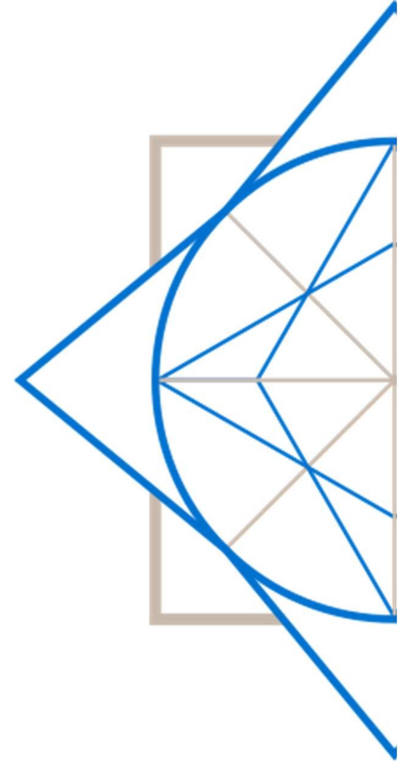

Quarterly Market Commentary

Q2 2020

SA Market Overview

South African capital markets performed strongly this quarter, mostly on the back of a global risk-on sentiment related to the hope of a quick economic recovery from the Coronavirus pandemic. Risk assets performed especially well with South African listed equities making up most of the losses from the COVID-19 related selloff, boasting a return of 23.2% for the quarter, leading to a slightly negative YTD return of (-3.2%). Listed property also had strong performance near the end of the quarter, with a June return of 13.4% bringing the total quarterly return to 20.4%. This must not be considered necessarily bullish news on property given that the YTD return is still strongly negative at (-37.6%) and the outlook is poor.

Cash performed roughly in line with expectations given the slew of recent rate cuts, only delivering 0.32% during June, but having performed relatively well over the quarter as a whole, returning 1.12%. The South African fixed income market (ALBI) recovered very well during April and May following the liquidity crunch caused by the COVID-19 related selloff. The ALBI returned an impressive 9.9% over the quarter, especially impressive considering the return during June was negative at (-1.2%)

Lockdown & Easing

South Africans have witnessed a historic quarter with Coronavirus prevention measures, specifically the implementation of lockdown measures to curb the growth in cases of COVID-19 in an effort to control the spread of the virus in a manner that our frail public healthcare system could handle. The entire month of April was spent in what has now become known as a 'hard lockdown', meaning that all residents were forced to stay home for all but the most essential of services such as groceries and medical care. This led to a mass reduction of economic activity the likes of which our country has never seen.

On the 1st of May, we saw the first reduction in restrictions, with the introduction of a staggered reopening of the economy involving COVID-19 alert levels. Level-5 being the most restrictive and taking the form of the 'hard lockdown' seen in April and level-1 being essentially a return to normal life. Level-4, which took effect on May 1st saw only minor changes such as outside physical exercise was allowed but coupled with restricted times and strict social distancing measures. A few select sectors of the economy were allowed to resume work on a limited basis.

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After a month spent on level-4 South Africans moved to lockdown level-3 which saw many more industries open, including mining and some manufacturing companies opening in a limited capacity, the country has since moved on to the somewhat arbitrarily named 'advanced level-3' that saw the opening of many service oriented businesses such as sit-down restaurants, hotels and casinos. This has brought a much-needed respite to many South Africans that had had little to no income in the preceding two months.

All in all the full economic toll that the lockdown restrictions have had on our country remains to be seen, however with production shrinking along with the tax base and increased government expenditure and public debt on the rise, the combination points to some harrowing years ahead as future generations will be on the hook for the expenses and debt generated in these troubling times.

Stimulus package

During April, President Ramaphosa announced a historic relief package to aid in limiting the economic and social impact of the pandemic. The stimulus package totals R500 billion and equates to roughly 10% of GDP before being adjusted for the downturn in economic activity. While the fiscus is already in dire straits, Treasury must be commended for the structure of the aid package, with only about R170 billion expected to directly affect the fiscus, amounting to 3.4% of GDP. While a far cry from ideal, we should accept that these are necessary actions and we can but hope that government finances will be better managed going forward.

