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Market and economic outlook: April 2020

Highlights

Markets

- Global financial markets plunged in the first quarter of 2020, as the vicious economic and health shock intensified, sending shares further into correction territory.
- The MSCI Developed Market (DM) Index lost more than a fifth of its value in the first quarter of the year, as the COVID-19 pandemic roiled financial markets. As growth fears deepened in the first quarter of 2020, emerging market (EM) equities tumbled 23.6%, alongside a 23.3% drop in the Bloomberg Commodity Price Index.
- The local equity market rout followed suit, as panic set in. The FTSE/JSE All-Share Index sank 24.1% in the first quarter of the year, dragged lower by a 39.5% collapse in the FTSE/JSE Financials Index and a 25.3% lurch down in the FTSE/JSE Resources Index.
- The JSE Assa All Bond Index fell 8.7% in the quarter, while the JSE Assa Government Inflation-linked Bond Index traded 16.8% weaker for the same period. Meanwhile, the FTSE/JSE SA Listed Property Index nearly halved in value since the end of 2019.
- During the indeterminate time as COVID-19 continues to spread, uncertainty will remain about the ultimate trajectory of the global economy with volatility in financial markets likely staying high, as growth expectations ebb and flow.
- Throughout this risk-off period, defensive asset classes (such as DM bonds, the United States (US) dollar and gold) are likely to trump the returns of risky asset classes (like global equities, credit, EM debt and EM currencies).
- Once the virus effect has played out, global supply chains become unblocked again and isolation measures cease, there will be a significant rebound in economic growth and company profits on the back of a normalisation in economic activity and the lagged effect of massive policy stimulus undertaken during the crisis. This economic rebound will renew risk appetite by global investors and will be discounted by rising risky asset prices ahead of the time. Whether this will occur within weeks, months or quarters depends on how the pandemic plays out.

Economics

- The barrage of measures in fiscal and monetary policy enacted by global policy makers in reaction to COVID-19 should induce a strong lagged cyclical recovery in global growth in the aftermath of COVID-19. Given the unpredictable nature of the spread of COVID-19, there is merit in mapping out alternative, plausible economic trajectories.

- In the V-shaped recovery, or best-case scenario, the globe undergoes a rapid growth slowdown in the first half of 2020, followed by an equally rapid recovery from the middle of 2020, as the virus spread is contained by then, hence, allowing annual growth rates to fully absorb the shock. This scenario necessitates strong public health structures and highly effective policy responses, which ultimately lead to a strong rebound in economic activity.
- In the U-shaped recovery, or base-case scenario, a sluggish upturn follows a more protracted slowdown. Disrupted global supply chains are only restored subsequent to the peak in COVID-19 fatalities in the third quarter of 2020, resulting in an economic recovery only taking hold from late 2020 and extending into 2021. While responses to public health in this scenario are sufficient, physical distancing and the control over the movement of citizens persist for additional months, in an attempt to prevent an escalation or resurgence in infections.
- In a protracted U-shaped recovery, or bear-case scenario, a second wave of the COVID-19 outbreak flares up, with quarantine measures extended to more regions and for longer. A re-emergence of disruptions in supply chains is likely under this scenario, and these bottlenecks would prolong the downturn in local demand and exports, negatively affecting corporate profitability and raising corporate credit risks.

High volatility in financial markets, as growth expectations ebb and flow

Global financial markets plunged in the first quarter of 2020, as the vicious economic and health shock intensified, sending shares further into correction territory. The responding bazooka of central bank and government spending plans, nevertheless, slowed the drop in global equity markets late in the quarter.

The CBOE Volatility Index (Vix), or fear gauge, climbed nearly 40 points in the first quarter of the year to 53 points, but touched an intra-quarter high of 83 points. Investor angst led to the MSCI All Country World Index crashing in the middle of the quarter, but strong efforts from policymakers to curb the spread of COVID-19 led a reversal in equity markets at the end of the quarter. The MSCI All Country World Index weathered a 21.4% fall in the first three months of 2020, led weaker by almost equally limp returns from developed and emerging equity markets.

The MSCI DM Index lost more than a fifth of its value in the first quarter of the year, as the COVID-19 pandemic roiled financial markets. US, European and Japanese bourses contributed to the extensive losses in the first quarter of 2020. The Eurostoxx 50 Index haemorrhaged 25.3% in the first quarter of the year, followed by a 19.6% crash in the S&P 500 Index and a 19.2% plunge in the Nikkei 225 Index.

