INVESTMENT NOTE

WHAT WE KNOW AND WHAT WE DON'T KNOW

DAVE MOHR AND IZAK ODENDAAL | OLD MUTUAL MULTI-MANAGERS
24 FEBRUARY 2020

WEALTH

There is a lot for investors to think about. Globally, the focus is still very much on the coronavirus outbreak, and investors are increasingly jittery. Looking a bit further ahead, the run-up to the November US presidential election is gathering speed. Normally this shouldn't mean much for investments, but this year might be different. Time will tell. Local markets have largely been in limbo ahead of this week's Budget Speech.

So let's think about what we have reasonable certainty on (you can never be 100% sure) and what we don't know.

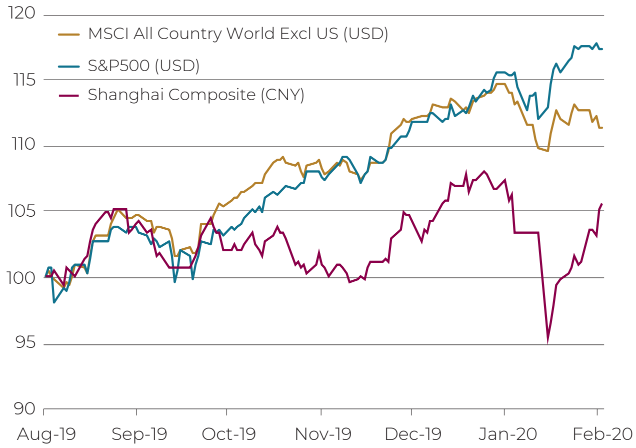
COUNTING THE COST OF COVID-19

We know the Covid-19 outbreak is severe, with more than 70 000 infections and 2 000 deaths, still mostly contained in China, but spreading around the world. The human toll has been pronounced. Estimating the economic toll is more difficult, since the most reliable data measuring economic activity is typically released with a lag of a month or two. It means that analysts and economists have turned to a range of alternative real-time data sources – such as traffic congestion, air pollution and attendance at movie theatres – to gauge the extent of disruption in the Chinese economy. These indicators point to much lower levels of economic activity that is normally the case this time of year. There is also spill-over to the rest of the world, with Chinese tourists staying at home, and global companies struggling to get supplies out of China. Most of the disruption, however, is still not from the virus itself, but from the steps taken to halt its spread.

What we don't know is for how much longer the outbreak will rage and how far it will spread, or whether the virus will mutate, starting the process all over again. Based on the numbers we have, the growth rate in daily infections in China is slowing, but whether the data collected in the crush of panicked patients in overwhelmed hospitals can ever be accurate is hard for outsiders to say. What we do know is that past episodes, though on a smaller scale, followed a pattern of economic rebound once the outbreak subsided with limited market damage.

That is what equity markets have been pricing in until recently, certainly the US market, which was pushing new record high levels. Markets were sharply weaker on Monday morning, with investors seemingly reassessing the scale of the outbreak. All-in-all, the inwardly-focused US economy is much less exposed to China than the likes of Europe, Australia and Brazil (about 10% of South Africa's exports by value go to China).

CHART 1: RECENT PERFORMANCE OF MAJOR EQUITY INDICES



Source: Refinitiv

We know that central banks are not going to take any chances. The US Federal Reserve (the Fed) cut rates at three consecutive meetings last year. Though it has signalled that it is happy with its current stance, it could cut again if growth disappointed or inflation declined. The stronger dollar this year might yet trigger a move. The bar for hiking rates, however, is very high. Inflation has persistently fallen short of the 2% target, and the Fed has indicated it would have to move above this target on a sustained basis for interest rates to be increased. The European Central Bank is even further behind its target.

LOWER FOR LONGER

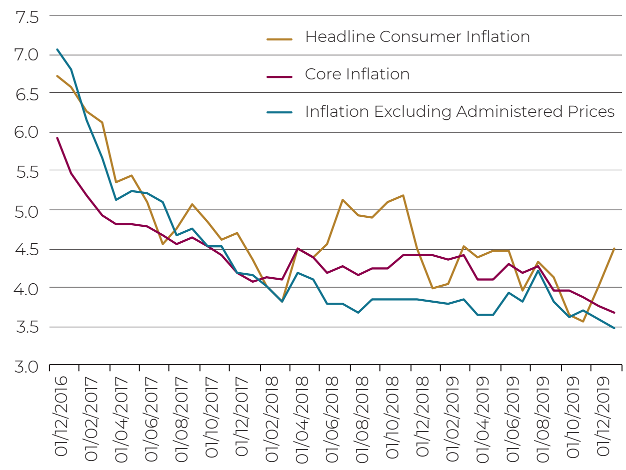
The world is therefore in a lower-for-longer interest rate environment. This places a lid on how high South African yields can rise, even if we have a disappointing Budget and ratings downgrades.

