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…financial markets have held up surprisingly well…

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## Global

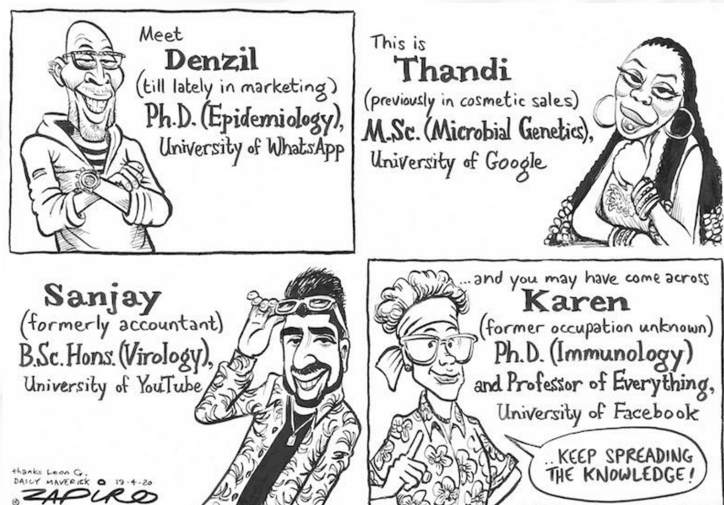
It feels like ages ago that a global trade war dominated news. It is sobering how quickly the spread of Covid-19 and the subsequent lockdown regulations changed the world while we were making other plans.

Most governments around the world are in the process of figuring out how to best balance a return to full economic activity whilst simultaneously curbing the increase in mortality rates associated with the spread of Covid-19. Harvard epidemiologist Marc Lipsitch made a very interesting distinction; He said that there are facts, informed extrapolations from analogies to other viruses and, lastly, opinion or speculation. Against this backdrop Howard Marks of Oaktree Capital added that “the scientists are trying to make informed inferences, and there’s not (yet) enough data to…turn these inferences into facts. Most of what we have today is opinion, and much of it is either optimistic or pessimistic. The gulf in between is massive: if you read just the optimistic pieces, you’d think the virus will soon be eradicated, and the economy brought back to health, and if you read just the negative ones, you’d think we’re all done for.”

There are many theories conjecturing what the best path from lockdown to freedom of movement is. The fact of the matter is that we simply do not know for sure, and that the range of potential economic outcomes varies greatly. Markets will reflect this uncertainty as it waxes and wanes along with the changes in investor sentiment. What we know for sure is that the global economy has shrunk significantly in the last two months and won’t recover to its pre-crisis levels anytime soon. It’s therefore not clear whether the market has reached a bottom yet, as Gavekal Research’s Monthly Strategy piece for April noted (with respect to the S&P 500):

“…markets rarely clear after one massive decline. In 15 bear markets since 1950, only one did not see the initial major low tested within three months. In all other cases, the bottom has been tested once or twice. Since news-flow in this crisis will likely worsen before it improves, a repeat seems likely.”

So is now the best time to buy? Maybe not. It could, however, be a good time to put some cash to work.



## South Africa

### Compared to the rest of the world, South Africa had one of the stricter lockdown routines in order to curb the spread of the coronavirus. It has put an already fragile economy under enormous strain with many businesses (especially smaller establishments) struggling to pay wages and other running expenses at the end of April.

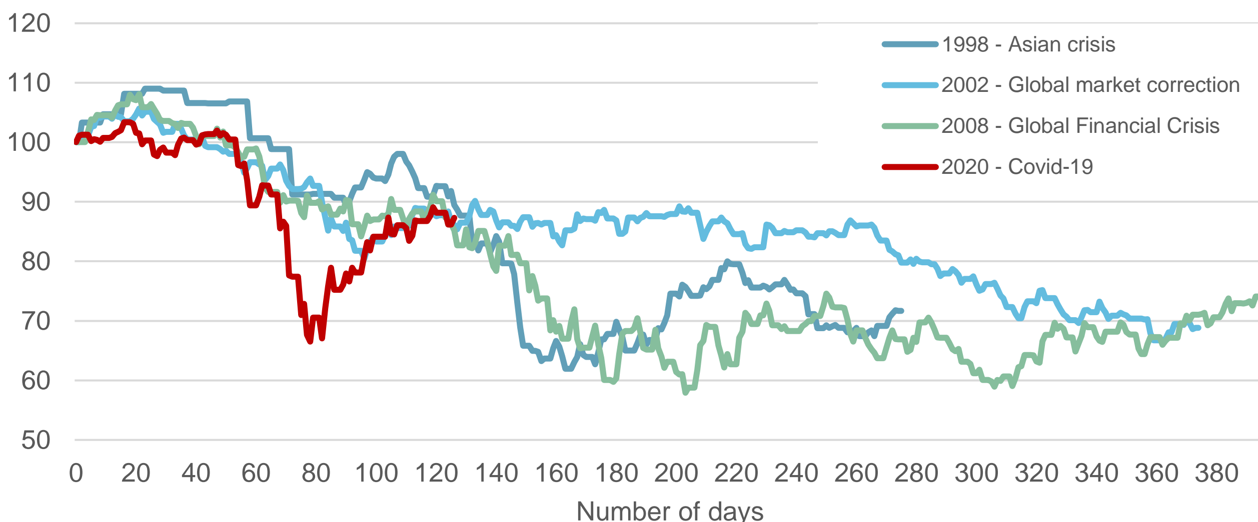
The government announced various fiscal packages to support business through these trying times. The almost R4 per liter reduction in the fuel price and 2.25% reduction in the prime interest rate (since January) equates to about a R800 billion stimulus package. This amounts to more than 15% of GDP and compares very well to similar initiatives around the world.