DM government bond yields plummeted further in the first quarter of 2020, as investors retreated to safety. The US 10-year government bond yield rallied 125 basis points to an all-time low of 0.6%, while the German 10-year government bond yield sank nearly 30 basis points deeper into negative territory to negative 0.5%.

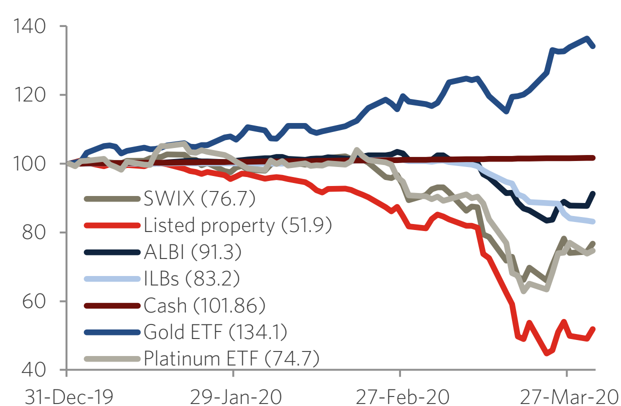
As growth fears deepened in the first quarter of 2020, EM equities tumbled 23.6%, alongside a 23.3% drop in the Bloomberg Commodity Price Index. The MSCI Latin America Index nosedived 45.6% in the first three months of the year, as investors lost confidence in Brazil's ability to improve its economic outlook. This was followed by a 33.9% crash in the MSCI Europe, Middle East and the Africa (EMEA) Index, following a scaling up of measures in South Africa (SA) and Russia (the two-largest constituents of the MSCI EMEA Index) to fight the COVID-19 pandemic. Losses in MSCI Asia Index trailed at 18.1%, after China eased the lockdown in Hubei, signalling increased control over the outbreak.

Risk appetite worsened towards EMs in the first three months of the year, with the JP Morgan EM Bond Index (Embi) spread ending the first quarter of 2020 nearly 300 points higher. Argentina, Indonesia and Russia were among the countries which experienced the largest deterioration in credit default swap (CDS) spreads since the end of 2019.

The local equity market rout followed suit, as panic set in. The FTSE/JSE All-Share Index sank 24.1% in the first quarter of the year, dragged lower by a 39.5% collapse in the FTSE/JSE Financials Index and a 25.3% lurch down in the FTSE/JSE Resources Index. In SA's fixed income markets, the SA 10-year government bond yield sold off 186 basis points since the end of 2019. The bulk of the sell off was generated in March 2020, when yields spiked more than 180 basis points. The JSE Assa All Bond Index fell 8.7% in the quarter, while the JSE Assa Government Inflation-linked Bond Index traded 16.8% weaker for the same period.

Meanwhile, the FTSE/JSE SA Listed Property Index nearly halved in value since the end of 2019 (see chart 1).

Chart 1: Returns from local asset classes (%)



Source: Iress, Momentum Investments, data up to 31 March 2020

An adverse shock to risk appetite caused by the virus and further downgrades of SA's sovereign rating by Moody's (to Ba1) and Fitch (to BB) rating agencies caused the rand to spike to historic levels. The rand weakened by 21.6% against the US dollar, 20.4% against the euro and 16.4% against the pound in the first quarter of
the year. SA's five-year CDS spread shifted nearly 260 points above levels seen at the end of 2019.

During the indeterminate time as COVID-19 continues to spread, uncertainty will remain about the ultimate trajectory of the global economy, with volatility in financial markets likely staying high, as growth expectations ebb and flow. Throughout this risk-off period, defensive asset classes (such as DM bonds, the US dollar and gold) are likely to trump the returns of risky asset classes (like global equities, credit, EM debt and EM currencies).

Once the effect of the virus has played out, global supply chains become unblocked again and isolation measures cease, there will be a significant rebound in global economic growth and company profits on the back of normalisation in economic activity and the lagged effect of massive policy stimulus undertaken during the crisis. This economic rebound will ignite renewed risk appetite by global investors and will be discounted by rising risky asset prices ahead of the time. Whether this will occur within weeks, months or quarters depends on how the COVID-19 pandemic plays out.

In terms of a possible timeline, a sustainable rebound in the returns from riskier asset classes will only be fundamentally justified once an infection peak is in the offing, with a subsequent economic recovery then on the horizon.

