analytics
CONSULTING

ECONOMIC AND MARKET OVERVIEW

PFPS

Global

The global economy is climbing out from the depths to which it had plummeted during the Great Lockdown in April.

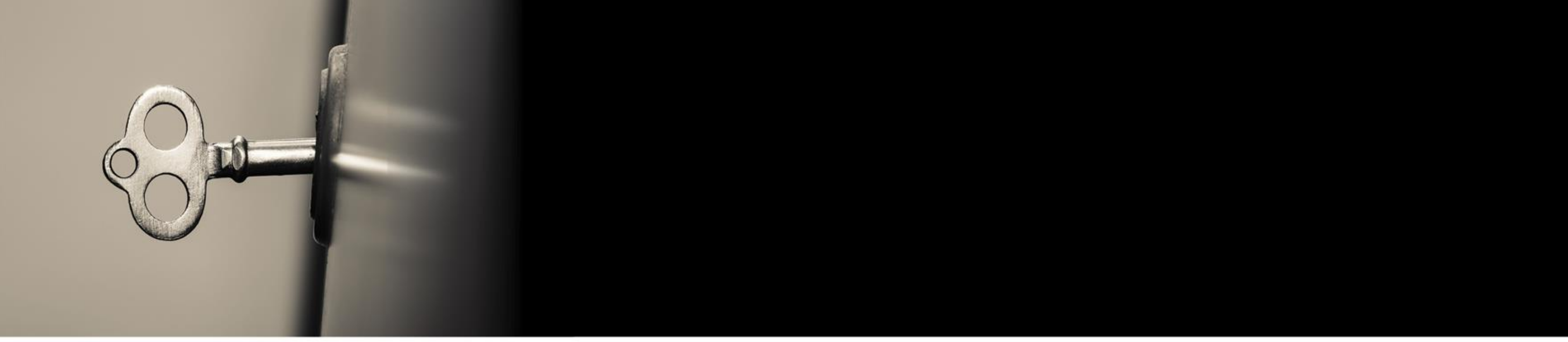
This is the sentiment of the International Monetary Fund (IMF) as expressed in their October 2020 World Economic Outlook. The rate at which economies are recovering have, however, now been hampered by the so-called "second waves" of COVID-19 infections in the northern hemisphere. Many countries have slowed re-openings and some are reinstating partial lockdowns to protect susceptible populations. While recovery in China has been faster than expected, the global economy's long ascent back to pre-pandemic levels of activity remains prone to setbacks.

…the **strong** economic rebound in emerging markets is **skewed by China**…

The global economy is now projected to contract by 4.4% in 2020, which is less severe than the IMF forecast of -4.9% made in June 2020. It's clear from the table below that the strong economic rebound in emerging markets is skewed by China's early and strong recovery. Many emerging markets are in a far worse position than their developed counterparts, and will take several years to return to their 2019 levels of economic output.

At the time of writing, Joe Biden has almost secured the US Presidential election, but the result is likely to be contested by the incumbent Donald Trump. Uncertainty about the outcome may lead to heightened volatility in markets but, more importantly, lead to a delay in the next round of fiscal stimulus in the United States. By the time it gets approved, it may be too little too late and could be the recipe for market turmoil in the first quarter of 2021.

It also seems as if the Democrats will not have done enough to have a majority in the Senate, which means that, even if Joe Biden is elected as President, it will take some time for Democratic policies to find their way into new legislation. Investment markets typically view this as a positive – it implies that changes will be slower with fewer surprises resulting in less volatile markets.



