momentum investments

Herman van Papendorp
Head of Investment Research & Asset Allocation

in the moment

Johann van Tonder
Economist

Sanisha Packirisamy
Economist

Market and economic outlook: April 2021

Highlights

Markets

- While the more risky asset classes enjoyed the improving growth picture during the first quarter of 2021, global bonds started fretting about the potential for tighter monetary policy.
- As a result, global bond returns (-5,8% in dollars) were particularly poor in the quarter, falling far short of the positive dollar returns provided by SA equities (12,3%), developed market (DM) equities (5%) or emerging market (EM) equities (2,3%). South Africa (SA) and Europe were the best-performing EM and DM equity markets, respectively, in the quarter and by large margins.
- SA equities also provided the highest returns among the local asset classes in the first quarter of this year (13,1% in rand terms), by far outpacing returns from listed property (6,4%), inflation-linked bonds (4,6%), cash (0,9%) and particularly nominal bonds (-1,7%).
- In our view, risky asset classes should continue to benefit from the ongoing recovery in global growth as long as the current supportive monetary and fiscal policy settings remain in place internationally.
- We expect returns from SA asset classes (particularly local equities) to benefit from such a conducive global risk-on environment, as well as from a more favourable valuation backdrop than global assets. SA nominal and inflation-linked bonds look attractive, but not cash or listed property.
- Globally, our preference remains for equities over fixed-income assets.

Economics

- Global economic growth rates are continually being revised higher for 2021 on the back of fiscal stimulus and progress with vaccinations.
- World employment may decline further in 2021, albeit at a slower rate compared to 2020.
- Countries that achieve herd immunity faster should be first to normalise fiscal policy in terms of reducing fiscal deficits through lower government spending and possible tax increases.
- Higher domestic personal income tax (PIT) collections and stronger global economic growth suggest SA's economic growth rate in 2021 may receive support from household consumption expenditure (HCE) and inventory building.
- Consumer price inflation (CPI) is on the rise, but estimated to subside in the second half of the year.
- The repo rate is expected to remain unchanged in 2021.

SA equities a global star performer in first quarter of 2021

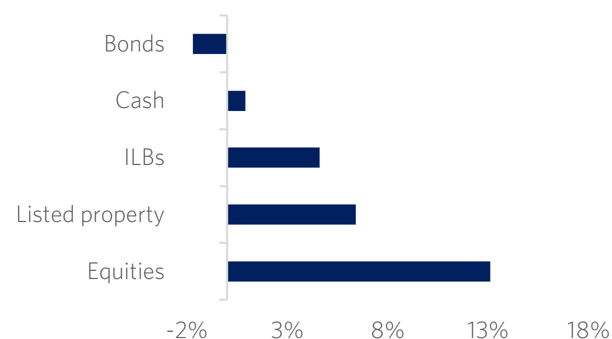
The global economic recovery gained further momentum during the first quarter of 2021, as the lagged effects of monetary and fiscal stimulus measures were increasingly felt in economies worldwide. Vaccination efforts also started gaining pace in some developed countries, which ignited positive sentiment about the gradual re-opening of economies and led to the continual upgrading of economic growth forecasts as the quarter progressed. Although the more positive economic growth outlook manifested in corporate profit upgrades, it simultaneously ignited fears about a higher inflation path going forward and the potential policy response from central banks to this.

While the more risky asset classes enjoyed the improving growth picture during the quarter, global bonds started fretting about the potential for tighter monetary policy, with US 10-year bond yields rising by 82 basis points in the first quarter of 2021. As a result, global bond returns (-5,8% in dollar terms) were particularly poor in the quarter, falling far short of the positive dollar returns provided by SA equities (12,3%), DM equities (5%) or EM equities (2,3%). SA and Europe were the best-performing EM and DM equity markets, respectively, in the quarter, and by large margins.

Chart 1 shows that SA equities also provided the highest returns among the local asset classes in the first quarter of this year (13,1% in rand terms), by far outpacing returns from listed property (6,4%), inflation-linked bonds (4,6%), cash (0,9%) and particularly nominal bonds (-1,7%).