Research from Bank of America shows that equity bear markets linger for a while after the initial 20% drop (reached on 12 March 2020), with further downside for about three to four months. If the history of the equity bear market is any guide, this would point to a possible bottoming in equity markets around the middle of 2020.

The meaningful adjustments in asset prices in February and March 2020 intimate that some degree of a dire economic outcome is at least already discounted by global equities, government bonds, credit, commodities and currencies. Research from JP Morgan has further shown valuations of risky asset classes are now cheap against history (with DM credit, SA bonds and EM currencies being the cheapest), while defensive asset classes are now expensive (with the US dollar, DM bonds and gold the priciest).

At the 9 April 2020 equity market close in the US, the S&P 500 Index was down 18% from its 19 February 2020 peak, which is still less than the median (28%) and average (31%) drawdowns experienced in the past 25 equity bear markets, and much smaller than the peak-to-trough declines in the

2001 dot-com bear market (35% down), the 1973 oil crisis (48% down) and the global financial crisis (GFC) bear market (52% down). This would suggest that not all the potential economic growth downside is reflected in the US equity market, particularly if the economic growth scenario trajectory turns out to be anything worse than a short-lived dip in global demand.

Mapping out alternative economic trajectories given the unpredictable spread of COVID-19

Globally, policymakers have responded aggressively in an attempt to avoid a prolonged economic crisis from the COVID-19 pandemic. In some countries, the fiscal responses unleashed exceed the stimulus triggered in the GFC. As COVID-19 induces a supply-side shock to the global economy through its effect on world-wide supply chains and an idiosyncratic demand-side shock, where large parts of the global economy are in lockdown mode and not spending on discretionary items, the typical demand-side stimulus responses of monetary and fiscal policies are unlikely to prove very effective during the crisis. However, the barrage of measures in fiscal and monetary policy enacted by global policy makers in reaction to COVID-19 should induce a strong lagged cyclical recovery in global growth in the aftermath of COVID-19.

Given the unpredictable nature of the spread of COVID-19, there is merit in mapping out alternative, plausible economic trajectories. In the first scenario, a V-shaped recovery, or best-case scenario, is considered. In our view, this is a scenario in which the globe undergoes a rapid slowdown in growth in the first half of 2020, followed by an equally rapid recovery from the middle of 2020, as the virus spread is contained by then, hence, allowing annual growth rates to fully absorb the shock. This scenario necessitates strong public health structures and highly effective policy responses, which ultimately lead to a strong rebound in economic activity.

The Harvard Business Review claims most prior epidemics followed a V-shaped economic trajectory. For this scenario to unfold, either a pharmaceutical breakthrough is required or government measures need to prove effective in containing the spread of the virus, by the second quarter of 2020, so quarantines are quickly lifted and disruptions in supply chains are limited to the first half of the year, with normal production resuming around the middle of 2020.

Under a V-shaped scenario, SA growth would still suffer from constraints in electricity supply and weak consumer and business sentiment. In light of an escalation in the number of COVID-19 infections, President Cyril Ramaphosa announced an escalation of containment measures to slow the progression of the disease. In a V-shaped scenario, these measures would be expected to hit discretionary spend and business output, and would leave the SA economy with a still-sizeable contraction in growth of about 3% in 2020.

Meanwhile, the plunge in international oil prices would translate into downward pressure on headline inflation, with a muted pass through from rand weakness (as struggling retailers clamber to protect volume growth) and would likely keep inflation well within the target band in the medium term. After executing 125 basis points worth of easing since the start of 2020, the Sarb would likely pause its interest-rate-cutting cycle after another 100 basis points of cuts by the third quarter of 2020.

In this environment, SA's current account deficit ratio is likely to remain close to its long-term average of around 3.0% of gross domestic product (GDP). SA's fiscal deficit ratio is nevertheless expected to expand to high single digits, due to fiscal stimulus measures because of COVID-19, strained revenue collection and difficulty in achieving the planned cuts in wage bills in the public sector. Subsequently, following Moody's ratings downgrade of SA's sovereign rating to junk and a further notch downgrade by Fitch, this scenario includes a further rating downgrade by Standard and Poor's (S&P) in 2020.

