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Market and economic outlook: October 2020

Highlights

Markets

- The messaging from global fiscal and monetary authorities remained highly accommodative during the third quarter of 2020 and underpinned robust quarterly gains in global equity markets. United States (US) and Asian markets outperformed, while European and Latin American markets trailed behind.
- The local equity market ended the quarter broadly flat. The FTSE/JSE Resources Index had the strongest performance in the quarter, while marginal losses were observed in the FTSE/JSE Industrials and Financial Indices.
- The JSE Assa All Bond Index climbed 1.5% in the quarter, while the JSE Assa Government Inflation-linked Bond Index traded 1.2% firmer for the same period. Meanwhile, the FTSE/JSE SA Listed Property Index lost 14.1% since the end of June 2020.
- Ongoing stimulus is likely necessary to support financial markets and underpin confidence for sustained economic growth. Sentiment and positioning are suggestive of equity complacency and could act as constraints to future global equity returns. In our view, the potential for higher taxes and increased regulation, stemming from the outcome of the upcoming US election, and virus and vaccine developments pose a threat to equity returns going forward. Relative to global bonds, global equity valuations rank as the most attractive since the Second World War.
- South African (SA) local shares staged a massive underperformance against SA global shares since the bottom in markets. We remain cautious in the near term on SA equities given short-term global risks, but we are more positive beyond that.
- SA government bond yields look attractive relative to those in developed markets (DMs) and emerging markets (EMs), but part of the high real yield differential is due to a fiscal risk premium. Our preference remains for SA nominal bonds over inflation-linked bonds and cash on a one-year basis.
- We remain cautious in the interim on SA listed property in view of near-term global market risks, but the return profile is asymmetric to the upside beyond that.

Economics

- Although COVID-19 infections have been steadily rising in countries which previously had the spread of the disease under control, governments have not re-imposed the most stringent forms of lockdown. The rate of fatalities and hospitalisations have not increased to the same extent as with the first wave of infections, with the rise mostly concentrated among the younger age cohorts or asymptomatic cases.
- High-frequency data releases and sentiment indicators nonetheless imply that a strong bounce back in global economic activity in the third quarter of the year may fizzle out prematurely.

- The economic recovery has shown signs of being unbalanced. Businesses have become less pessimistic about the outlook for the economy and corporate earnings, whereas consumer sentiment and behaviour appear to continue to reflect the uncertainty of COVID-19.
- Fiscal expansions in the DM composite are expected to push the debt-to-gross domestic product (GDP) ratio from 120% in 2019 to 147% in 2020, raising concerns over how governments will service this mountain of debt and how the related surge in bond issuance will affect markets and longer term growth.
- With the blurring of fiscal and monetary policy, it is not clear what will force governments to rein in spending. This raises an additional concern of central banks becoming more vulnerable to political interference. Moreover, inflation expectations are also at risk of becoming unanchored.
- Even as further restrictions are lifted on the economy, ongoing electricity supply shortages, crippling policy uncertainty, lingering unemployment, an anticipated rise in bankruptcies, a slow implementation of structural reform policies and soaring government debt will continue to hold back spending and investment and underscore weak trend growth, thereby limiting SA's recovery to a below-consensus 2% in 2021 in our view, from a contraction of around 8% in 2020.
- The price of electricity tariffs is the main source of upside risk to the inflation forecast in the near term. We anticipate an average headline inflation rate of just above 3% for 2020, rising mildly to just below 4% in 2021.
- We see interest rates remaining unchanged until the second half of 2021 when the SA Reserve Bank (Sarb) begins to unwind negative real interest rates to avoid endangering the savings industry and broader financial stability.

Global policy support has underwritten the performance in financial markets

The messaging from global fiscal and monetary authorities remained highly accommodative during the third quarter of 2020 and underpinned robust quarterly gains in global equity markets. Investors were encouraged during the quarter by the reopening of economies and stimulus efforts which buoyed sentiment. The CBOE Volatility Index (Vix), or fear gauge, was relatively stable throughout and ended the quarter four points lower.