The strong returns from SA equities were largely driven by Naspers and the non-gold resource sector, with the platinum stocks benefiting strongly from a supply-demand imbalance. In contrast, gold stocks were among the worst performers, with the gold price under pressure from rising global real interest rates.

Chart 1: Local asset class returns in 1Q 2021 (%)



Source: Iress, Momentum Investments

While global supportive policies remain, risky asset classes should benefit from growth recovery

In our view, risky asset classes should continue to benefit from the ongoing recovery in global growth as long as the current supportive monetary and fiscal policy settings remain in place internationally. We expect returns from SA asset classes to particularly benefit from such a conducive global risk-on environment, as well as from a more favourable valuation backdrop than global assets.

Globally, our preference remains for equities over fixed-income assets. An exaggerated US growth recovery, spiking inflation and higher effective net bond supply (with fiscal issuance expected to rise above Federal Reserve buying) all fundamentally point to rising US bond yields. While bonds historically give the poorest returns when inflation is below trend and rising, like now, equities, in contrast, do best in such an inflation regime.

Rising nominal bond yields are not necessarily bad for equities when they are associated with economic growth and corporate profit recoveries, which are currently providing fundamental support for equities. In this vein, research by JP Morgan shows that US equity returns were positive on days when bond yields rose in the past 20 years, and even more so since the trough in the US equity market a year ago while the economic recovery unfolded (see table 1). In contrast, the US

equity market fell on days when bond yields declined in the same periods. We think that rising bond yields could be more problematic for equities once they become indicative of imminent tighter monetary policy, which still seems to be some way off.

Table 1: US equities and bond yields are positively correlated

	Daily S&P 500 performance since '00	
	Bond yield up	Bond yield down
Average	0,4%	-0.3%
Median	0,3%	-0,1%

	Daily S&P 500 performance since 23 Mar '20	
	Bond yield up	Bond yield down
Average	0,7%	-0,2%
Median	0,6%	-0,1%

Source: JP Morgan

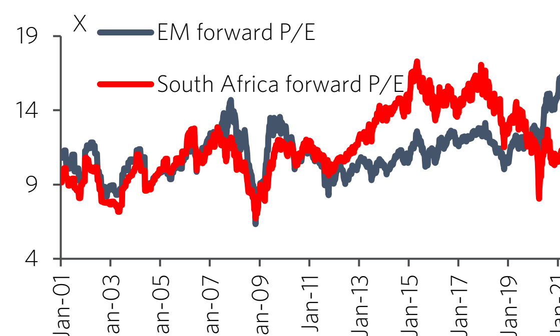
We do not think global equities, in general, are in a bubble. When comparing current global equity market returns and valuations against previous equity bubbles (Japan in the late-1980s, the dotcom in the late 1990s and emerging markets before the global financial crisis in 2008), Citi research shows that it is only the recent Nasdaq performance and valuation that resemble anything close to trends in these previous bubbles. The behaviour of the general US equity market and, even more so, non-US equity markets still fall well short of previous bubbles. In contrast, with bond yields now mere fractions of equity earnings yields (in contrast to previous equity bubbles when they were multiples of earnings yields) it can be argued that it is indeed government bonds that are now exhibiting bubble characteristics and thus provide no viable long-term asset allocation alternative for equities this time.

In our view, sector composition will be key for relative regional equity performance. Simplistically, the US equity market largely comprises of growth sectors (mainly information technology), while the rest of the developed world's equity markets are dominated by value sectors (mainly financials and cyclicals). As the value sectors historically react favourably to rising real yields while growth sectors do not, we maintain a preference for the former and for non-US equity markets.

