The Outlook

May 2020

In this edition of The Outlook…

- As of April 29, Worldodometers.info reported 3.2m Coronavirus cases, 228.517 deaths and 1m recoveries.
- In terms of cases confirmed important western economies have been hit hardest: US (33%); Spain (7.4%); Italy (6.3%; France (5.2%); UK (5.1%) and Germany (5%). These six countries account for 62% of global cases and 74.6% of deaths.
- South Africa, gratifyingly, has reported only 5,350 cases and 102 deaths, something that might catch the attention of foreign investors in due course.
- China's reported cases and deaths are remarkably low and the early newsflow indicates that its economy is in recovery.
- The US Congress gave the Fed emergency lending authority and a $2.2 trillion stimulus package is being rolled out. On Wednesday, Fed Chairman Powell said that "*the pandemic posed considerable medium-term risks, perhaps a year or more*".
- Global government debt has climbed to unthinkable levels with no impact on inflation. Japan and Europe are already there, now the US and UK are being drawn into a cycle of lower inflation and lower interest rates.
- Post COVID-19 is bound to see a resumption of the US/China trade conflict with an added dose of protectionism.
- US equities, particularly the tech-dominated Nasdaq Index, has strongly outperformed the MSCI World index. In turn, three stocks account for 32.8% of the Nasdaq.
- AlpineMacro's strategy is to favour the US Dollar and equities.
- Over the past five years, the local All Share Index (-0.5% pa) has battled in the face of a moribund economy. Now that the whole world is in disarray, there is more utility in everyone getting behind President Ramaphosa - this is South Africa's "Cometh the hour, cometh the man" moment.

COVID19 - large developed economies bearing the brunt

According to Worldometers.info, by 29 April there were 3.2m cases of COVID-19 confirmed globally, 228,269 deaths and 1,005,440 recoveries. In terms of cases confirmed the large western economies: US (33%); Spain (7.4%); Italy (6.3%; France (5.2%); UK (5.1%) and Germany (5%) have been hardest hit. These six countries currently account for 62% of reported cases and 74.6% of global deaths.

Across these countries, the spread of the virus appears to be slowing and governments are looking at ways to re-open their economies. Whilst re-opening poses a health risk, there is a risk that many businesses might not survive. From a market perspective, the great unknown is how quickly and how many corporates will get back to profitability. But it is not good enough that only the large companies survive. In all economies, a substantial number of people work for SMEs or themselves and account for a substantial percentage of consumption expenditure. Without them, the big corporates have no customers.

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COVID19 - unprecedented monetary response

The sudden lockdown of global economies and predictions of a 5-6% fall in GDP has prompted an unprecedented monetary policy response (+$12 trillion) on a scale never seen before. As ever, it is important to focus attention on the US and China. If these two giants don't come right, then little else matters.

With a population of about 1.44bn the recorded COVID-19 cases of 83,909 and deaths of 4,512 in China are small in comparison to the countries listed above. This may be due to the early and vigorous response. At this point, newsflow indicates that the Chinese economy is in recovery. The market, however, will be mindful of a potential second wave of the virus.