A second U-shaped economic recovery is considered, as our base-case scenario, in which a delayed and sluggish upturn follows a more protracted slowdown. Under the U-shaped scenario, in our view, disrupted

global supply chains are only restored subsequent to the peak in COVID-19 fatalities in the third quarter of 2020, resulting in an economic recovery only taking hold from late 2020 and extending into 2021.
While responses to public health in this scenario are sufficient, physical distancing and the control over the movement of citizens persist for additional months in an attempt to prevent an escalation or resurgence in infections.
Under this scenario, announced global efforts in fiscal and monetary policy are only likely to benefit growth from the fourth quarter of 2020 and are expected to facilitate a recovery into 2021. According to the International Monetary Fund (IMF), world growth troughed at negative 0.1% in 2009, after the GFC, while the average, since 1980, printed closer to 3.5% (see chart 2).

Chart 2: Global growth has averaged 3.5% historically

Source: IMF, Momentum Investments

Global growth in this U-shaped environment is likely to fall to negative 2.3% in 2020, before recovering to 2.9% in 2021. Growth on a sectoral basis will differ substantially, in our view. Areas such as tourism, hospitality and the airline industry will experience a permanent loss in demand during COVID-19, which is largely irrecoverable, while other discretionary-spending sectors could see delayed demand until after the crisis.

Growth in the US is unlikely to escape a meaningful contraction in this scenario of about 5%, as shocks to the real economy, through the crash in financial markets and enforced social isolation, would weigh heavily on household demand in the interim. Despite extensive interest-rate cuts and additional liquidity-easing measures by the US Federal Reserve, as well as government stimulus packages, discretionary consumer spending would be negatively affected well into the third quarter of 2020, by dashed consumer sentiment and restrictions on the movement of people.

Although the European region already started to underperform towards the end of 2019, under a U-shaped recovery, we would expect additional European governments to impose more stringent restrictions on the movement of citizens, to curb the spread of the virus, resulting in a sharper contraction in economic activity of about 6.5% in 2020. While Hubei in China is in the early stages of its recovery, a lower-than-usual availability of migrant workers may delay the full resumption of activity at manufacturing plants. With inventories being drawn down, a shortage of critical inputs may delay China from operating at full capacity, leaving growth in 2020 at about 1%. Moreover, McKinsey warns "the unpredictability of the timing and extent of the demand rebound will mean confusing signals for several weeks".

Under a U-shaped scenario, SA growth crumples to about negative 5.0%, as discretionary spending and business output is hit harder under the nationwide lockdown. Exports would stay weaker for longer, due to lower global demand, while downtrodden consumer and business confidence as well as ongoing constraints in electricity supply would dampen local demand. Suppressed international oil prices would translate into downward pressure on inflation, leaving the headline figure at about 3% in 2020, while a muted pass through from a more depreciated currency would likely keep inflation well within the target band in the medium term. In addition to implementing 125 basis points worth of easing since the start of 2020, the Sarb would likely cut interest rates further to around 3% by early 2021.

Even with a dramatic decline in exports, the current account would likely narrow relative to its long-term average in response to lower demand in imports.
A worsening global economic outlook extending to SA

for longer, additional COVID-19 fiscal stimulus measures, sharply weaker revenue collection and increased difficulty in achieving the planned public sector wage bill cuts in this scenario would likely lead to the fiscal deficit ratio expanding to the low teens. Further staggered downgrades in SA's sovereign ratings by Fitch, Standard and Poor's (S&P) and Moody's in 2020 and 2021 become likely in this scenario.
In our analysis, we also consider a protracted U-shaped recovery in which a second wave of the COVID-19 outbreak flares up globally and in SA, with quarantine measures extended to more regions and for longer.
In addition, new cases could rise in other parts of the world, despite changes in seasons, dragging out the peak in global infection rates. A re-emergence of disruptions in supply chains are likely under this scenario and these bottlenecks would exacerbate and prolong the downturn in local demand and exports. This would, in turn, negatively affect corporate profitability, with corporate credit risks rising as a consequence.

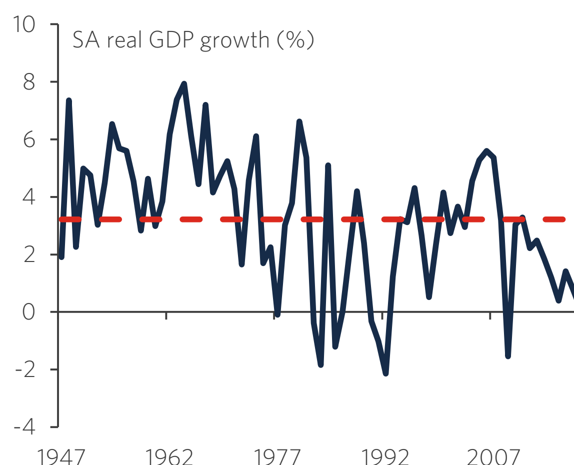
Historically, the US underwent a protracted U-shaped recovery in the 1970s, when unemployment and inflation remained high for years. In 1980, the US experienced a double-dip or W-shaped recovery, where the economy dropped twice before a full recovery was achieved.