Global equity markets rose 8.1% with US and Asian markets outperforming, while European and Latin American markets trailed behind. The Global All Country World Index rose 8.1% in the third quarter of 2020, with similar gains in DMs and EMs. The MSCI DM Index gained 7.9% in the same period, supported by a bounce of 8.9% in the S&P 500 Index which gained on signs of an economic recovery and loose monetary policy. US consumer discretionary shares and distribution companies fared well, while airline and energy shares continued to struggle. This was followed by a 4.7% uptick in the Nikkei 225 Index, notwithstanding a strengthening in the yen and a change in leadership, while the Eurostoxx 50 Index slipped 0.7% in the quarter. The poor relative performance of European stocks was largely attributable to a rise in COVID-19 infections in several countries and a reintroduction of localised restrictions to economic activity, to help curb the spread of the disease. Energy and financial shares were amongst the poorest performers in the quarter, while materials, consumer discretionary, automotive and luxury goods shares staged a decent performance.

The MSCI EM Index shot 9.6% higher in the third quarter of 2020, supported by a firm 11.9% performance in Asian shares, which were driven by gains in the Indian, South Korean and Taiwanese equity markets. The MSCI Europe, Middle East and Africa Index inched 1.8% higher, while the MSCI Latin America Index shed 1.3% in the same quarter.

Government bond yields were mixed during the quarter against a generally risk-on backdrop. The US 10-year government bond yield was little changed by the end of the quarter, despite election uncertainty beginning to build and broad disappointment with an unchanged policy by the US Federal Reserve, while the German 10-year government bond yield dropped a further seven points in the quarter.

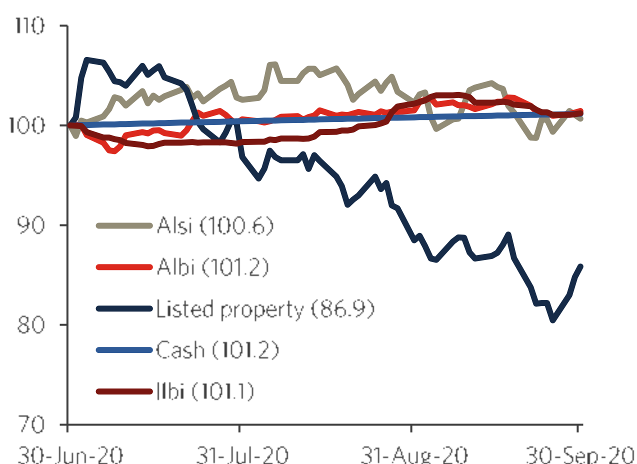
As investor fears subsided in the third quarter of 2020, the JP Morgan EM Bond Index (Embi) spread narrowed by around 36 points. Malaysia, Chile and Romania were among the countries to experience the largest improvement in credit default swap (CDS) spreads since the end of June 2020, while a further deterioration in spreads was noted in Russia, Thailand and Turkey.

The local equity market ended the quarter broadly flat (up 0.7%). The FTSE/JSE Resources Index had the strongest performance in the quarter and added 6%, in line with a robust performance in the Bloomberg Commodity Index, which increased 9.1% in the quarter. The international price of gold and platinum lifted 5.9% and 7.7%, respectively, in the corresponding period, while Brent crude oil prices fell by a marginal 0.4%. The FTSE/JSE Industrials Index dipped 2.3% in the quarter, while the FTSE/JSE Financials Index shed a lesser 1.6% in the third quarter of 2020.

In SA's fixed income markets, the 10-year government bond yield rallied by a mere seven basis points. The JSE Assa All Bond Index climbed 1.5% in the quarter, while the JSE Assa Government Inflation-linked Bond Index traded 1.2% firmer for the same period.