Finance minister Tito Mboweni delivered an emergency revised budget in late June that focused on the brutal effect that the pandemic has had on our country's finances. He stated among other statistics that expected tax revenue for 2020/21 has been revised downward from R1.41 trillion to R1.12 trillion and stated that they expect gross national debt to rise to 81.8% of GDP from an initial estimate of 65.6%. The far-reaching effects of this are clear, the government must now implement broad sweeping fiscal reform if we are to avoid a sovereign debt crisis in the near future. Governments political will to enact this change has been lacking in the past and the finance minister's speech was clear in its intent to shock political leaders to action.

ZAR depreciation

While the ZAR was positive during the quarter, returning 2.74% vs the US Dollar, the YTD calculations tell a much more sombre story, totalling a Rand depreciation of 20.31%. While much of the depreciation over the course of the year can be attributed to the dollar's status as a safe haven currency, strengthening during the COVID-19 selloff in March, the poor fiscal state of South Africa has ensured that the subsequent recovery of the local currency has been muted, even when compared to other emerging market currencies such as the Turkish Lira and Brazilian Rial.

Even after the numerous rate cuts over the past six months (repo cut from 6.5% to the current 3.75%), the policy interest rate in South Africa is still relatively high compared to most economies. This has come in handy, stabilizing of capital markets, via a very attractive carry trade involving the ZAR. A carry trade is a trading strategy that is categorized by borrowing in a low interest rate currency (Euro, Dollar, Pound) and investing the proceeds into a higher interest rate currency (ZAR), the trade is profitable when the high interest rate currency (or asset such as bonds) does not depreciate more than the positive difference between interest rates of the two currencies. At current levels, the currency could strengthen over the coming six months.

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New infrastructure plan

On 23 June 2020 President Cyril Ramaphosa hosted the Sustainable Infrastructure Development Symposium (SIDS), in which he unveiled a 10-year R2.3 trillion infrastructure plan. The goal of the symposium was twofold; to raise investment from the private sector both locally and globally; and to promote improved transparency of infrastructure investment projects in South Africa, that has long been a contentious topic, given the level of corruption at tender and supervision level in the past.

With detailed business plans available for 276 currently shortlisted projects being evaluated for inclusion in the plan, investors attending the conference felt that the government has taken welcome steps in creating transparency in the infrastructure development field. The plan includes a broad range of projects including human settlements, agriculture, transport, communication, electricity generation and water.

The updated process of infrastructure investment is a welcome step forward in the red tape laden industry that has been difficult to break into due to the aforementioned corruption and lack of transparency. Broadly speaking the idea of reform in the public works sector is market positive in the long term, as it crowds in private investment and will in the long-term alleviate the burden placed on the fiscus.

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Global Market Overview

In a welcome turn from the previous quarters market decline, all major global asset classes posted positive returns during the second quarter. Risk assets were the preferred method of participation in the recovery, with global and especially US equities performing strongly, this despite most companies' earnings having been decimated by global lockdown measures. A major risk to the current recovery is the upcoming US earnings season considering that almost 60% of companies did not provide any earnings guidance prior to quarter end.

The global equity markets seemed to ignore all negative news flow during the back end of the quarter, with the main theme being the rally created by the sheer amount of fiscal and monetary stimulus announced to counteract the economic effect of the COVID-19 pandemic. Global equities had a strong quarter, almost erasing the losses from the first quarter, ending the period up 20.06% but still -6.83% YTD. Global property followed suite in the rally, although coming nowhere close to recovering the losses suffered earlier this year, the quarterly return of 10.51% was only enough to bring the YTD return to a staggering -20.94%.

Fixed income performed well during the quarter, although the returns seem fairly muted following the rush to safety in Q1 that caused unusually high returns from global bonds. The global bond market was up 1.46% during the quarter, bringing the YTD return to a very respectable 4.68%. Global cash was muted during the quarter, likely a result of developed markets cutting rates dramatically causing near-zero (or even negative) rates in most developed markets.