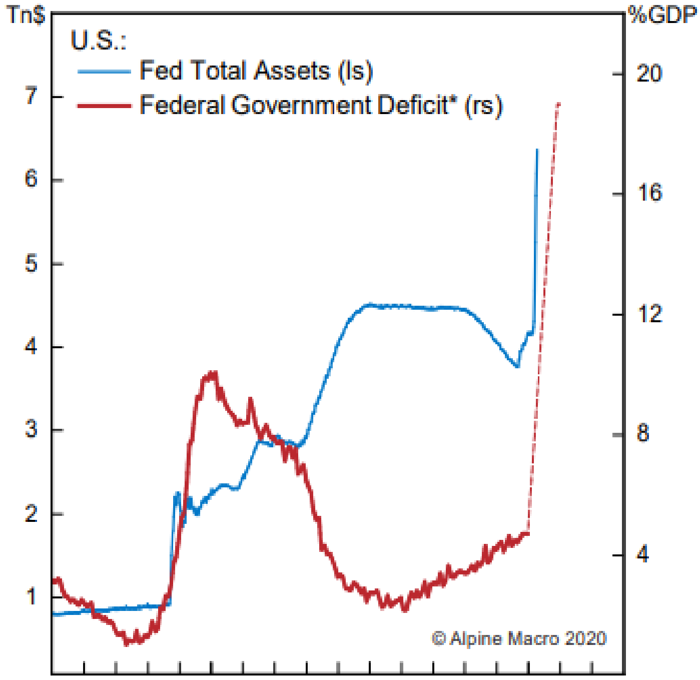
By now you will all have read about the US Fed's $2.2 trillion stimulus package. Following the GFC in 2008, Congress gave the Fed emergency lending authority for "unusual and exigent circumstances", albeit with a range of procedural restrictions attached. The impact of COVID-19 has seen the Fed move beyond buying huge amounts of government treasuries to corporate debt and even junk-bond exchange-traded funds. If things worsen, will the Fed venture into buying equity ETFs to avoid a stock market sell-off? At the end of Wednesday's Fed meeting Jerome Powell said: *"the pandemic poses considerable medium-term risks",* adding that *"we are doing all we can….amid considerable risks over the medium term, perhaps a year or more*".

Congress gave the Fed emergency lending authority for "unusual and exigent circumstances"

In its Feature Report (April 22, 2020) AlpineMacro says "*conceptually, the financial system balance sheet, wherever stress requires it, can be transferred to the Fed's balance sheet*". With the Fed and Treasury working closely to relax certain constraints, "*theoretically the central bank can replace the entire financial system with Fed liabilities, as long as the US government is solvent*".

The chart which follows shows the massive increase in the Fed's assets and the forecast deficit - up from <5% to around 18% of GDP. You may well ask whether the Fed's deficit matters and why it can't just print more money. To this same question, former Fed governor Janet Yellen replied: "*it is all about market confidence in the Fed's balance sheet - a case of credibility and confidence*". This is the basis for all fiat currencies!

US stimulus: unprecedented but credible



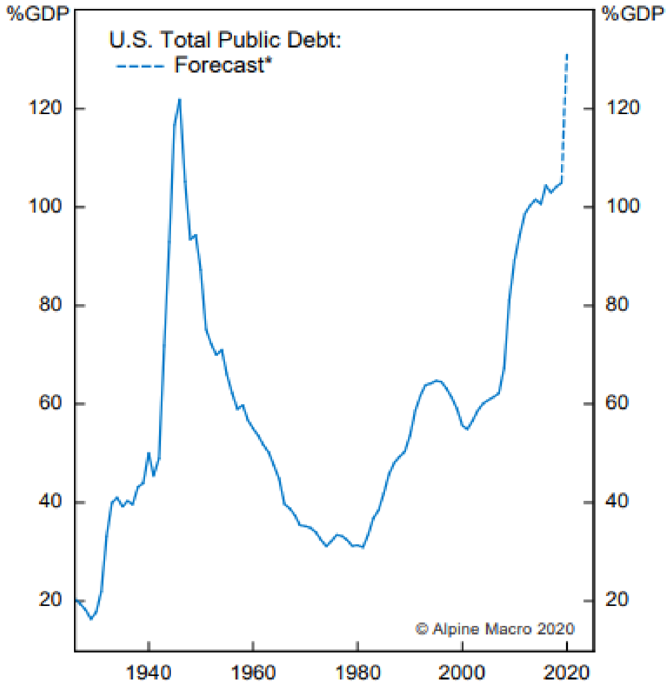
*2020 forecast based on Goldman Sachs report

AlpineMacro reports that "*the consensus view, including that of the IMF, is that the initial shock will give way to healing in the second half of 2020. Two key assumptions driving this forecast are that the stimulus limits the damage and that the virus cooperates".* On this basis, AlpineMacro believes that "*policy-wise, it is credible that the Fed and the US government can do this*". Capital Economics - Global Economic Outlook (23 April 2020) says that "*once the virus is under control output should rebound, but it will take years to return to its pre-virus path*". With infections and deaths in decline, several US states have announced a cautious re-opening of their economies. This should answer some questions, but not all.

