ASSET MANAGEMENT HouseView

This Month's Focus

In this issue

Special Budget June 2020

At the end of June 2020, the minister of Finance delivered a Special Adjustment or Emergency budget to parliament, which sought to make adjustments to the 2020/21 budget and to enable spending on the COVID-19 pandemic. The revision of the budget was prompted after President Ramaphosa declared a state emergency on 15 of March and then again announced a R500 billion support package to combat the effects of the pandemic. The minister also delivered a very sobering analysis of the country's economic position even before we entered the COVID -19 crisis. An economy hampered by low growth, high unemployment, ailing state-owned enterprises and a weakening fiscal situation.

The adjustments were substantial and largely know no precedent. The economy is now forecast to contract by 7.2% for 2020/21 compared with a meagre but positive 0.9% growth announced in February's budget speech. The consolidated budget deficit is expected to ramp up to 15.7% of GDP versus the original tabled figure of 6.8%. The tax collection shortfall is expected to be at least R300bn for the 2020/21 tax year. The main budget expenditure is expected to rise by only 2.5% to R1 809bn from R1 766bn. The underlying assumptions being CPI inflation of 3% versus previous 4.4% and GDP inflation of 4%. Gross loan debt is now projected to be 81.8%, rising to 86% in 3 years' time. The minister sketched two scenarios where debt is concerned - a passive approach where debt spirals out of control and an active approach in which reforms and fiscal consolidation are implemented rapidly to stabilise debt in 2023/24.

Treasury expects a significant portion of the extra required funding to come from foreign loans (mainly from multinational institutions including the IMF, World Bank and the New Development Bank), the utilisation of sterilisation deposits and higher short-term borrowing. A further sizeable increase in weekly bond issuance is on the cards concentrated in the 7-10yr area of the yield curve.

Government also envisions a package of economic reforms that will improve productivity, lower costs and reduce demands of state-owned companies on the public purse. These measures include finalising electricity determinations, unbundling Eskom and taking other steps to open energy markets, modernising ports and rail infrastructure, and licensing spectrum.

The issue of zero-based budgeting was touched on briefly with the process to start in July. Hopefully, this concept will lead to significant enough savings and less corrupt activity. The devil is always in the detail and no doubt the implementation of such a system will come with its own challenges.

Good news in the form of R3bn support for the Landbank provided some uplift to a rather dreary outlook.

The budget, in many ways, was as expected but came with a stern warning that "we must do something now". One could say that it was a "bridging budget" to the Medium Term Budget Policy Statement (MTBPS) expected in October.

All that remains is the political will to follow through, especially when it comes to containment of expenditure, and the intellectual wisdom to make the best possible decisions as we traverse the uncharted waters of the COVID-10 pandemic.

International Market Overview

The second quarter of 2020 continued where Q1 2020 left off, with increased volatility in global equity markets as well as increasing concerns regarding the impact Covid-19 would have on world economies. Government reactions to the pandemic in some cases appeared to be extreme, but with the continued escalation in infection numbers, notably in the US, as well as warnings by the World Health Organisation that 'the worst is yet to come', there is an expectation of new restrictions as well as potential rollback of re-openings to stem the tide.

The US currently accounts for around 20% of all reported Covid-19 deaths worldwide, prompting questions regarding the country's economic resilience. Global concerns have been heightened by increased trade tensions between the US and China, compounded by China's legislative crackdown in Hong Kong.

United States of America

Markets in the United States ended the quarter in the green, with volatility being the main hall-mark. During the period, the Federal Reserve played a particularly prominent role, increasing its balance sheet by $1.4 trillion in April, following the $1.1 trillion in March. Significantly, by so doing, the FED has done more quantitative easing in these two months than it did over five years during the global financial crisis.

The DOW Jones ended the quarter up by 17.77%, the S&P 500 up 20%, and Nasdaq up a whopping 30.63%. Paradoxically, earnings during the quarter were severely impacted, most notably in the banking sector as they were forced into reserving billions of dollars, especially for potential credit card loan losses, as the unemployment numbers spiked, with 20 million workers filing initial unemployment claims during April, and 8.5 million in May, adding to the 10 million claims already filed in March. These numbers pushed the US unemployment rate to 19.7% to its highest level since 1935.