Oil Flash Crash

The lockdown measures intended to limit the spread of the COVID-19 pandemic across the globe placed severe limits on the movement of people, goods and many business services, this had a major effect on the demand for petroleum products and had economists expecting a prolonged depressed oil price. Then came an even more significant shock from the supply side as a squabble over global oil market-share led to the two largest oil suppliers in the world, the Kingdom of Saudi Arabia (KSA) and Russia, flooding the market with an oversupply of oil. Within weeks the global oil storage was approaching capacity, this ultimately meant that investors holding WTI futures (which demand physical delivery) had nowhere to keep the oil they had purchased. As these investors offloaded their positions the price of oil reached a record low and in fact WTI went negative to -$40 per barrel. This was quickly rectified however as the delivery date passed and KSA and Russia (along with the US) agreed to cut production by upwards of 12 million barrels per day. Prices have approached normal levels and at quarter end with Brent crude oil trading at $41.60 and WTI at $39.83 per barrel but down 34% YTD. The depressed oil price has also had a major effect on the response to the economic weakness caused by COVID-19, as oil is a major component in almost all countries inflation, thus contributing to lower inflation across the globe and giving policymakers more space to implement monetary policy expansion without causing massive inflation.

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US Unemployment

The past three months have seen the three highest US unemployment rate prints since the data was initially published in 1948. Whilst the unemployment rate has dropped from 14.7% in April to 11.1% in June, the number of job losses classified as permanent has been rising. The past two months have however seen the highest numbers of jobs added in US history with 2.7 million jobs added in May and 4.8 million more in June. These jobs created however pale when compared to the 20.8 million jobs lost in April 2020 due to the COVID-19 induced lockdown regulations. While the US economy has been steadily opening up, some southern states have halted and even reversed their reopening policies due to a strong resurgence in new virus cases. The US had at quarter end recorded three consecutive days of record case number increases illustrating just how fragile the reopening of economies around the world could be. Many economic observers believe that the Jobs data does not fully reflect the sheer scale of job losses as many workers are being classified as 'furloughed workers' meaning they are not classified as unemployed yet, but are not currently actively working due to the lockdown measures.

US - China Sabre Rattling (again)

A main market driver during 2019 was the escalated trade tensions between the US and China which tapered off at the end of the year. The trade war attributed to attempts by US President Donald Trump to prop up the US economy in order to raise his chances of winning reelection in November 2020. A few months later the COVID-19 pandemic decimating productivity across the globe and has resulted in the biggest economic downturn since the great depression, thus making an a booming economic running platform near impossible for the incumbent President. The dire political position that Trump finds himself in can be highlighted by the fact that current polls show Democratic nominee Joe Biden ahead of Trump by 11 points. The recent reescalation of tensions with China might be a last-ditch effort by Trump's administration to attempt a "rally around the flag" tactic to sure up Trump support for the upcoming election.

The soft conflict between the US and China was amplified later in the quarter after Beijing enacted a recently proposed new Hong Kong security law, which would see any acts of secession, subversion, terrorism or collusion with foreign or external forces criminalized. This new law is very troubling to Hong Kong residents given that the interpretation of these definitions is currently at the door of Beijing officials and can carry a penalty of up to life-imprisonment if prosecuted. The US has now officially suspended any special economic treatment it gave to Hong Kong, essentially recognizing it now as a part of mainland China, thus symbolically ending Hong Kong's 23-year history of economic autonomy from Beijing.

Brexit on the cards again

30 June 2020 marked the last chance for Britain to seek an extension on the Brexit transition period. With all that has happened over the past three months, including a suspension of Brexit negotiations, it seems that the British government has taken a massive gamble by not seeking to extend the transition period beyond 31 December 2020. This leaves the British with only six-months to eke out a new trade deal with the EU. Failure to agree a deal will see the country leave the EU with no official deal, with potentially disastrous consequences to the UK (and EU). This will come at a time that most economies will already be decimated, with the OECD estimating that the UK will suffer the worst economic downturn in the developed world this year.