Although high equity starting valuations have no bearing on shorter one-year return outcomes, they do matter for long-term equity returns and now point to low-single-digit annual returns in the next decade. However, global bond valuations remain even more expensive than equities, with the relative valuation of US equities to bonds still cheap as a consequence, even with low trailing earnings in the base. Against the backdrop of many global risks and uncertainties, central banks are likely to remain strongly committed to keeping interest rates at very low levels even as inflation starts drifting upwards, particularly with the shift to average inflation targeting policies. Although global cash exposure in a very low-interest rate environment should be limited, in our view, some rand weakness could boost rand returns from global cash.

The SA equity market should benefit from the envisaged continuation of a global risk-on environment. Although the SA equity performance has been strong in recent months, this has been accompanied by simultaneous sharp upward earnings revisions, which have kept valuations in check. It is very evident that there has been a significant evolution in SA equity market valuations this millennium. Whereas SA equity valuations were in line with those of EM equities in the first 12 years of the millennium, they traded at a significant premium to EM (therefore very much like a developed market) in the subsequent seven years, but are now trading at a significant discount to EM equities (see chart 2).

Chart 2: SA versus EM one-year forward P/E



Source: RMB Morgan Stanley

SA government bond yields look appealing against their own history on an after-inflation basis, as well as relative to those in developed and emerging markets, with only part of the high real yield differential due to a fiscal risk premium. Current SA real bond yields and yield spreads are attractive on a multiple-sigma basis against historical averages. In the inflation-linked bond (ILB) space, the expected rise in SA inflation to mid-2021 should provide a positive fundamental underpin for the asset class going forward. More specifically, the meaningful positive monthly inflation accruals expected to be banked by ILB investors in the coming months should be particularly favourable for the asset class.

Due to a combination of aggressive SA Reserve Bank (Sarb) rate cuts in 2020 in response to COVID-19, as well as expectations for higher local inflation in the next year, prospective SA real cash yields have fallen close to zero, which is more than one standard deviation below its historical average. This makes the real returns available to investors from local cash unappealing.

Property fundamentals remain weak, with retail rentals too high for sales levels, vacancies rising in the retail and office sectors, and rental holidays and negative rental reversions the order of the day. Although listed property values have declined by 8% so far, we think total declines should be 15%-25% peak-to-trough. The sector is thus not as cheap as it might look on a price-to-tangible-net-asset-value basis, while it is now outright expensive versus bonds.

Vaccinations taking over from fiscal stimulus as driver of economic growth

Estimates of global economic growth for 2021 are being revised upwards on a regular basis as new information becomes available on the state of vaccinations against COVID-19, the opening and closing of economies, the effect of economic stimulus packages and changing interest rates. For instance, the Sarb in March 2021 increased its 2021 economic growth forecast for SA's trading partners to 5.8%, from January's estimate of 5%. And the International Monetary Fund in April 2021 revised its world economic growth estimate for 2021 upwards to 6%, from 5,5% estimated in January 2021 and 5,2% estimated in October 2020.

Table 2: Estimates of global economic growth rates

	2021 (%)	2022 (%)
US	6,5	3,3
Eurozone	4,0	5,1
UK	4,9	6,8
Japan	3,9	1,8
China	8,7	5,5

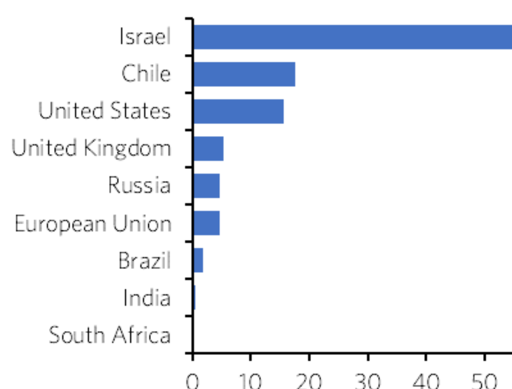
Source: Momentum Investments

However, world economic growth forecasts may continue to be moving targets as they continue to be affected by factors such as the pace and distribution of vaccinations, the possible origination of new COVID-19 variants that may require new vaccines, as well as the intermittent introduction and lifting of lockdown restrictions.