The flipside is that South Africa's government debt will increase significantly in order to fund most of this fiscal stimulus. In order to successfully reduce its debt over the long term, South Africa will have to grow its economy much faster. This puts a lot of pressure on the ruling party to make significant structural changes to labour and other laws in order to improve the ease of doing business. Only time will tell if President Rampahosa and his close allies have the political will and power to enforce these changes during this trying period.

On the ratings front Standard and Poor's Ratings Services decided to cut SA's international credit rating from BB to BB- (BB- is three notches below investment grade) but revised the outlook from negative to stable. This reflects a qualitative view on South Africa's ability to repay its debt. What's interesting though is that the market (or quantitative) view went the opposite direction – South African government bond yields have rallied significantly in recent weeks and are now at lower levels than when they were rated investment grade a few months ago.

## Market Performance

Equity markets around the world rallied strongly in April but are generally still some way off their February highs. Visio Capital reports that, given the magnitude of the economic shock, financial markets have held up surprisingly well when compared with other (less severe) economic shocks. The "subdued" market move can be attributed to the decisive policy action taken by many governments. Economic data over the next few months will determine whether the markets were correct in taking a relatively sanguine view. When we reflect on recent global financial crises the fall in markets was much steeper, and so was the recent bounce as Rezco Asset Management shows in the graph below:




Domestic equities had a strong bounce and delivered their best monthly performance in 17 years. This was lead by the resource stocks, with Sasol and gold stocks doing particularly well. Listed property was the second-best performing asset class but, as an equity play, lagged all the other main industry sectors.

Despite rating downgrades, foreign selling and a weaker rand, domestic bonds had a strong month. It was likely supported by the repo rate cut and lower inflation. After the recent rate cuts local cash does not look particularly attractive from a valuation point of view and it's unlikely to beat inflation by much (if at all) in the short to medium term.

| MARKET INDICES [1] (All returns in Rand except where otherwise indicated) | 30 April 2020 | | |
|---|---|---|---|
| | 3 months | 12 months | 5 years |
| SA equities (JSE All Share Index) | -8.8% | -10.8% | 1.6% |
| SA property (S&P SA Reit Index) | -46.2% | -51.3% | -12.5% |
| SA bonds (SA All Bond Index) | -6.3% | 0.1% | 6.1% |
| SA cash (STeFI) | 1.6% | 7.2% | 7.2% |
| Global developed equities (MSCI World Index) | 8.1% | 23.7% | 15.0% |
| Emerging market equities (MSCI Emerging Markets Index) | 7.2% | 13.2% | 9.3% |
| Global bonds (Bloomberg Barclays Global Aggregate) | 22.9% | 36.5% | 12.0% |
| Rand/dollar [2] | 22.4% | 28.1% | 9.0% |
| Rand/sterling | 17.2% | 23.9% | 4.7% |
| Rand/euro | 21.0% | 25.2% | 8.5% |
| Gold Price (USD) | 6.4% | 31.3% | 7.3% |
| Oil Price (Brent Crude, USD) | -56.6% | -65.3% | -17.7% |

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

## Commentary – The shape of the recovery

There is a lot of speculation of the shape and pace of the recovery following the Covid-19 pandemic. It's important to distinguish between the recovery in markets and the recovery in the real economy. The market recovery typically precedes the economic recovery by months, if not years.

The debate of the potential shape of the economic recovery is around a few letters of the alphabet: V, W, U or L.

A V-shaped recovery is one where economic activity falls steeply but soon recovers at pretty much the same pace as the original decline. In contrast to a V-shaped recovery in which the economy rebounds as strongly as it declined, an L-shaped recovery refers to a type of economic recession and recovery characterized by a steep decline in economic growth followed by a slow recovery. In an L-shaped recovery, a steep decline caused by plummeting economic growth is followed by a straight line indicating a long period of stagnant growth. An L-shaped recovery (and in this context "recovery" is a strong word…) is the most dramatic type of recession, and recovery can take as long as a decade.

