The Outlook

June 2020

In this edition of The Outlook…

- Before COVID-19 the world was already experiencing significant structural changes;
- COVID-19 has served to fast-forward these changes;
- Economies around the world beginning to re-open;
- Massive US Fed 'stimulus' packages rolled out to provide liquidity to markets and help prevent insolvencies;
- The US and China back on a collision course;
- China announces further 'stimulus' measures;
- The Eurozone, UK and Japan announce additional 'stimulus' measures in the face of pretty bleak economic data;
- The US equities recovery largely driven by its global tech stocks (FAAMA) and more recently by the next layer of tech stocks - very skewed;
- South Africa establishes the National Coronavirus Command Council with Dlamini-Zuma de-facto running the country;
- SARB cuts Repo rate to 47-year low;
- SA moves to level 3 on 1 June;
- The JSE also suffers from incredible skewness and dominance by Naspers;
- Tumbling interest rates put income-reliant investors under tremendous pressure;
- Equity prices for the most have been battered, we trust that politicians, here and elsewhere, will allow people back to work so that equities regain their traditional role of wealth generation.

Coronavirus hastens geopolitical issues to the fore

In January Ian Bremmer, editor-at-large at TIME predicted that *"2020 would prove a tipping point moment in international politics"*. He highlighted the huge positives around decades of globalization where billions had gained peace and had been pulled out of poverty as opportunities were created. But with "*China and the US decoupling on technology, the 21st-century economy is now breaking in two. Developed countries have become toxically polarized. Climate change matters as never before. Taken together, these trend lines are likely to produce a global crisis*". He added that "*governments and the private sector will respond, but the scale of the challenges is greater than in the past, and tribalism within national politics undermines global co-operation*".

To this, we would add the growing income and wealth gap within most countries and between Developed and Developing economies, Brexit, Hong Kong, an uneasy Middle-East and the unknown intentions of Russia. Either way, the spread of COVID-19 around the world has served to fast-forward these issues, which has added great uncertainty to all our lives.

COVID-19 - health versus jobs

The Initial lockdown action taken my most governments around the world was applauded as the right thing to do if it was aimed at protecting the aged and the vulnerable and to allow the medical fraternity to be properly prepared. Two months later there seems to be enough evidence that the Pareto Principle (80:20) applies to COVID-19 as it does to all domains. In order not to wreak greater carnage on the global economy, political leaders need to do more than talk about central bank stimulus.

As economies open-up, we will soon know what our fate is. Suffice to say that most economies rely heavily on small and medium-sized business, who cannot afford the stimulus loans offered by their governments and so people in large numbers must get back to work.

The US - leader of the pack

Like it or not, global markets follow the US and importantly about 70% of world trade is conducted in US Dollars. Last week, Fed chairman, Jerome Powell addressed the Peterson Institute for International Economics.

Powell indicated that "*the scope and speed of this downturn are without modern precedent, significantly worse than any recession since WWII*". He then referred to a Fed survey that found that "*among people who were working in February, almost 40 percent of those in households making less than $40,000 a year had lost a job in March*". Powell reminded the audience that "*this time, high inflation is not a problem. There is no economy-threatening bubble to pop and no unsustainable boom to bust…….something worth keeping in mind as we respond*".

Powell warned that "*deeper and longer recessions can leave behind lasting damage to the productive capacity of the economy*". He also noted that "***the Fed has lending powers, not spending powers** and warned that the passage of time can turn liquidity problems into solvency problems*" and that "*additional fiscal support could be costly, but worth it if it leaves us with a stronger recovery*". Powell left the best for last: "*this tradeoff is one for our elected representatives, who yield powers of taxation and spending*".

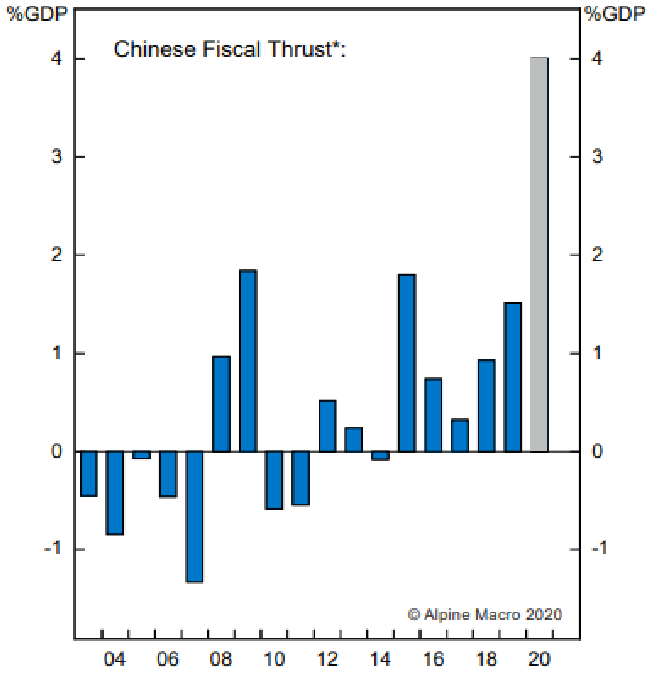
US-China on a collision course?