Meanwhile, the FTSE/JSE SA Listed Property Index lost 14.1% since the end of June 2020 (see chart 1).

Chart 1: Returns from local asset classes (%)



Source: Iress, Momentum Investments

Following the risk-on mood, the rand strengthened by 3.6% against the US dollar in the third quarter of 2020. However, the rand weakened by 0.7% against the euro and 0.5% against the pound in the same period. SA's five-year CDS spread shifted 12 points higher in the quarter but remained significantly below the high of 497 points in early April 2020.

US equity markets experienced their greatest equity rally of all time since bottoming in March 2020. However, in the real economy, growth momentum stalled after an initial bounce. As such, ongoing fiscal and monetary stimulus is likely necessary to support financial markets and underpin confidence for sustained economic growth. Sentiment and positioning, which typically act as contrarian indicators, are suggestive of equity complacency and could act as constraints to future global equity returns. In our view, the potential for higher taxes and increased regulation, stemming from the outcome of the upcoming US election, and virus and vaccine developments pose a threat to equity returns going forward.

In our opinion, global bonds remain expensive. Relative to global bonds, global equity valuations rank as the most attractive since the Second World War or the Great Depression. Central bankers have acted aggressively in response to the COVID-19 pandemic by slashing already-low interest rates, relaxing capital requirements and expanding quantitative easing programmes. With the expectation of mild rand strength in the coming year, from current levels, global cash returns will likely not be meaningful.

Major sections of the SA equity market have displayed a disparate performance this year. SA local shares have staged a massive underperformance against SA global shares since the bottom in markets. Assuming growth in earnings of 13% in the next year, the SA equity market is now one standard deviation expensive against its average since 1999 and a third of a standard deviation cheap against the average since 2013. We remain cautious in the near term given short-term global risks, but we are more positive beyond that.

SA government bond yields look attractive relative to those in DMs and EMs, but part of the high real yield differential is due to a fiscal risk premium. Current SA

real bond yields and yield spreads remain attractive on a multiple-sigma basis against historical averages.

We expect break-evens to continue to narrow into the end of the year and only see them expanding in line with rising inflation as 2021 progresses. As such, monthly inflation accruals are only expected to become supportive again in 2021. Our preference remains for SA nominal bonds over inflation-linked bonds and cash on a one-year basis. Aggressive interest rate cuts have driven prospective SA real cash yields down to one standard deviation below historical averages.

In SA listed property, share prices, at the time of writing, imply a 32% decline in property values compared to our base case assumption of a fall of 25% over three years and a worse case decline of 30%. The relative rating of listed property to bonds is at historical extremes and the price to net asset value (NAV) ratio is cheap even with an assumed 20% to 30% drop in NAV. We remain cautious in the interim in view of near-term global market risks, but the return profile is asymmetric to the upside beyond that.

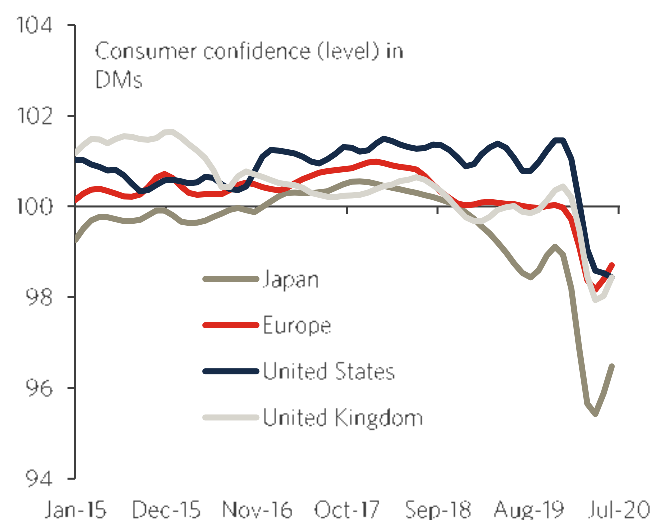
Global economy stirs from the COVID-19 coma

The COVID-19 pandemic has hit the entire world, with the disease tide rising in some areas and falling in others in recent weeks. New cases have risen sharply in areas where social distancing measures were adopted late, such as Latin America, which was the new epicentre of the crisis at the time of writing, accounting for almost half of all deaths each day.