Debt - an ingenious substitute for the chain and whip of the slave-driver (Ambrose Bierce)

Quoting from the IMF's latest Fiscal Monitor, AlpineMacro says that "*US public debt will rise to 131% of GDP by the end of this year, still manageable given the dollar's reserve currency role which keeps foreign governments holding about 60% of that*".

Public debt manageable, so far



*2020 forecast based on IMF Fiscal Monitor (April 2020)

Ultimately it is all about the cost of the debt. AlpineMacro points to "*real interest rates being negative and nominal rates close to zero",* adding that *"as long as that doesn't change, the US government will remain solvent*".

What could undermine Fed credibility? AlpineMacro says "*the nightmare scenario is that government bonds sell off or investors unload junk bonds, leading to a vicious circle out of the Fed's control*". They "*don't expect that*", but also don't rule out "another *round of infection in the US, in which case the Fed would have to do massive stimulus yet again*".

The US has no history of defaulting on its debt or nationalisation, therefore a flight of capital does not make sense and frankly, the alternatives are worse.

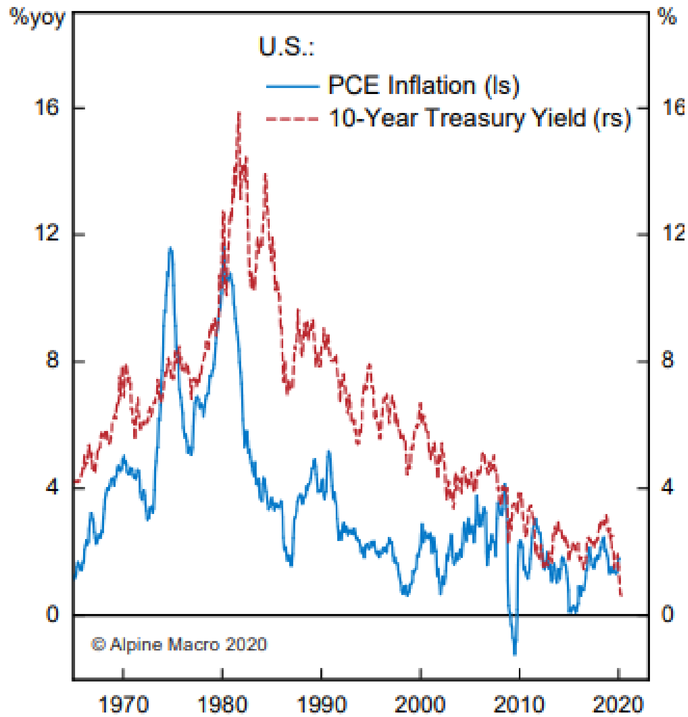
The great inflation debate

Since the oil price shocks of the 1970s, keeping inflation under control has been high on the agenda of most central banks. For a long time Milton Friedman's famous quote, "*inflation is always and everywhere a monetary phenomenon*", defined monetary policy. Friedman asserted "*that inflation is and can be produced only by a more rapid increase in the quantity of money than in output".*

Inflation matters because interest rates are an important tool used to control inflation. In turn, conservative investors like high real interest rates, whereas equity investors (higher risk) like low real interest rates. Despite the massive injection of funds into the system since the GFC, the Fed has consistently over-estimated inflation.

The chart below highlights the relentless fall in inflation since the highs around 1980, with interest rates trending downwards in sympathy.

No inflation for some time



AlpineMacro admits that "*there is a lot of uncertainty about the inflation process and how the pandemic might affect it".* We think that the rising savings rate will be reinforced by the COVID-19 experience and become more structural and fairly insensitive to low-interest rates. AlpineMacro believes that "*the market-clearing real interest rate in industrial countries is likely to be negative for an extended period*". Lower rates for longer will also lessen Treasury's debt-servicing requirements. AlpineMacro's bottom line is "*that the Fed is printing the premier asset in the world. Inflation will stay low for years to come".*