In its **Great Concerns In Greater China** report (27 May 2020) AlpineMacro reported that *the White House had released a harsh update on its China policy, which is akin to an official declaration of a cold war*". In response to China's national security legislation over Hong Kong, the US has "*added another 33 Chinese companies to its 'entity list', pledged to respond strongly to the Hong Kong legislation, and approved another batch of arms sales to Taiwan*".

Alpine Macro is "*greatly troubled by how rapidly the great power competition between the US and China has degenerated*" and believes that "*the US views China as an economic, ideological and security threat, and is beginning to drive it back on all fronts*". These two giants account for almost 40% of global nominal GDP. One can only hope that the rhetoric is worse than reality.

AlpineMacro's take on last week's National Peoples Congress (NPC) is that "*China is entering 'survival mode' and the government's main focus is to maintain basic social and economic stability and minimum job creation rather than pursuing strong growth*". The reason for holding back on further stimulation is that it intends to '*save its 'policy bullets' in preparation for a prolonged conflict with the US*".

A significant increase in fiscal thrust



*Includes general government budget, net issuance of local government special bonds, and RMB 1 trillion special treasury bond to be issued in 2020; Alpine Macro proprietary calculation

AlpineMacro estimates China's new round of fiscal stimulus at RMB4.6 trillion or 4% of current GDP to go with more bond issues (RMB2.6 trillion), tax breaks and lower social welfare contributions. The NPC has outlined 'six guarantees' that include "*job creation, the basic livelihood of the population, prevention of mass bankruptcies, the security of energy and food, stability of supply chains and the normal operation of grass-roots government agencies*".

Arguably, China is better positioned than most countries to recover from the damage inflicted by the pandemic. A greater challenge may be the continuity of its imports and exports as its trading partners come back on stream at different intervals.

Eurozone, UK, Japan, and South America

Around the world, the news is very similar, herewith some comments from Top News - Bloomberg:

- ECB's Legarde says Euro economy headed for worst-case slump;
- The EU plans to backstop the struggling South with fiscal 'Shock and Awe' - €750bn and to underwrite Italy's membership of the 27-nation bloc;

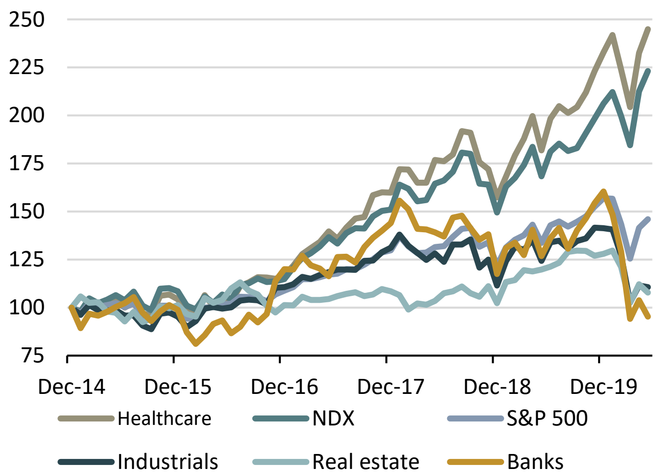
- The UK's support programme increased by £10bn in a week - a stark reminder of the heavy price to keep businesses afloat;
- Japan sinks into a deep recession - cabinet set to deliver the world's biggest stimulus package; and
- Argentina defaults on $500m interest payment; US equity market - as skewed as ever

US equity markets

There has been talking in US equity markets about the win-win situation created by the Fed: ultra-low interest rates; the purchase of junk-bond ETFs; and whether the Fed will buy equities. Some think that in a worst-case scenario - "nothing is impossible". This, they think, puts a floor under prices.

Following the highs posted in February, the S&P 500 fell 34% and has subsequently recovered 34.4% to be down 6.9% year-to-date (YTD). In turn, the tech-dominated Nasdaq fell 28%, then rose 21% to be down 3.2% YTD. However, a deeper look into the major sub-indices indicates that the market, for the most, is as discerning as ever. Information Technology (+5.2%) is the only index up YTD. Other YTD performances include: Communication Services (-1%); Healthcare (-2.5%); Consumer Staples (-9.1%); Real Estate (-15.8%); Industrials (-21.8%) and Banks (-40.6%).

Nasdaq, S&P 500 and selected sub-indices



Source: Refinitiv

The YTD performance data shows that investors and traders favour the technology-related stocks that typically operate across the internet and have access to a global client base. Where the market may not be as discerning, is within the group of large tech stocks just below the FAAMA stocks, where stocks such as (Zoom +146%), Shopify (+90%), Datadog (+90), Beyond Meat (+78%) and Docusign (+61%) have rocketed YTD. The catalyst seems to be hedge funds and new retail money flowing into this next layer of tech stocks, which some have singled out as "bubble stocks". This seems very much like a liquidity-fueled rally driven by traders that missed the recovery rally post-23 March.