New COVID-19 infection waves are currently emerging in the United States, some areas in the European Union such as France and Germany and densely populated countries including India and Brazil. Renewed restrictions in these countries are bound to slow economic progress in some regions, contributing to some disappointing economic growth rates during the first quarter of 2021. However, growth is expected to recover and accelerate from the second quarter onwards on the back of fiscal stimulus and vaccinations occurring at a faster rate than new infections in countries where vaccinations are available and rolled out efficiently. These countries are bound to recover faster and normalise fiscal policy (less spending, higher taxes and lower fiscal deficits) earlier than the unfortunate ones where vaccines are not freely available and affordable.

Unfortunately, the global vaccination process remains slow. Information from ourworldindata.org shows that only 129 million people worldwide had been fully vaccinated by the end of March 2021. This represents 1,7% of the world population, suggesting that it will take a few years for the world population to be fully vaccinated against current variants of COVID-19 (see chart 3). Israel is on track to be the first country to reach herd immunity.

Chart 3: Percentage of population fully vaccinated



Source: Ourworldindata.org, Momentum Investments (Comparable information for China is not available, but one of two dosages had been administered to 8,3% of the population by the end of March).

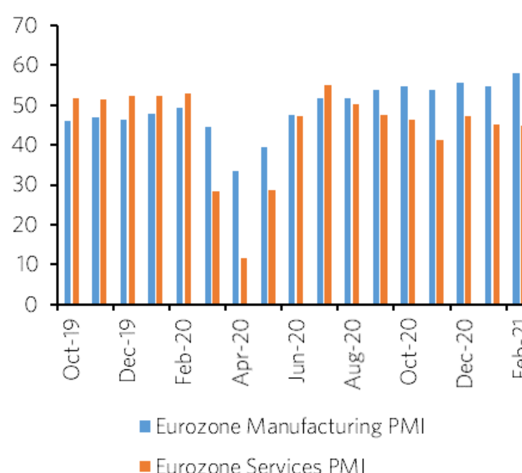
As world economies are not able to return to 'full' states of operation due to continual adjustments to lockdown restrictions, the International Labour Organisation expects the number of employed to decrease further in 2021, albeit less so compared to 2020. An exercise to assemble employment and unemployment numbers around the world revealed that there were 144 million less workers in 2020 than there could have been without the pandemic. The outlook for 2021 suggests a slowdown in the pace of decreasing employment to an estimated 68 million less workers compared to what employment could have been without the pandemic. This suggests that there may be 212 million less workers by the end of 2021 than what there could have been (compared to the start of 2020), contributing to increased poverty and inequality.

The G-20 countries, therefore, in November 2020 called for a continuation of expansionary fiscal and monetary policies for as long as possible to, among others, support economic growth and the creation of jobs worldwide. So far, barring a few countries with hefty inflation problems, most of the world adhered to this call. The central banks of the US, Eurozone and UK already made it clear that, at this stage, they do not foresee interest rate increases in the next two years despite indications of rising consumer price inflation, driven primarily by stronger demand and higher input prices such as oil. Central banks view much of the rising input costs as transitory and for CPI normalisation to occur by 2022.

Expansionary fiscal and monetary policies may therefore continue for a few years, but the magnitude thereof will differ based on the needs of different countries. So far, particularly the US consumer benefitted from the job creation and resultant income-earning prospects stemming from lower borrowing costs and fiscal transfers. Statistics published by the US Federal Reserve show that even real disposable personal income excluding fiscal transfers improved to 2019 levels by February 2021. However, although expansionary fiscal policies may continue, it is expected to be toned down as vaccinations increase and economic restrictions are lifted, while tax rates may be raised to finance bloated fiscal deficits.

At this stage, Purchasers Managers Indices (PMI) suggest that lockdown restrictions contributed to the services sectors lagging manufacturing, particularly in the Eurozone (see chart 4). This is especially true for the tourism sectors such as airlines, hotels and restaurants, and tour operations. The opening of services in the world tourism sector will to a large degree depend on the rate of vaccinations. As countries with fast vaccination rates will reach herd immunity long before those who were slow out of the blocks, they should gain international tourism market share, which in turn will support their economic growth and employment rates.