An extended outbreak of COVID-19 in the Eurozone and the US in a protracted U-shaped scenario would place their healthcare systems under significant pressure. A fall in demand would be experienced in a wider array of service sectors rather than just the travel and tourism industries, and disruptions in supply chains would be more extensive.

Severe restrictions on normal economic activity would prolong the downturn in economic activity well into 2021, with the rebound in growth more drawn out. Under a protracted U-shaped recovery, the global weighted-average interest rate would likely reach a new low, while stronger fiscal responses from DMs and EMs would be enacted. Although monetary and fiscal policymakers would step up their stimulus efforts in such a scenario, consumers may be more inclined to increase their savings and could remain wary of discretionary spending. Nevertheless, policy easing could prevent a further tightening in financial conditions and keeping accommodation in place could aid a gradual recovery in demand later in 2021.
A dragged out economic recovery would cap the recovery in business and consumer sentiment, leading firms to delay spending on fixed investment projects and the hiring of new workers, exacerbating the length of the slowdown in global economic activity through second-round effects.

Under a protracted U- or W-shaped scenario, the damage to the SA economy would be far more severe than any period observed historically (see chart 3).

Chart 3: SA growth has averaged 3.2% historically



Source: Sarb, Momentum Investments

Delayed recovery in aggregate global demand would send the economy into a more profound slumber in 2020, with a recovery in global demand only beginning in earnest later in 2021. SA growth would plummet to about negative 7.5% in 2020 under an extended nationwide lockdown, compounded by negative global growth signals. Consumer and business confidence would dip markedly lower from already-decimated levels. The damage to discretionary spending and business output would be more pronounced, while exports would remain weaker for longer due to prolonged weakness in global demand.

Suppressed international oil prices would translate into downward pressure on headline inflation, while a muted pass through from an even more depreciated currency

would likely keep inflation below 3% in 2020 and 2021, as demand is quelled under this scenario. In addition to implementing 125 basis points worth of easing since the start of 2020, the Sarb would cut interest rates to 2.25% by the end of the year.

In this scenario, the current account deficit ratio would likely narrow substantially on the back of vastly weaker import demand. However, the fiscal deficit ratio would rise beyond the mid-teens, in our opinion, as a stretched out recovery in the global environment bears negatively on SA's economic trajectory. Accelerated COVID-19 measures for fiscal stimulus, immense pressure on revenue collection and little chance of achieving the planned cuts in the public sector wage bill, in this scenario, would likely lead to a chain of downgrades by the three major rating agencies.

Keeping our focus on our clients' long-term investment goals

While investment returns in the short term will be negatively affected by the destructive effect of COVID-19 on growth asset classes, history has shown that long-term returns are largely unaffected by these kinds of events, which in retrospect are barely discernible on longer-term graphs of returns from asset classes and, hence, turn out to be far less significant than they are deemed at the time.

We remain steadfast in our mission to keep our focus on our clients' long-term investment goals by not overreacting to short-term events in a way that could have a detrimental effect on the probability of attaining these goals. As such, our overriding guiding principle is to encourage our clients to stay invested throughout all market cycles, rather than attempt the timing of markets at times like this, when there is a virus outbreak.

Selling into market weakness locks in paper losses and also exposes investors to the risk that they miss any eventual rebound in markets, if they have not reinvested by that point. Although investors often feel the behavioural urge to at least 'do something' to their portfolios during uncertain times, history shows that the more prudent and lucrative investment strategy during these events is actually to 'stay invested'.

It is in times like these that we remain deeply anchored in our outcome-based investing philosophy and process, where we are unwavering in our belief that a well-constructed diversified portfolio is the most efficient way to achieve the long-term investment outcomes for our clients and, in these uncertain and volatile market environments, we continue to vigilantly manage the risk in our portfolios and look for opportunities to harness the available opportunity set towards achieving our long-term investment goals.

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