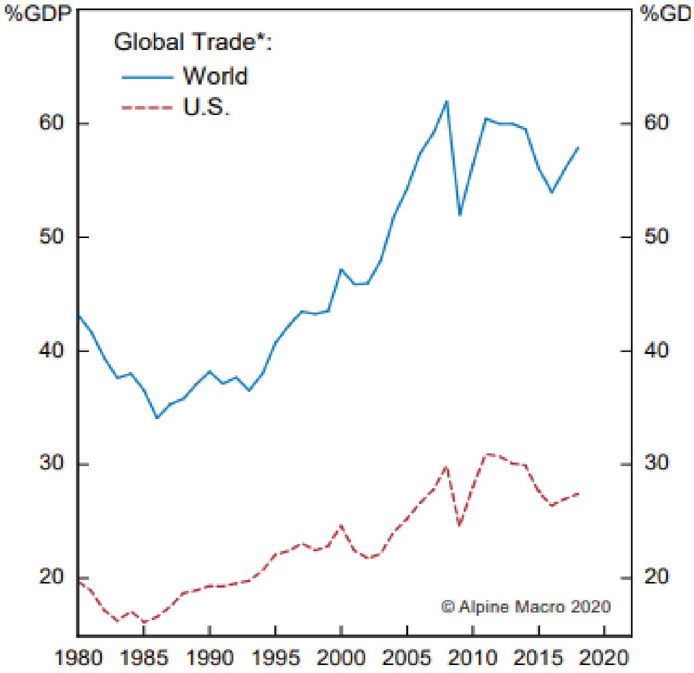
The reality is that the US and the UK are following the same well-trodden path of the European Central Bank and the Bank of Japan of "doing whatever it takes". Reuters reports that on April 27, the Bank of Japan again "*expanded its monetary stimulus and pledged to buy an unlimited amount of bonds to keep borrowing costs low".* This lower for longer interest rate outlook places pensioners who live off income in a difficult situation, but it is positive for risk assets such as equities.

Global trade - the US/China conflict

There seems little doubt that post-COVID-19 we will see a dose of protectionism added to the deferred US/China trade conflict. And remember that Brexit is still to be resolved. The net effect is that global trade will probably shrink, just at a time when all economies are trying to recover.

In time to come books will be written on this period of economic chaos. Suffice to say that trade accounts for almost 60% of global GDP and about 28% of US GDP - these are big numbers. The level of disruption and uncertainty is going to depend on the quality of politicians at the table. Never a good thing to rely on.

Globalization will shrink



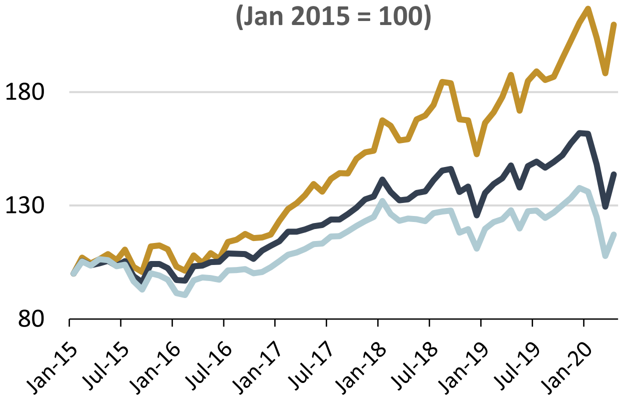
*Sum of imports and exports of goods and services
Source: World Bank

AlpineMacro sees the potential for "*taxing of capital exports, even prohibiting foreign investments and lower net lending between countries*". Their bottom line is that "*these forces are dollar bullish because they boost instability and uncertainty around the world*". A stronger US dollar implies a weaker Rand, this is important for local investors to take on board.

US equities and the MSCI World Index

Over the past five years, the US economy has been in better shape than most and the Nasdaq and S&P 500 have benefitted from Trump's tax cuts and falling interest rates. When looking at the mighty US stock market, it is important to note the extent that technology-related stocks dominate. Much the same as Naspers/Prosus dominate the JSE.

Nasdaq, S&P 500 and MSCI WI (Jan 2015 = 100)



Source: Refinitiv

Since 2015 the Nasdaq is up 15.2% annually, the S&P 500 7.2% and the MSCI WI 3.1%. Year to date the Nasdaq is up 0.9% and the S&P 500 down 11.2%, with all its sub-indices down. The range extends from Healthcare (-1.7%), Information Technology (-3.3%) to Banks (-39.8%) and Energy (42.1%). It is astounding to consider that just three stocks: Microsoft (11.6%), Apple (11%) and Amazon (10.2%) currently account for 32.8% of the Nasdaq. A real test of portfolio diversification.