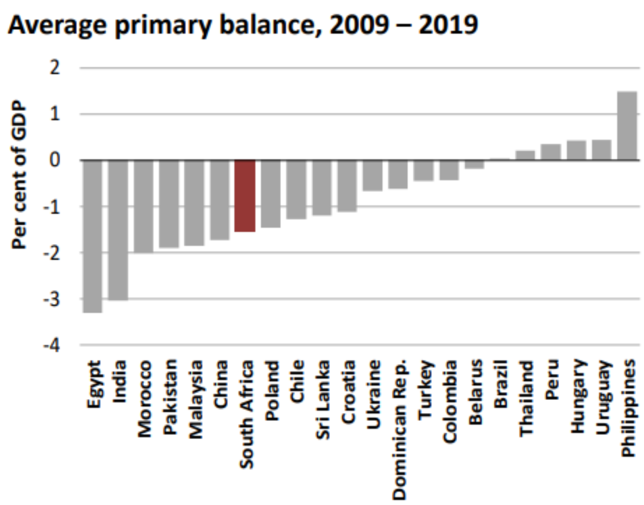
South Africa

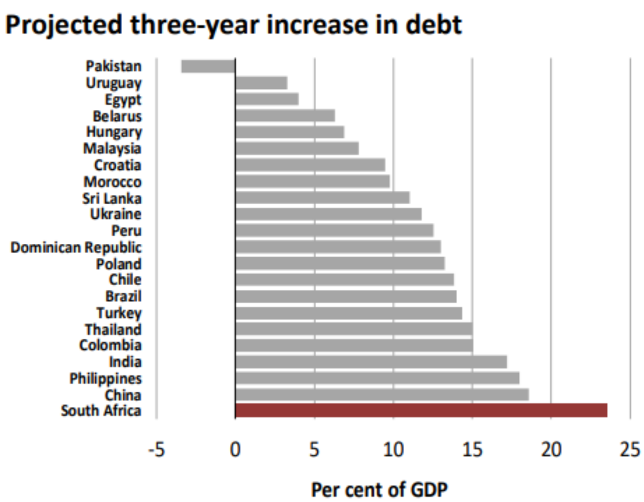
Finance Minister Tito Mboweni delivered the much-anticipated Medium Term Budget Policy Statement (MTBPS) at the end of October in what remains a very challenging economic environment both locally and around the globe.

He painted a worse debt-to-GDP trajectory compared with his estimates during the June Supplementary Budget and noted that the cost of servicing debt will, by 2024, consume more than 24 cents in every rand of tax revenue. This compares to debt servicing cost of less than 10 cents in every rand of tax revenue in 2008/2009.

South Africa is of course not the only economy that's in a spot of bother. Our average primary budget deficit over the last decade lies in the middle of a pack of other emerging market economies. It is, however, disconcerting that the country's three-year increase in debt-to-GDP levels is the largest in this not so illustrious company:

South Africa is…**not the only** economy that's in a spot of bother.





Source: IMF Fiscal Monitor, October 2020

The MTBPS offers more detail on expenditure cuts, which is largely based on the containment of the public sector wage bill. This underlies the intent to divert expenditure away from consumption towards capacity building infrastructure. Visio Capital reports that, after increasing at an average annual rate of 1.5% above nominal GDP over the last 15 years, public-service compensation is now projected to rise by an annual rate of 6% below nominal GDP growth over the next four years. Given the political sensitivity around this cost containment they consider this to be the largest risk to achieving the proposed fiscal path.

Somewhat disappointingly, government continues to provide funds to its failed airline to the tune of R10.5bn. While this is funded in a fiscal-neutral way, it diverts funds away from other more productive expenditure. Encouragingly, however, there were no further allocations to other state-owned enterprises.

From Minister Mboweni's speech, it appears that expenditure containment (assuming that it will be achieved) has reached the end of the road and any meaningful improvement in the longer-term fiscal sustainability will have to shift to revenue growth. Encouragingly, government seems to have acknowledged that tax increases are not the answer and structural reforms are the only viable solution.

Market Performance

Tantalum Capital reported that unease ahead of the US elections and a resurgence in COVID-19 infections in Europe, the United Kingdom and the United States provided markets with a troubled and fraught backdrop during October 2020.

While China and most Asian countries sustained their recent economic recovery trajectory, European countries like Germany, France, Spain and the UK adopted renewed lockdown measures to contain the spread of COVID-19. This sparked social and political discord and threatens to derail the pace of the recovery in business activity and consumer confidence.

Against this backdrop, markets retreated from their recent recovery highs. The MSCI All Country World Index (ACWI) ended the month 2.5% lower (in USD) with Europe leading the charge with a drop of more than 7%.