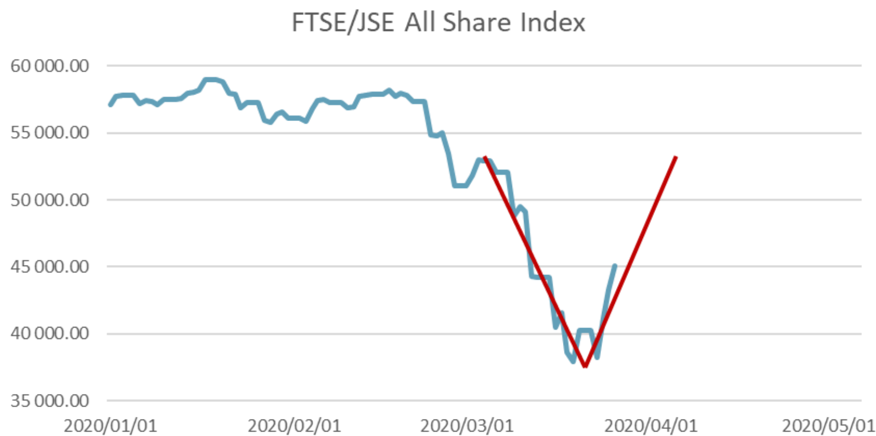
A W-shaped recovery involves a sharp decline in economic metrics followed by a sharp rise back upward, followed again by a sharp decline and ending with another sharp rise. The middle section of the W can represent a significant bear market rally or a recovery that was stifled by an additional economic crisis.

A U-shaped recovery describes a type of economic recession and recovery that charts a U shape, established when certain metrics, such as employment, GDP and industrial input decline gradually and then gradually rise back over time, typically over a period of 12 to 24 months.

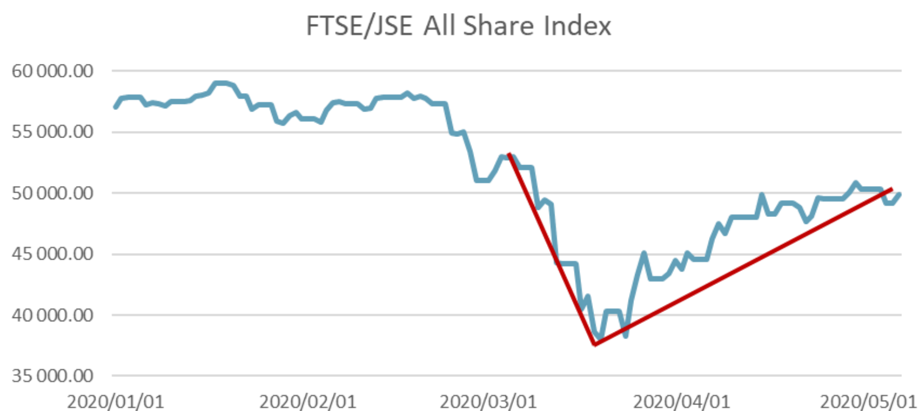
Simon Johnson, former chief economist for the International Monetary Fund, described a U-shaped recession like a bathtub in an interview in 2009. "You go in. You stay in. The sides are slippery. You know, maybe there's some bumpy stuff in the bottom, but you don't come out of the bathtub for a long time."

Given that capital markets are forward looking and act as a discounting mechanism of future cash flows, it initially (at the end of March) seemed as if a V-shaped economic recovery was priced in. Much of this was on the back of the expected success of global stimulus packages:

Sources: Sanlam Investments, Morningstar, Investopedia




That assessment may have been somewhat premature as reality set in and data about the contraction in the real economy (in South Africa and abroad) caused many reasons for concern. It's now become apparent that, despite the immense fiscal stimulus, it is unlikely that economies around the world (and specifically South Africa) will bounce back to their pre-crisis levels any time soon. This change in outlook was reflected in the market movement during April as the graph indicates:




It's clear that the market recovery, at least in the very short term, does not forecast a V-shaped recovery in the economy. It didn't take much more than a few weeks for the market to realise that the end of lockdown will take much longer and will be much more prohibitive on company earnings than we initially thought, and this is now being reflected by something in between a V-shaped and L-shaped recovery in equity prices.

It is, however, early days in the containment of the coronavirus, the market reaction and change in economic activity. Much will still be learnt and changes in facts, opinions about these new facts and speculation will continue to influence markets.

As a parting shot: Sanlam Investments recently performed an analysis of previous bear markets in South Africa and came to the conclusion that a V-shaped recovery is the norm rather than the exception in our local equity market. Using data from the JSE Total Returns Index since 1925, they concluded that the average of the ten worst drawdowns in history was a staggering -40%. For perspective, the current drawdown we're experiencing is -22% (period for current drawdown is 30 May 2019 to 31 Mar 2020), and only ranks 13th in the 40 worst drawdowns since 1925.

The main deduction from their research: The larger the drawdown, the more likely the recovery is V-shaped and twice as fast as expected.

We don't know if we've seen the true bottom yet. Either way – there's hope once we have.

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