The aftermath of COVID-19 in Developed Markets will likely see ongoing low inflation, 'stimulus' and low-interest rates. We concur with AlpineMacro's latest strategy call to "*favour the US Dollar and equities*". But we must point out that the recent rally in US stocks is factoring in a V-shaped recovery, an assumption that embodies a lot of risks.

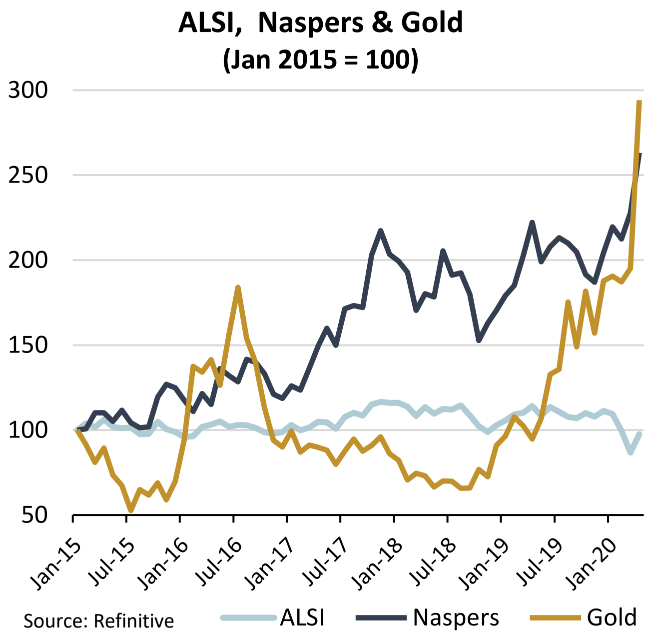
South Africa - saving lives versus saving jobs

To date, the government has acted swiftly to lockdown the economy and so far the reported cases (5,350) and deaths (103) are gratifyingly low - may catch the attention of foreigners in due course. This is game-theory at its best, or maybe worst. The choice is to prevent infection and save lives or shutdown businesses, risk jobs and add to destitution and hunger (death) or vice versa. The real test will play out over the next month as businesses deemed essential and safe to operate are phased back into production.

Before COVID-19 swept across the world our local economy was already in recession, there was no defined government policy to foster new businesses and create jobs, all the SOEs were in trouble and the budget deficit was fully stretched. Now is South Africa's 'COMETH THE HOUR, COMETH THE MAN' moment.

SA equities - dominated by Naspers and gold

Over the past five years, the SA economy has struggled and so has the All Share Index (-0.5% pa). Had it not been for Naspers (+20.2%pa) and the Gold Index (+22.8%pa) more recently, the performance of the ALSI would have been a lot worse. This is especially so as Naspers and its subsidiary (Prosus) account for more than 20% of the ALSI. These few shares represent substantial concentration risk within the ALSI, making it difficult to diversify portfolios and to benchmark against the ALSI.



Earlier this month the SARB cut the repo rate by another 100bps to 4.25% (Rand negative). This together with the near 80% fall in the rand oil price over the last 12 months would normally have been a huge boost to the economy. To non-savers (of which there are many) the 21% cut in the prime rate to 7.75% is welcome, but the benefits tend to roll in over the longer term (mortgage and vehicle financing). SARS, of course, won't be happy with the fall in the oil price as levies will fall off sharply.

The dramatic sell-off of equities in recent weeks is highly stressful to all, whereas the large cuts (200bps) in interest rates will also negatively impact those that are reliant on income flows. The 32% fall in the SARB repo-rate does, however, make for an easier decision not to dump equities.

There are many other pressing issues such as SAA and the impending exit from the World Government Bond Index to ponder. However, now that the whole world is in disarray, there is more utility in everyone getting behind President Ramaphosa - this is South Africa's "Cometh the hour, cometh the man" moment.

Global and even local economic and financial conditions favour shares (equities) more than ever on a longer-term basis, but extreme price volatility will remain the norm.

Sincerely,

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