COVID-19 infections have been steadily rising in countries which had previously had the spread of the disease under control, partly because of the easing of travel restrictions being eased. Nonetheless, governments have not re-imposed the most stringent forms of lockdown in countries such as Spain, France, Italy and the United Kingdom. This is justified by the rate of fatalities and hospitalisations not having increased to the same extent as with the first wave of infections, with the rise mostly concentrated among the younger age cohorts or asymptomatic cases.

Despite the lower likelihood of returning to more stringent levels of lockdown, high-frequency data releases and sentiment indicators are indicating that the strong bounce back in global economic activity in the third quarter of the year, following a general ease in lockdown restrictions, may fizzle out prematurely. The economic recovery following the lockdown-imposed economic slump in the second quarter of the year has shown signs of being unbalanced. On the whole, businesses have become less pessimistic about the outlook for the economy and corporate earnings, whereas consumer sentiment, surveyed by the Organisation for Economic Co-operation and Development (OECD), and consumer behaviour appear to continue to reflect the uncertainty of the disease evolution (see chart 2) and have led consumers to pull back on spending on non-essentials.

Chart 2: Consumers remain hesitant



Source: OECD, Momentum Investments

Although fiscal support has been the largest and fastest in peacetime, not all of this additional stimulus has landed in the real economy. Private savings rates have soared and may remain high well into 2021. According to the Peterson Institute of International Economics, cash transfers and unemployment benefits in the US are likely to prop up private US savings to their highest level since the Second World War. Although the narrowest form of money supply has surged to more than 38%

year on year (y/y), growth in bank loans to businesses and consumers peaked at 10% y/y and has since rolled over. Bank lending criteria have also tightened up to levels last seen in the global financial crisis (GFC) as banks grow cautious on default rates.

Moreover, further rounds of business closures and layoffs could stall the recovery in the unemployment rate and act as a further constraint to consumer spending. According to Yelp Inc., more than half of the small business closures (including restaurants, retail and beauty industries, bars and fitness centres) that were considered temporary when the COVID-19 pandemic erupted are now being considered permanent. Although the National Federation of Independent Business showed some areas of improvement for small businesses in August 2020 (which according to JP Morgan account for nearly half of employment in the US), many were still struggling and remained uncertain about future conditions.

Funding for the temporary jobless benefit payments is running out, but the chances of another round of fiscal stimulus before the November 2020 US elections have dropped in response to a partisan split over a smaller package proposed by Republicans. This sign of policy fatigue could keep household incomes under pressure and impair prospects for consumption spending and growth, particularly as economies are fast running out of monetary policy room.

Even without this additional fiscal package, the Bank for International Settlements expects the US fiscal deficit to swell from 7% in 2019 to 24% in 2020. Fiscal expansions in the rest of the DM composite are expected to push the debt-to-GDP ratio from 120% in 2019 to 147% in 2020 (higher than experienced during the Second World War) raising concerns over how governments will service this mountain of debt and how the related surge in bond issuance will affect markets and longer term growth.

With the blurring of fiscal and monetary policy (triggered by initiatives ranging from yield curve control and central bank purchases in Japan to funding for lending in the UK and central bank purchases of corporate debt in the euro area), it is not clear what will force governments to rein in spending, particularly with central banks being forced to mop up the additional debt issued by governments. This raises an additional concern of central banks becoming more vulnerable to political interference and could also risk inflation expectations from becoming unanchored.