Chart 4: Eurozone services lagging manufacturing



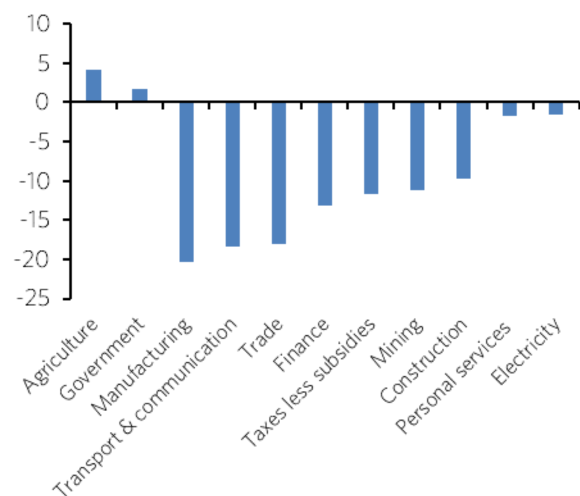
Source: Markit, Momentum Investments

Nevertheless, CBP's World Trade Monitor shows world merchandise trade volumes increased to its highest level in January 2021 (since October 2018), driven primarily by imports to and exports from Asia, including China. As China is SA's largest trading partner, this should be supportive of increased economic activity in SA.

Household consumption expenditure and inventory building should support the SA economy

SA's gross domestic product (GDP) contracted by 7% year-on-year (y/y) in 2020 when measured from the production side of the economy. Had it not been for positive growth in the agriculture and government sectors, the contraction would have been larger (see chart 5). The manufacturing sector contributed most to the contraction (-20,3%), followed by transport & communication (-18,4%), trade (-18%) and finance (-13,2%).

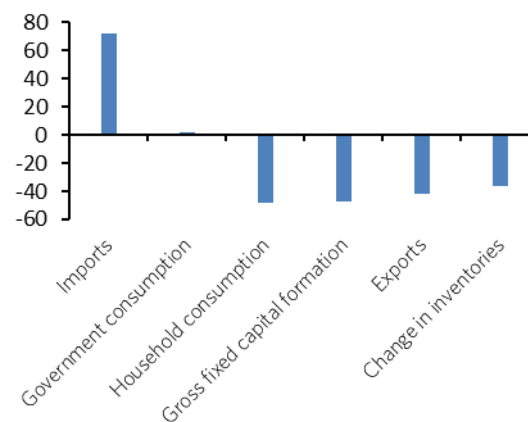
Chart 5: Percentage contribution to the economic contraction measured from the production side



Source: Stats SA, Momentum Investments

The contraction was marginally higher (7,1%) when measured from the expenditure side. Lower imports compared to 2019 made a positive contribution to economic growth (see chart 6), while strong declines in household consumption expenditure (HCE), gross fixed capital formation (GFCF), exports and inventories contributed to the contraction.

Chart 6: Percentage contribution to the economic contraction measured from the expenditure side



Source: Stats SA, Momentum Investments

Given current circumstances, we estimate that the SA economy may expand by 3,4% in 2021 and 2,3% in 2022 (y/y). Our growth estimates, which are supported by the low base established in 2020, would have been higher had it not been for worries about load shedding and the slow pace of vaccinations which will likely act as drags on production and expenditure growth.

Growth rates in 2021 and 2022 should be supported by an expected continuation of re-employment/new employment of workers in the middle-to-higher-income groups, which improved further in the fourth quarter of 2020. This should underpin household consumption expenditure going forward. We also expect some inventory accumulation, following a drawdown of almost R90 billion in 2020, while the opening of the world economy should support exports and imports.