Our own central bank is an outlier. Though inflation has declined materially, it maintains high real interest rates to guard against destabilising capital outflows and to force inflation expectations lower.

Consumer inflation ticked up to 4.5% year-on-year in January, but this was largely because of a large decline in fuel prices a year ago. (A petrol price cut of around 17 cents per litre is currently on the cards for March, unless there is a substantial change in global oil price or the rand-dollar exchange rate.) Food inflation is expected to rise further through the year. The headline consumer price index is probably the best measure of increases in the cost of living of the average urban South African, but from the point of view of setting monetary policy, one should also focus on the underlying trends, specifically the risk second round inflation. This happens when price increases in one area spill over to other areas.

Core inflation fell further to 3.7%. It excludes food and fuel prices, whose volatility can obscure deeper inflation dynamics. The other reason for excluding them is that they are determined by global market forces. Consumers cannot shop around for lower petrol prices and their only response to a price increase is to drive less. For the same reason, many administered prices set by government agencies should also really be excluded. These are not subject to market forces or consumer demand, but set by bureaucrats. Consumers cannot negotiate their municipal tariffs. Non-fuel administered price inflation was 7.4% in January. In the absence of strong income growth, these administered price increases put downward pressure on demand for other items. Inflation excluding administered prices was only 3.5% in January.

CHART 2: DIFFERENT MEASURES OF LOCAL INFLATION



Source: Stats SA

We know one of the main reasons inflation is low is because the economy is struggling. In the absence of much stronger growth, it is hard to see inflation accelerating. While there are many things that can light the flame of higher inflation – food, oil, the rand – strong demand and credit growth is the oxygen necessary to sustain it.

When fourth quarter GDP is released in two weeks, it might show a small positive or small negative growth number. If it's the former, it means that the economy will have escaped a technical recession (two consecutive negative quarters) but this will hardly warrant celebration since the economy is clearly very weak.

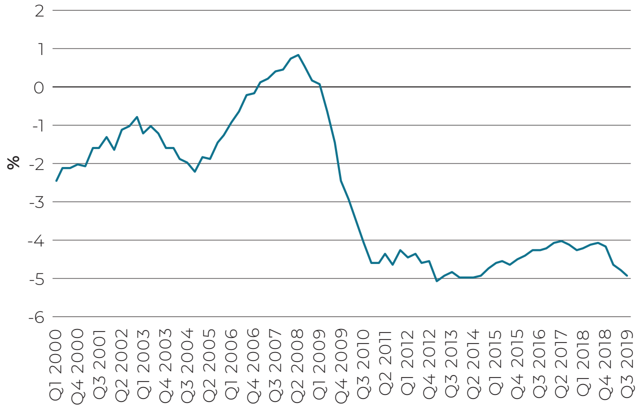
BUDGET BIND

A struggling economy means tax revenues are under pressure and lagging behind target. This is the backdrop against which this week's Budget Speech takes place. To cope with lower-than-expected tax revenue, the government will either have to raise tax rates, cut back spending, borrow the shortfall, sell state assets or some combination of the four. Tax hikes are obviously unpopular and might not work as expected. Prior tax rate increases have not delivered much additional revenue. Spending cuts limit government's ability to deliver services and to invest in infrastructure. Selling state assets makes sense, but political and ideological opposition is enormous, and not all assets are in good enough condition to be sold. Further borrowing therefore seems like the easiest option, except for the fact that government debt has increased so much over the past decade that it will spend more than R200 billion on interest this year.

The October Medium Term Budget signalled an additional R150bn of revenue or spending measures over three years to narrow the deficit. Following through on this, it is important to maintain what is left of government's fiscal credibility, but cutting interest payments, wages or social grants is near impossible. The burden of cuts will therefore fall on capex, maintenance and service delivery. Real progress can come from limiting growth in the wage bill to 3% per year instead of the 7% per year currently budgeted for. This can save an additional R150 billion over three years, but will still need to be negotiated with public sector unions during the course of the year.

There are no easy answers and we expect the Minister to announce tax tweaks and spending trims to contain the damage, but no large-scale politically-difficult changes. The budget deficit will therefore be in the region of 6% of national income (GDP) per year over the next three years and the overall debt-to-GDP ratio will continue climbing.