In our view, the latter poses less risk in the near to medium term given counteracting disinflationary forces such as ageing populations, excess savings, lower wages, spare capacity and technological innovation that reduce costs. The Federal Reserve Bank of San Francisco admitted that despite the longest economic expansion on record before the COVID-19 outbreak, the personal consumption expenditure deflator measure of inflation stayed below the 2% target for most of the past decade. With much of the world facing the zero-lower bound in interest rates, the US Federal Reserve has adopted an average inflation targeting approach to mitigate the limited use of conventional policy tools in a low interest rate environment.

As we shift closer to the November 2020 US presidential election, it appears as though both candidates favour looser monetary policy, but the outlook for fiscal policy could be dependent on the makeup of Congress.

BBVA Research suggests that in a 'blue wave' scenario, where the Democrats take control of the White House, Senate and the House of Representatives, a more progressive agenda, including key tax and spending policies, is likely to be pursued. The scope of regulatory policy would likely alter, while foreign policy objectives would be overhauled to include support for strategic trade deals and a less aggressive stance against China. Democrats would further feel empowered to reshuffle heads of government agencies, in our view.

In the scenario where Democratic presidential nominee, Joe Biden, wins the presidency, the Democrats regain control of the House of Representatives, but the Senate is retained by the Republicans, bipartisanship politics could mean little movement outside of areas where there is common ground. In a more forceful approach, this partial victory for the Democrats could be viewed as an endorsement to shift away from policies pushed

in the last four years and may even result in blocking of appointments and a choking of international agreements.

Should President Donald Trump secure a second term in the presidency, the Republicans retain the Senate and the Democrats cling to the House of Representatives, there would be co-operation in basic areas and some chance of passing legislation on immigration and infrastructure. But if neither party makes concessions, there would be an increase in reliance on executive actions and legal challenges and rulings.

In a 'red wave' scenario (deemed a lower probability based on current polling suggesting a high probability of the Democrats controlling Congress and the White House), the Republicans secure the White House, the Senate and the House of Representatives. This defeat of the Democrats would embolden President Trump and he would likely double-down on some of his more controversial promises, including reshaping immigration. A continuation of the disruption to the global order through an increasingly protectionist stance is also probable under this scenario.

BBVA Research investigated presidential terms from the 1950s and found that while stock prices were significantly lower during periods of unified governments (where both branches of government are controlled by the same party), GDP, employment and real per capita income growth were much higher than with divided governments. Moreover, consumer and small business confidence were higher under a unified government, possibly signalling that unity and progress, regardless of party affiliation, are viewed as positives. Despite similar inflation outcomes under a unified and divided government, nominal long-term interest rates were slightly higher in the periods of a divided government, reflecting higher uncertainty and risk perception.

Flailing growth and fiscal troubles haunt SA

Already-weak growth outcomes in SA were hobbled by the COVID-19 pandemic and the ensuing lockdown. Even as further restrictions are lifted on the economy, ongoing electricity supply shortages, crippling policy uncertainty, slow implementation of structural reform policies and soaring government debt will continue to hold back spending and investment and underscores weak trend growth.

Economic Research Southern Africa and the Sarb have shown that economic growth in the aftermath of the GFC was primarily led by consumption and services. Total consumption (including household and government spending) surged 25% since 2009, while fixed investment registered only 5% higher by the end of the period. Household and government consumption have climbed to an 84% share of GDP in this period, while the GDP share of fixed investment has fallen to below 18%, a level last observed in 2005. On a sectoral basis, the tertiary sector (mainly services) has grown around 23%, while the primary (agriculture and mining) and secondary (manufacturing, construction and utilities) sectors are only between 2% and 6% larger than they were in 2009.

In the International Monetary Fund's (IMF) SA country report published in July 2020, it noted the deep contraction in economic activity anticipated for 2020 would have lingering negative effects on growth levels and as such the IMF did not project recovery to 2018 levels in its medium-term forecasts to 2023.