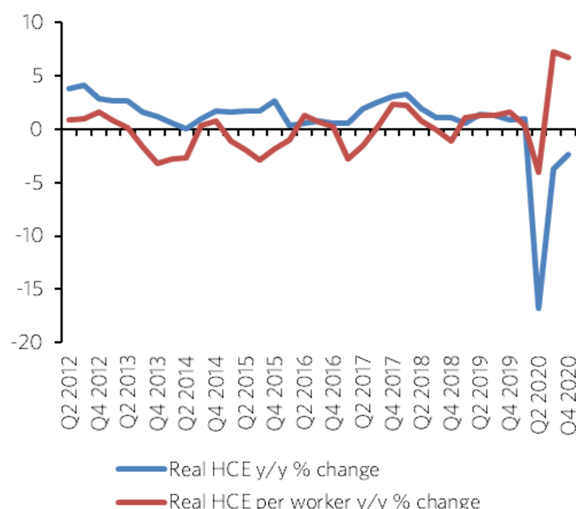
Real household consumption expenditure contracted by 5,4%, or R106,4 billion, in 2020. The bulk of the contraction was caused by the hard lockdown during the second quarter of 2020 (72,5% of the contraction), while the decline in purchases of semi-durable goods such as clothing was the 'spending section' which

decreased most (32,4% of the contraction). A medium-paced recovery occurred in the second half of 2020, particularly in the fourth quarter, when HCE was just 2,4% lower compared to the fourth quarter of 2019.

Our analysis suggests that real HCE can grow by 3,5% in 2021 and 3% in 2022. These estimates imply that real HCE may reach the 2019 level by the end of 2022. The analysis is informed by current evidence on the type of worker that has been re-employed/newly employed since the second quarter of 2020 and a continuation of the process of re-employment and/or new employment.

National Treasury's government finance statistics suggest that most of the 875 000 workers that were re-employed/newly employed since the second quarter of 2020 (Stats SA estimated a 2,2 million decline in the number of workers in the second quarter of 2020) are personal income tax (PIT) payers and therefore in the middle-to-higher-income groups. PIT collections were far below the 2019 levels from April 2020, when lockdown started, up to October 2020. However, it improved strongly in November 2020, reached the 2019 level in December 2020 and then remained close to the January, February and March 2020 levels. Indeed, the South African Revenue Service announced preliminary PIT collections for the financial year at R488,6 billion, suggesting an overrun of R6,4 billion compared to the February '21-22 budget estimate. As the PIT payers are also the individuals who are responsible for the majority of household consumption expenditure, the strong recovery in HCE per worker during the latter part of 2020 is estimated to continue in 2021 and 2022 (see chart 7). In addition, National Treasury estimates that the number of PIT payers may increase to 6,9 million in 2021/22. Should this happen, it means that another 500 000 PIT payers may be employed this year.

Chart 7: Higher-income individuals employed: Growth in real HCE per worker exceeds growth in HCE (% change y/y)

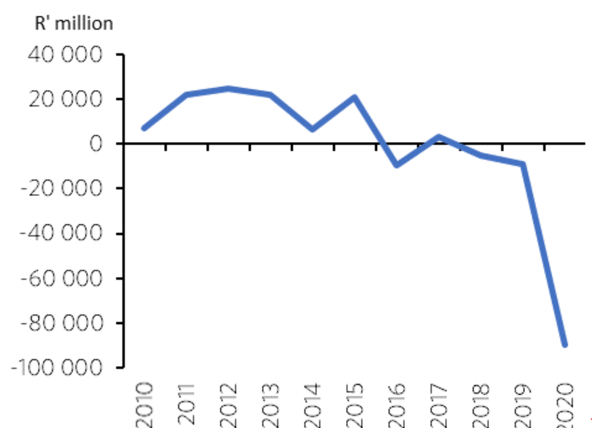


Source: Stats SA, Momentum Investments

Economic growth should also receive support from gross capital formation in 2021. Gross capital formation consists of gross fixed capital formation and the change in inventories (the difference between inventories at the beginning and end of the period). Such support is expected to emanate from companies rebuilding inventories rather than gross fixed capital formation.