The Oil price retreated sharply as Brent Crude ended the month 8.5% lower. Gold, silver, copper and aluminium traded flat for the month. South Africa is a net importer of energy (with the oil price as proxy) and a net exporter of precious and industrial metals. If the price of the former falls while the price of an export basket of metals rises, it improves our trade balance and provides support for the rand against the US dollar. The rand gained 2.7% against the greenback in October.

The local equity market ended the month 4.7% lower, led by Industrials (-11.4%), while bonds strengthened by nearly 1%.

MARKET INDICES [1] **(All returns in Rand except where otherwise indicated)**	**31 October 2020**		
	3 months	12 months	5 years
SA equities (JSE All Share Index)	-6.5%	-5.8%	2.2%
SA property (S&P SA REIT Index)	-16.3%	-53.8%	-15.0%
SA bonds (SA All Bond Index)	1.7%	4.8%	7.5%
SA cash (STeFI)	1.1%	6.1%	7.1%
Global developed equities (MSCI World Index)	-4.6%	13.2%	12.3%
Emerging market equities (MSCI Emerging Markets Index)	-2.0%	17.2%	11.9%
Global bonds (Bloomberg Barclays Global Aggregate)	-5.0%	13.9%	7.3%
Rand/dollar [2]	-4.6%	7.9%	3.3%
Rand/sterling	-6.0%	7.8%	-0.3%
Rand/euro	-6.0%	12.6%	4.4%
Gold Price (USD)	-4.4%	24.2%	10.5%
Oil Price (Brent Crude, USD)	-13.5%	-37.8%	-5.4%

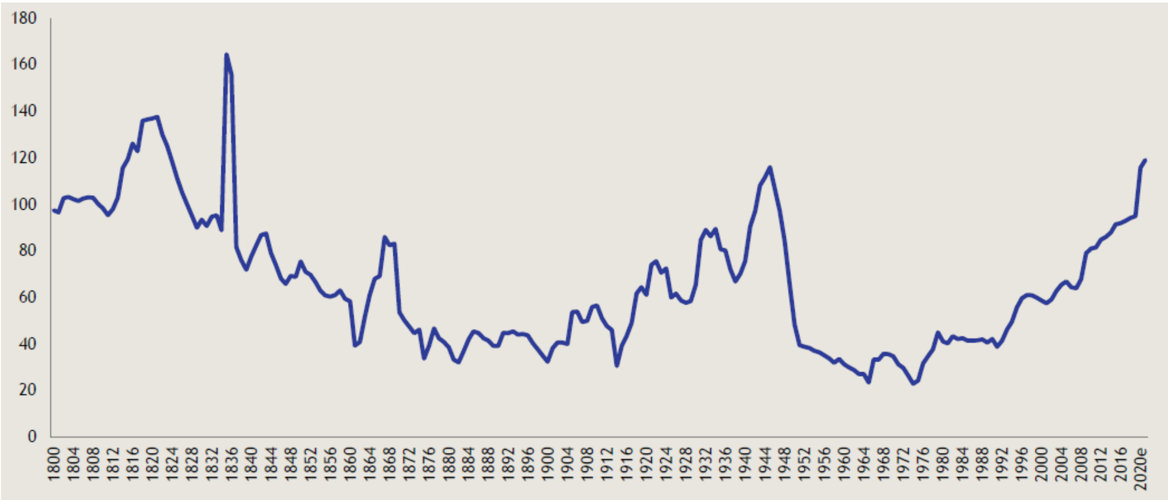
1. Source: Factset
2. A negative number means fewer rands are being paid per US dollar, so it implies a strengthening of the rand.

Commentary – The world economy beyond 2020

“2020 has been the toughest five years of my life”. This is a thought that more than one of us have had this year. Ironically, 2020 brought very clear vision, but only in hindsight.

Looking ahead at what the world economy may hold in store for the next ten years is at best an educated guess, but a useful exercise, nonetheless. According to a recent Economist Intelligence Unit (EIU) report, we are likely entering an era of slow growth, low inflation and high levels of debt around the world.

World gross government debt as a % of GDP (G-20 Advanced Economies)



…entering an era of **slow growth, low inflation and high levels of debt** .