BNP Paribas has shown that while it took SA GDP 20 quarters to recover to pre-crisis levels in the early 1990s recession, two quarters in the late 1990s Asian crisis and seven quarters in the GFC, fixed investment lagged the recovery at 23 quarters, 15 quarters and 19 quarters, respectively. Growth in the asset base in the private sector has not kept pace with the depreciation and amortisation of fixed assets. However, with 72% of manufacturers, surveyed by the Bureau of Economic Research in the third quarter of 2020, ascribing insufficient demand as a constraint to outlaying capital and a near-record 85% attributing a lack of investment

activity to policy uncertainty, we may not be able to rely on private fixed investment to bail out poor growth outcomes. While government's infrastructure interventions under the Infrastructure Investment Committee are encouraging, lingering uncertainty remains over timelines and the day-to-day management of the infrastructure projects. The 50 bankable projects and 16 special projects in the pipeline amounting to R360 billion will have to be fast-tracked to ensure a speedier macro recovery.

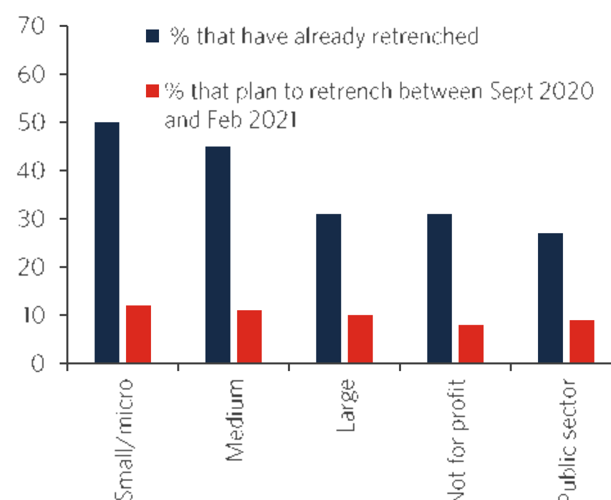
Although government has provided COVID-19 support to the business sector through the loan guarantee scheme, by the middle of August 2020, the scheme had only lent out R13.4 billion to qualifying businesses. In its best-case scenario, the Banking Association of SA expects total loans to reach R43 billion despite changes being made to the eligibility for the loans and to improve the terms of the loans.

While we have seen consumption accounting for the bulk of economic activity in the past decade, the COVID-19 pandemic is likely to put a dampener on spending going forward. The University of Cape Town argues that COVID-19 relief distress grants have lessened the likelihood of a spike in SA's already elevated Gini coefficient, which measures income inequality. The COVID-19 grant managed to bring several uncovered households, operating in the informal sector, into the system and is said to have aided more than 60% of the population. Spending by the ninth and tenth expenditure deciles were buffered by savings, but the data reveals the seventh and eighth deciles were hit the hardest. This is less surprising when considering the outcome of the National Income Dynamics Study: Coronavirus Rapid Mobile Survey (Nids-Cram), which claims that 75% of the population live in households where monthly per capita income is less than the minimum wage of R3 500. Despite the additional grant support, the Nids-Cram Survey shows a reversal in gains achieved in reducing child hunger since the GFC given the severity of the economic decline during the COVID-19 pandemic.

Moreover, a report by the United Nations (UN) warns that more than a third of the middle class (classified as a monthly mean household expenditure per capita of R4 656) are likely to transition from the middle class into vulnerability considering the adverse income effects of the pandemic. The UN also cautioned that households whose employment type changed from permanent to contract employment had a 44% chance of falling into poverty.

The Nids-Cram Survey for April and May 2020 showed that female, less educated and lower-income workers faced the highest rate of job losses during the most stringent levels of lockdown, while Redflank Management Consultants highlighted that small/micro and medium enterprises retrenched the most workers. Meanwhile, employees at large firms or the public sector appeared to have been better insulated from the wounding economic effects of COVID-19 (see chart 3).