Although the GDP numbers for the first quarter showed a 4.8% contraction, with personal spending dropping by 10%, other economic data toward the tail end of the period painted a more upbeat picture as the impact of the economic stimulus by the Federal Reserve boosted investor sentiment. Housing activity in the US showed a quick recovery in May, with consumer confidence data for June exceeding the economic forecast consensus, by recording its biggest jump since 2011.

Europe

The European markets followed the US markets in ending the quarter on a firmer note, with the FTSE 100 up by 8.78%, the DAX 30 up by 23.9%, and the CAC 40 up by 12.28%. European economic confidence for both the EU and eurozone for the period improved dramatically as the Economic Sentiment Indicator climbed to 75.7 from 67.5 in May, although we did see Q1 GDP numbers decline by 3.8%. In the same vein, we also saw a decline in the German GDP by 2.2%, as the largest economy in Europe experienced its sharpest drop since the global financial crisis. In addition, the composite PMI for the eurozone plunged from 29.7 in March to 13.6 in April. Although this improved in May, with the PMI print coming in at 28.9, a welcome reversal from the previous reading, it still shows a contraction (a reading above 50 points to expansion, whilst one below 50 points to contraction).

The UK government also responded comprehensively to the Covid-19 crisis which included 5% of GDP in discretionary spending, basic unemployment support and loans and guarantees to assist businesses affected by the crisis, in an effort to support economic recovery. Growth in investments is expected to remain sluggish, however, with a weak trade outlook as talks seeking a free trade agreement between the EU and the UK remain unresolved.

On a positive note, the large new recovery plan for Europe, as proposed by France and Germany, was welcomed by the markets as it is to be funded by common debt issuance and allows for substantial grants for the most affected countries.

Asia

Asian markets also had a good second quarter with the Nikkei up by 17.82%, the Hang Seng up by 3.49% and the Shanghai Composite up 8.52% for the period.

Chinese industrial output grew by 3.9% in Q2, which was better than expected and a significant swing from the previous fall of 13.5% experienced during the two months of lockdown. Data at the tail end of the quarter points to the start of an economic recovery in China, as both the June PMI (in at 50.9 vs 50.6 previous and expected of 50.4), and the Caixin/Markit manufacturing PMI in at 51.2, above expectations of 50.5. This more sanguine view needs to be balanced by the potential fall-out from the new national security law for Hong Kong, which gives China greater control, as well as outlawing previously accepted protests.

In April, the Bank of Japan (BoJ) pledged to buy an unlimited quantity of government bonds as well as announcing that it would quadruple its limit on corporate debt purchases to ¥20 trillion in an effort to cushion the blowback to the economy due to the Covid-19 pandemic. The BoJ has also continued to step up total government support, which now amounts to an unprecedented 42.4% of GDP. This largely includes such off-budget measures as emergency loans, guarantees, as well as tax and social premium deferrals, while maintaining stability in their financial system by lowering the regulatory capital liquidity buffers, as well as continued exchange-traded funds, corporate and government bonds. All this is designed to ensure that households and firms continue to have access to adequate financing.

Local Market Overview

Local Equities

Resources

The RESI20 index had an extremely strong quarter rising by a stellar 41.3%. The index was led by Sasol which made a strong recovery, up 319.7%% to R132.20, on a more positive oil outlook as well as planned asset sales, capex and cost savings to strengthen its balance sheet. The precious metal miners also had a very good quarter led by the platinum stocks, with Amplats (+74.5%), Northam Platinum (+72.4%) and Impala Platinum +56.5%. The gold miners were by no means laggards, with Gold Fields up 62.4%, followed by AngloGold (+49.5%). The precious metals' strong performance is largely due to a 'perfect storm' of surging government debt levels, plunging real bond yields and rising coronavirus cases in the US, leading investors to pile into 'save haven'-type assets.