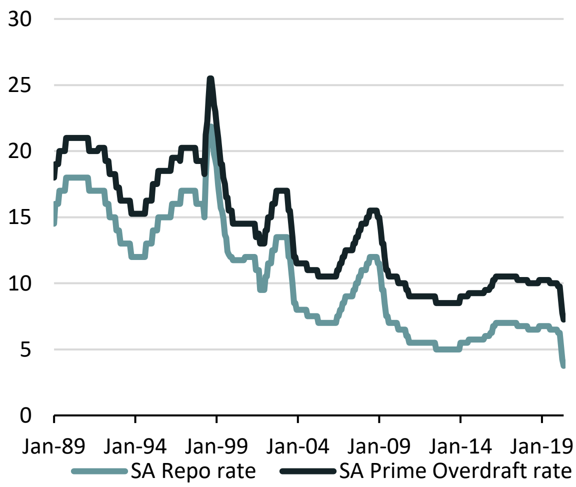
South Africa - who is calling the shots?

Following a special cabinet meeting on 15 March 2020, President Ramaphosa declared a state of disaster in terms of section 27 of the Disaster Management Act, 2002 and nominated Dlamini-Zuma as the Minister in charge.

It is the task of the National Coronavirus Command Council (NCCC) to draft regulations that create a regulatory framework for the government to respond to COVID-19 in an integrated and co-ordinated manner. These regulations are a rule of order which have the force of law. To us as outsiders, it seems that the NCCC and not cabinet is making all the decisions. We highlight this because at times President Ramaphosa has seemed most uncertain.

Away from all the bleak COVID-19 news, the South African Reserve Bank (SARB) cut the Repo rate to 3.75% which is an almost 47-year low. The repo rate started the year at 6.5%. In turn, the prime lending rate of commercial banks has been cut to 7.25% - see chart below.

South African Repo & Prime rates



Source: Refinitiv

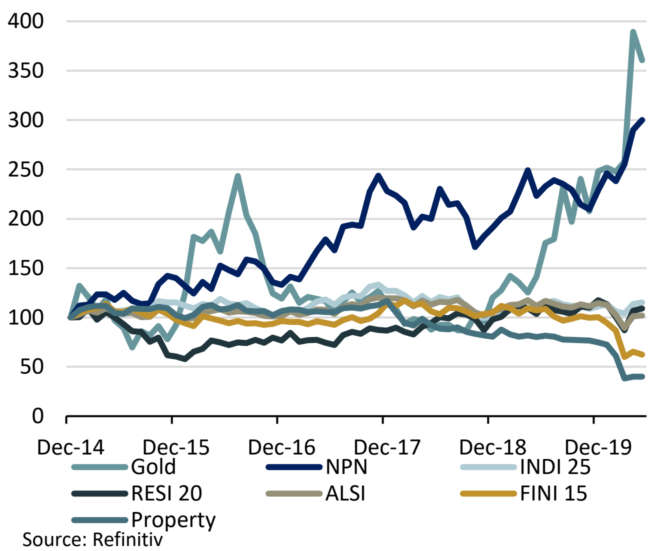
The decision by the SARB to follow international central banks and cut rates further is due to lower trending inflation and any number of negative demand and supply-side shocks. The reality is that the cabinet needs to understand that monetary policy cannot compensate for structural shortcomings, of which there are many. Lower interest rates, per se, will not spur growth and create jobs.

As level 3 kicks in from 1 June, entrepreneurs will need to rise to the many challenges that await them, least of all consumers with less in their pockets.

The JSE - similar pattern to US indices

Our local market suffers from a similarly high level of skewness that pervades the US stock market. The chart below depicts the major JSE indices, plus Naspers, since the end of 2014: Gold (+26.7%pa); Naspers (+22.7%pa); INDI 25 (+2.7%pa); RESI 20 (+1.6%pa); ALSI (+0.3%pa); FINI 15 (-8.3%pa); and Property (-15.2%pa).

ALSI and selected major sub-indices



Source: Refinitiv

Over the past year, gold shares have rocketed on the back of safe-haven buying and a sharply weaker Rand. But it is the performance of Naspers, up 22.7%pa since the end of 2014 that has completely dominated the JSE. On a combined basis, Naspers and its subsidiary Prosus now account for around 25% of the ALSI. Not a healthy situation.

Outlook

Post-COVID-19 will be challenging and South Africa will have to chase hard to keep up with even more tech-driven changes that are coming.

Tumbling interest rates have put income-rellant investors under tremendous pressure (Repo rate down 42% YTD) and global interest rates seem set to stay low for several years. In turn, the global pandemic has greatly affected equities, but for a few tech-related stocks.

For the most, equity prices have been battered and we can only trust that politicians, here and elsewhere, will allow people back to work so that equities regain their traditional role of wealth generation.

Sincerely,

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