The challenges created by this deadline were further exacerbated when the first talks held since February were suspended a day early due to "a lack of progress on serious disagreements". With markets focused on the economic effect of COVID-19 as well as the subsequent fiscal and monetary stimulus, investors seem to have forgotten about major risks such as these, with the GBP actually appreciating against the Dollar in the days leading up to quarter end.

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Iran and Trump arrest warrant

One may recall that at the very beginning of the year political and military tensions between Iran and the USA reached a fever pitch, culminating in the killing of Iranian General Qasem Soleimani by way of a targeted drone strike on his convoy near Baghdad International Airport. Tensions have since abated but have come rushing back recently after Tehran issued local arrest warrants and applied for Interpol red-notices on more than 30 people involved in Soleimani's killing including US President Donald Trump.

An Interpol red-notice is essentially an agreement that no member state would provide assistance or sanctuary to such a person. While it is highly unlikely that Interpol would elect to grant such a notice due to their policy of not getting involved in political issues, the very fact that Tehran would invoke their right to apply for the notice is evidence of a rise in underlying tensions. Many believe that the act was merely a political show of strength after Tehran's dismal reaction to COVID-19, the long-term effects could spell danger for geopolitical stability in the Middle East.

India China border

An outlier risk that reared its head during the latter end of the quarter manifested itself through a number of border skirmishes that took place between the military forces of China and India. This culminated in two separate instances of melee fighting resulting in the death of 20 Indian soldiers and 43 Chinese soldiers. Experts believe that this was a result of preemptive measures taken by Chinese officials to curtail Indian infrastructure development near the border region, but many believe it to be an example of Chinese 'salami slicing', referring to a territory grabbing technique which involves encroaching on small parts of a territory small bits at a time.

Chinese and Indian officials have stated that there are more than enough diplomatic channels available to resolve these tensions, but an escalation in tensions between the largest emerging economy and their fastest growing economic peer is market negative in the medium term.

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STAR INVESTMENT PARTNERS

ANNEXURE A

Asset Class Performance (ZAR)

As at 30 June 2020	MTD	QTD	YTD	1 Year	3 Years*	5 Years*
Global Equity – MSCI ACWI	1.76	16.80	15.77	25.25	16.49	14.57
Global Property - FTSE EPRA Nareit DR	1.15	7.51	(1.76)	5.03	9.30	10.42
Global Bond - JPM GBI Global Traded	(0.96)	(1.30)	29.97	29.68	14.46	11.53
Global Cash - ICE LIBOR 1 Month	(1.43)	(2.56)	24.97	25.27	11.89	8.84
SA Equity - FTSE/JSE All Share	7.74	23.18	(3.16)	(3.30)	5.11	4.16
SA Property - FTSE/JSE SA Listed Prop	13.41	20.43	(37.56)	(39.98)	(18.33)	(9.06)
SA Bond - FTSE/JSE All Bond	(1.18)	9.94	0.36	2.85	8.11	7.49
SA Cash - STeFI Call Deposit	0.32	1.12	2.69	6.03	6.45	6.53

Asset Class Performance (USD)

As at 30 June 2020	MTD	QTD	YTD	1 Year	3 Years*	5 Years*
Global Equity – MSCI ACWI	3.25	20.06	(6.83)	1.65	6.03	6.64
Global Property - FTSE EPRA Nareit DR	2.63	10.51	(20.94)	(14.76)	(0.51)	2.78
Global Bond - JPM GBI Global Traded	0.49	1.46	4.60	5.24	4.19	3.81
Global Cash - ICE LIBOR 1 Month	0.02	0.16	0.58	1.67	1.85	1.31
SA Equity - FTSE/JSE All Share	9.32	26.62	(22.06)	(21.52)	(4.32)	(3.05)
SA Property - FTSE/JSE SA Listed Prop	15.07	23.79	(49.75)	(51.29)	(25.66)	(15.36)
SA Bond – FTSE/JSE All Bond	0.26	13.01	(19.23)	(16.53)	(1.60)	0.05
SA Cash - STeFI Call Deposit	1.79	3.94	(17.35)	(13.95)	(3.11)	(0.85)

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