Source: International Monetary Fund

This graph clearly shows how debt as a percentage of economic output has steadily increased since the 1960’s to the levels the world has last seen during and shortly after the Second World War. More recently, the COVID-19 outbreak and related economic lockdowns have prompted advanced economies to unveil extraordinary fiscal measures, which have greatly added to government debt levels. This year the G20 countries have announced stimulus packages of roughly USD 11 trillion. This is close to the annual economic output of Japan, Germany and France combined. The purpose of these stimulus packages was to help keep many companies afloat, keep workers employed and to stabilise financial markets. It has, however, pushed national budget deficits to an average of 17% of GDP across OECD countries, and has increased government debt to around 140% of GDP (or USD 13 000 per head) across developed economies.

Whereas in the past such high levels of debt would have raised the alarm bells, it’s not the case now. This can be ascribed to two factors. The first one is that governments have enlisted central banks to finance this additional spending. The second reason is that low and stable inflation will lead to a slow but sure erosion of debt over time as economic output (GDP) increases while debt (at least in theory) remains stable. With low interest rates, the cost of servicing this debt is also virtually zero. As Olivier Blanchard, a former chief economist for the IMF puts it, at a zero-interest rate, it “does not matter whether you finance by money or finance by debt”.

Commentary – The world economy beyond 2020 (continued)

At some point during the onset of the Coronavirus pandemic, there were fears that shortages of some goods and constrained supply chains would lead to a sharp rise in consumer prices. Inflation has however remained subdued across the world this year. Looking back at how 2020 unfolded, this is perhaps not so surprising. In times of uncertainty, consumers prefer to save rather than to spend. Businesses are also hesitant to invest and the combination of these two elements kept inflation in check.

Debt is however onerous and while governments are too busy dealing with the pandemic and resulting lockdown measures, the ballooning levels of debt will have to be addressed at some point. Austerity will probably not be a credible option, while tax increases will likely do little more than erode political goodwill among the already overburdened global taxpayer. It really leaves slow but steady economic growth as the most sensible solution to reduce a mountain of debt to a mole hill. This means that advanced economies may need to do precisely nothing except letting time continue its course. Over time, if nominal economic growth remains higher than interest rates, the piles of debt will simply reduce and eventually disappear. With near-zero interest rates, and under the assumption that the stimulus packages manage to boost economic growth, it does not seem like a bridge too far.

… **active stock picking** may just prove to be a **winning strategy.**

Investors seem to still be comfortable to fund this growth in debt. The situation may look unprecedented, but the world has been here before. In the years that followed the second world war, the US public-debt-to-GDP ratio stood at 112%; that of the UK was more than twice that figure, at 259% of GDP.

As was the case 75 years ago, this situation creates the chance to finance investment and research to fuel the post-pandemic recovery and boost long-term growth prospects. This new normal also comes with risks. Generous support measures will help to keep otherwise unprofitable companies alive, weighing on productivity and innovation and fueling a rise in the number of “zombie” firms. The companies that benefited from government-sponsored loans will also spend years repaying their debt, instead of investing in research and development. In addition, if inflation rises unexpectedly, central banks will have no choice but to hike interest rates to curb price growth. In turn, the cost of sovereign borrowing could spiral out of control. This is a significant risk.

Over the last decade, the relationship between unemployment levels and inflation have broken down. As unemployment (specifically in the US) continued to decrease, inflation did not move up. There is a chance that this relationship could rear its head again, and it would be a significant drag on global economic growth.

The EIU report concludes as follows: until the start of the coronavirus outbreak, Japan was considered an economic oddity. After the country’s equity and real estate bubbles burst in 1989, the economy crashed abruptly before going through a “lost decade” of feeble growth between 1991 and 2001. The government tried to boost activity via fiscal stimulus programs, which increased the debt-to-GDP ratio to around 240%. These measures failed, and subdued demand meant that inflation remained stubbornly low. Coupled with a bleak demographic outlook, these three characteristics—slow growth, low inflation and high debt— will become common features of advanced economies in the coming decades. The impact of such unprecedented conditions will be a game changer for the global economy. The pandemic may not last once a vaccine is found. However, the post-coronavirus zombification of advanced economies appears to be here to stay. It’s in such an environment that active stock picking may just prove to be a winning strategy.

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