Industrials

The INDI25 provided an exceptional return of 17.12% for the quarter. This strong performance was driven by the market bouncing sharply from the lows reached in March following the global market sell-off resulting from concerns around the Corona virus pandemic. The top five leaders within the INDI25 Index for the quarter were Aspen Pharmacare Holdings (+59.5% - due to the company producing a drug that has been proven to help COVID-19 patients on ventilators); MTN Group (+40.4%); Bidcorp (+38.3%); Truworths International (+36.6%) and Prosus (+31.2%). The bottom five laggards over the quarter, which included three food retailers whose results were impacted by the national lockdown and social distancing requirements within stores limiting capacity, were Pick n Pay (-17.1%); Clicks Group (-16.2%); Shoprite (-11.6%); Life Healthcare (-4.7%) and Spar (-2.6%).

Financials

The Fini15 index was up 14.5% over the quarter, lagging the JSE all share index, which was up 23.2%. The index was led by strong performances by RMB Holdings (+108.7%) and two of the big four local banks, Nedbank (+47.8%) and Absa (+44.0%). The local insurers also had a decent month as all of the companies in the index recovered from the global sell-off in the previous quarter, with Discovery (+43.0%) and Sanlam (+28.5%), the best performers amongst the local insurers. The laggards in the index were the other three banks, with Investec (+5.82%), FirstRand (+5.3%) and Capitec (+3.7%) reversing the trend from the previous quarter.

Local currency

The rand once again saw extreme volatility through the quarter, reaching a weak point of USDZAR 19.08, and strengthening USDZAR 16.52. The average exchange rate through the quarter was USDZAR 17.95. The quarter included South Africa's expulsion from the World Government Bond Index, which was already reflected in the currency, and a special budget by Finance Minister Tito Mboweni on the implications of the virus on the country's fiscal position. The rand did manage to make some gains through the quarter, however, appreciating by 2.7% against the green back and ending the quarter at USDZAR 17.35. Although the performance of the ZAR was not spectacular, other major emerging market currencies such as the Turkish lira and the Brazilian real saw their currencies rapidly depreciated relative to the dollar, so this performance could have been a lot worse.

Local Fixed Income

Market Review

Markets reacted positively to the flattening of the Covid-19 infection curve and the partial resumption of economic activity in large parts of the world at the beginning of the quarter. Developed economies started to implement monetary and fiscal stimulus support, which caused a wave of risk-on sentiment to return. Some of the positivity was curtailed by a sharp rise in US-China tensions and mounting concerns over a second wave of Covid-19 infections. The stimulus programmes kept global bond yields in check, with most of the decline in yields initially experienced in European bond markets before yields retraced and settled at slightly higher levels by the end of the quarter.

The local fixed interest landscape was driven by substantial rate cuts in April and May as the SA Reserve Bank provided much needed stimulus and liquidity to the local bond market. The SARB continues to provide additional liquidity through open market operations via daily overnight repurchase auctions, seven-day and special three-month term repurchases, weekly auctions and intervention in the secondary market via purchases of government bonds. These actions have supported our local bond market well, but foreigners remained net sellers of SA bonds as Fitch and S&P Global downgraded the country's sovereign credit rating in April and South Africa's exit from the FTSE World Government Bond Index commenced. Local bonds performed exceptionally well during the month of May as the global risk-on trade returned. The gains were offset somewhat, however, by the announcement by National Treasury, in its supplementary budget, that issuance of local bonds would increase. The JSE All Bond Total Return Index was up 9.94% for the quarter.

Inflation-Linked Bonds initially benefitted from the global risk-on trade, but lost ground towards the end of the quarter as inflation continued to print at the lower end of the target range. This asset class was up 4.68% for the quarter.

Our fixed income outlook for the coming months is detailed as follows:

- Economic growth remains low with little sign of substantive recovery.
- Currency volatility continues to be fueled largely by international factors.
- Monetary policy intervention is set to slow down as the effect of the initial stimulus filters through.
- The growth and fiscal metrics remain weak which does not rule out the possibility for future downgrades.
- Foreign flows are volatile, and the economy remains vulnerable.
- Short- and long-term technical trends are in neutral territory.
- Local sentiment is cautious.

We continue to seek value along the yield curve with careful duration risk positioning of our portfolios.