Chart 3: Looming job losses



Source: BeyondCOVID, Redflank, Momentum Investments

Elevated and rising public debt, heightened scrutiny by the major rating agencies and high premiums on debt have limited SA's fiscal room to manoeuvre, constraining growth further. While SA's social grant system was expanded during a period of high economic growth, there is a concern whether this is still sustainable in a low growth environment. The OECD notes that SA has one of the strongest redistributive budgets with 68% of government spending allocated to social objectives (including education, health, social grants and basic services). SA's extensive grant coverage has become an important source of financial support and has reduced the country's share of the

population with 60% or less than the median disposable income from 45% to 32%. This has lent credence to an extension of social grant top-ups or a fiscally-neutral form of a basic income grant. This will, however, require a reprioritisation of expenditure given government's stretched finances.

In government's passive scenario, in which it takes no steps to counter weaker growth and higher spending, government debt is expected to exceed 100% of GDP by 2022. Reforms, including curbing the wage bill, improving the efficiency of spending and reducing state transfers to ailing state-owned enterprises (SoEs), are crucial to guarantee the sustainability of government debt in SA.

SA's burgeoning government wage bill, at 12% of GDP, is one of the highest in the OECD grouping. Per capita remuneration in the public sector has increased by an annual average of 3.1% in the last decade. While the share of public sector workers of total employment is not extreme on a global comparison, the proportion ranks as high on an EM comparison. While government promises to cut the government wage bill by R160 billon over the next three years, organised labour and government remain in a deadlock over R37.8 billion in salary increases for the 2020/21 financial year.

Government's exposure to SoEs, which excluding the independent power producers stood at 7.5% of GDP in the 2019/20 financial year, represents a further threat to debt sustainability. The OECD notes that the governance failures behind the SoEs have been reflected in inefficiencies, corruption and financial mismanagement. Moreover, SA's Auditor General reported R94.6 billion in wasteful, irregular and unauthorised expenditure at all levels of government in the 2018/19 financial year.

As such, SA ranks poorly on Transparency International's index of public integrity, control of corruption measure and overall corruption perceptions index. With many key investigations not progressing to the stage of prosecution, public confidence has not yet been restored. The University of Johannesburg-Human Sciences Research Council Democracy Lockdown Survey, which collated responses between 3 and 17 July 2020, recorded a drop in support for the president's handling of the COVID-19 outbreak from 85% in April/May 2020 to 61%. The decline ranged from 15% among residents in informal settlements (to 71%) and among students (to 62%) to a 49% decline to 41% among white adults.

Political trust is a crucial ingredient to restore the social compact between government, business, labour and civil society, in our view. After a delay of six months, the National Economic Development and Labour Council (representing all social partners) has eventually agreed to an economic plan for SA. However, lingering unemployment, an anticipated rise in bankruptcies and ongoing electricity supply constraints limits SA's recovery to a below-consensus 2% in 2021 in our view, from a contraction of around 8% in 2020.

SA's wide output gap is representative of spare capacity in the system. Accordingly demand price pressures are largely absent. Even though the rand has experienced the fifth worst sell-off from its EM peers year to date, the weakness in the currency has not translated into higher retail prices. Downward pressure on household incomes, triggered by retrenchments and pay cuts, together with an excess supply of housing stock on the market will likely keep rental inflation at bay for some time. This leaves the price of electricity tariffs as the main source of upside risk to the inflation forecast in the near term. We anticipate an average headline inflation rate of just above 3% for 2020, rising mildly to just below 4% in 2021.

Although the nature of the COVID-19 pandemic has complicated the effect of the monetary policy mechanism on growth given the disruptions to demand and supply, lower interest rates are expected to help indebted consumers and provide a marginal boost to despondent businesses and consumers. We see interest rates remaining unchanged until the second half of 2021 when the Sarb begins to unwind negative real interest rates to avoid endangering the savings industry and broader financial stability.

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