In 2020 a massive rundown of inventories (see chart 8) to the magnitude of R89,8 billion occurred (equal to -3,1% of GDP in real terms, which is very large for inventories). This drawdown subtracted 2,6% from the economic growth rate. The majority of the drawdown occurred in three sectors, which experienced large y/y production contractions, namely mining, manufacturing and trade (refer to chart 5). The inventory drawdown in the mining sector was R52,5 billion, followed by trade (R28,9 billion) and manufacturing (R13,3 billion). The main reason for the drawdowns is a lack of demand stemming from lockdowns worldwide, compelling producers and sellers to use existing stock and not invest huge amounts in new inventories.

Chart 8: Lockdown caused a considerable depletion of inventories in 2020 (2010 prices)



Source: Stats SA, Momentum Investments

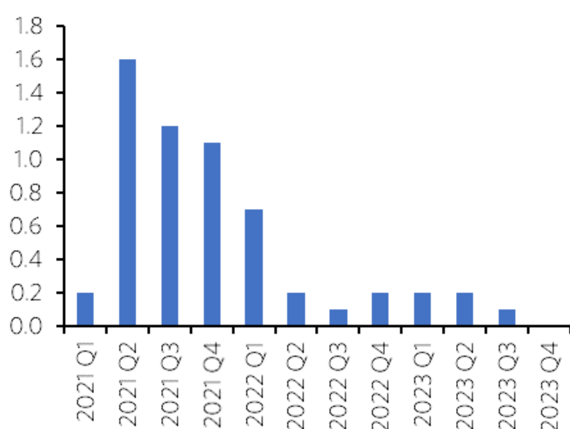
Given the depletion of inventories, companies that trade internationally may need to rebuild stocks, especially as world merchandise trade demand is growing. In addition, chances are slim that South Africa will again move towards lockdown levels 5 or 4, meaning that the economy will be more open for domestic business in 2021 compared to 2020. This should add pressure for investment in inventories.

Even if the inventory drawdown of R89,8 million in 2020 is merely reduced to (a drawdown of) R27,5 billion this year (thus still negative), gross capital formation can increase by close to 16% y/y. Such a smaller depletion of inventories compared to last year may on its own add 0,6 percentage points to the overall economic growth rate in 2021.

Higher near-term CPI should subside in due course

Analysis on prices, the exchange rate and interest rates show that headline CPI is expected to increase to above 5% in the near term on the back of a low base, elevated international oil and food prices, as well as high administered prices such as electricity tariffs and municipal rates. However, the increase is expected to decline gradually as international prices normalise and the effect of the low base dwindles (see chart 9).

Chart 9: Headline CPI minus core CPI: Diminishing effect of higher fuel and energy prices



Source: Sarb, Momentum Investments

The rand exchange rate to the US$ is, at this stage, expected to perform stronger than in 2020 as periods of 'risk on' should outweigh those of 'risk off'. Stronger world economic growth in 2021 and 2022 and progress with vaccinations, albeit slow, should support emerging market currencies. The Sarb expects the real effective exchange rate to strengthen by an average of 4,9% in 2021. However, the rand may depreciate somewhat in the second half of the year as growth differentials between SA and its trading partners widen. A better performance of the rand exchange rate should nevertheless limit pass-through effects of higher international prices to CPI.

Although CPI is estimated to increase from very low levels in 2020, the Monetary Policy Committee (MPC) of the Sarb is expected to keep the repo rate unchanged in 2021. The MPC is more concerned about second-round effects of, for instance, higher fuel prices or a weaker rand and will therefore monitor core CPI closely for evidence of such price pressures. Given a high unemployment rate approaching 45% (expanded unemployment definition), slow household credit growth, expected stabilisation in the growth rate of high international input prices and still weak domestic

demand (notwithstanding higher economic growth), second-round effects are expected to be muted. The MPC is, however, expected to become more hawkish towards the end of the year as expected CPI for 2022 and 2023 approaches the target of 4,5%.

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