5%
INDIA	- A stimulus package worth 1.7tn rupees.	1700	22	2936	1%
INDONESIA	- First package: Rp10.3tn. - Second package: Rp 22.9tn. - Third package: Rp 27.17tn. - Rp120tn tax incentives and subsidies for businesses and households.	180370	12	1112	1%
ITALY	- A package of €25bn for emergency aid to households, businesses and the health care system. -Considering a second package more than €25bn.	50	54	1989	3%
JAPAN	- ¥1.6tn low interest government loans to support SMEs. - ¥430bn fiscal spending across the economy. - Ruling party is considering an ¥56tn emergency economic package.	58030	528	5154	10%
MEXICO	- Mex$181bn fund to minimize COVID-19 impact.	181	7	1320	1%
NEW ZEALAND	- A NZ$12.1bn package including wage and income support and support for health services and national airline.	12	7	205	3%
POLAND	- A zł212bn program to boost infrastructure and healthcare spending and shield companies from the impact of the virus	121	28	607	5%
RUSSIA	- Considering a 300-billion ruble anti-crisis fund to try to shield its economy from the coronavirus shock	300	4	1638	0%
SOUTH KOREA	- ₩3.2tn to plug the expected budget deficit. - ₩8.5tn in fiscal spending. - ₩50tn 'emergency funding' for small businesses.	58500	47	1630	3%
SAUDI ARABIA	- Stimulus measures amounting to SAR 120bn, including SAR 50bn package to support SMEs and SAR 70bn to aid businesses.	120	32	779	4%
SINGAPORE	- First package in Feb: S$6.4bn. - Second package: S$48bn.	54	38	363	10%
SPAIN	- A €200bn package, including €100bn of state loan guarantees,	100	108	1398	8%
SWEDEN	- A package of measures worth more than 300 bn to support the economy.	300	29	529	5%
SWITZERLAND	- CHF 32bn package mostly targeted at SMEs. - CHF 10bn in emergency aid including wage subsidies. - Setting aside CHF 20bn to guarantee bank loans.	42	43	715	6%
TURKEY	- Economic Stability Shield Package ₺100bn.	100	15	814	2%
UK	- Four stimulus packages worth £65.5bn. - £350bn government-backed loans and guarantees.	66	77	2744	3%
US	- A $2.2tn package including about $350bn guaranteed loans	1850	1850	21439	9%
TOTAL			3892	71566	5%

NOTE: LOAN GUARANTEES AND TAX DEFERRALS ARE EXCLUDED FROM THE CALCULATION IF THE AMOUNT IS SPECIFIED IN THE DESCRIPTIONS.
* CALCULATED USING SPOT EXCHANGE RATES ON 19 MARCH, 2020.
** SOURCE: IMF.

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ANNEXURE B

Asset Class Performance (ZAR)

As at 31 March 2020	MTD	YTD	1 Year	3 Years*	5 Years*
Global Equity – MSCI ACWI	(2.78)	(0.88)	8.56	11.37	11.28
Global Property - FTSE EPRA Nareit DR	(12.45)	(8.62)	(3.94)	6.74	7.15
Global Bond - JPM GBI Global Traded	13.63	31.68	32.95	15.06	11.48
Global Cash - ICE LIBOR 1 Month	13.67	28.26	26.50	12.09	9.46
SA Equity - FTSE/JSE All Share	(12.13)	(21.38)	(18.42)	(2.07)	(0.13)
SA Property - FTSE/JSE SA Listed Prop	(36.57)	(48.15)	(47.91)	(23.00)	(13.50)
SA Bond - Beassa ALBI	(9.75)	(8.72)	(2.99)	5.27	5.18
SA Cash - STeFI Call Deposit	0.52	1.55	6.57	6.66	6.58

Asset Class Performance (USD)

As at 31 March 2020	MTD	YTD	1 Year	3 Years*	5 Years*
Global Equity – MSCI ACWI	(14.37)	(22.40)	(12.34)	1.22	2.97
Global Property - FTSE EPRA Nareit DR	(22.88)	(28.46)	(22.44)	(2.98)	(0.85)
Global Bond - JPM GBI Global Traded	0.09	3.10	7.35	4.57	3.16
Global Cash - ICE LIBOR 1 Month	0.13	0.42	2.14	1.88	1.28
SA Equity - FTSE/JSE All Share	(22.60)	(38.45)	(34.13)	(11.00)	(7.59)
SA Property - FTSE/JSE SA Listed Prop	(44.13)	(59.40)	(57.94)	(30.02)	(19.96)
SA Bond - Beassa ALBI	(20.50)	(28.53)	(21.67)	(4.33)	(2.68)
SA Cash - STeFI Call Deposit	(11.46)	(20.49)	(13.95)	(3.06)	(1.37)

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