CHART 3: SOUTH AFRICAN GOVERNMENT BUDGET DEFICIT, % OF GDP



Source: National Treasury

The only thing that can stop this negative spiral is much faster economic growth. All government can do to ignite this is to significantly reduce the cost and difficulty of doing business, crowd in private sector investment and remove policy uncertainty. Some steps have been taken in this direction and Minister Mboweni might announce further initiatives, but a 'Big Bang' deregulation approach is very unlikely. We also need to understand that governments cannot create jobs; if they could there would be no unemployment anywhere.

The most immediate challenge to the economy is the lack of reliable electricity supply. We know that load-shedding will be a reality for the next year, maybe two, as Eskom undertakes much-needed maintenance on its old power stations, while its new power stations are not yet complete. The government has been moving slowly to allow for alternative sources of power, but we'll get there eventually. In a few years' time, the country will be covered in wind farms and solar plants.

POSITIONING PORTFOLIOS

Faced with what we know and what we don't know, how do we invest? For all its problems, including the coronavirus outbreak, the global economy is in much better shape than the local economy. Therefore, growth assets appear more attractive globally than locally. While global equity valuations have increased, equities are still cheap compared to global bonds. Locally, the opposite is the case. Equity valuations have declined over the past year, but bond yields are still much higher than equity yields. Bonds are therefore the more attractive asset locally and are also attractive relative to bonds in other major economies. However, we also know that only about half of local equities are exposed to the local economy, the rest are global. This needs to be taken into account.

We also know that the rand weakens when there are serious problems anywhere in the world, whether they are linked to South Africa or not. The rand weakened last week in line with other emerging markets. Offshore exposure in a portfolio is therefore important. However, this does not mean abandoning South African investments altogether. That would amount to throwing the baby out with the bathwater. For instance, few people realise that the rand is in fact slightly stronger against the dollar than four years ago. There is a plausible scenario where local investments outperform global assets, and in any event, a lot of the bad news about the local economy is priced in already.

Given the uncertain environment, appropriate diversification remains the best defence.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 403.0	-1.15%	2.60%	1.91%	15.70%
United States	S&P 500	US$	3 338.0	-1.24%	3.47%	3.31%	20.29%
Europe	MSCI Europe	US$	1 769.0	-0.56%	1.78%	-0.84%	9.40%
Britain	FTSE 100	US$	9 593.0	-0.77%	-0.29%	-4.09%	2.66%
Germany	DAX	US$	1 373.0	-1.01%	1.54%	-0.11%	12.54%
Japan	Nikkei 225	US$	212.3	-1.60%	-2.77%	-2.46%	9.52%
Emerging Markets	MSCI Emerging Markets	US$	1 084.0	-1.99%	2.07%	-2.78%	3.14%
Brazil	MSCI Brazil	US$	2 128.0	-2.79%	-2.96%	-10.32%	-3.71%
China	MSCI China	US$	85.5	-1.17%	5.54%	0.45%	6.97%
India	MSCI India	US$	595.7	-0.64%	1.48%	0.62%	10.11%
South Africa	MSCI South Africa	US$	450.0	-2.17%	3.45%	-5.86%	-4.46%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	57 336.0	-0.91%	2.24%	0.44%	3.34%
All Share	All Share (Total Return)	Rand	8 705.0	-0.91%	2.24%	0.51%	6.93%
TOP 40/Large Caps	Top 40	Rand	7 795.0	-0.90%	3.01%	1.54%	8.29%
Mid Caps	Mid Cap	Rand	17 205.0	-0.14%	0.26%	-2.86%	7.96%
Small Companies	Small Cap	Rand	16 354.0	-2.47%	-4.35%	-5.02%	-7.96%
Resources	Resource 20	Rand	3 418.5	2.37%	5.08%	1.31%	14.56%
Industrials	Industrial 25	Rand	14 469.0	-1.88%	2.81%	4.99%	12.75%
Financials	Financial 15	Rand	8 843.0	-3.50%	-0.01%	-5.87%	-8.96%
Listed Property	SA Listed Property	Rand	1 692.5	-2.64%	-7.01%	-9.83%	-12.31%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	514.6	0.15%	-0.70%	0.56%	6.45%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	715.7	0.61%	1.26%	2.46%	11.52%
Government Bonds	BESA GOVI	Rand	707.8	0.61%	1.28%	2.46%	11.44%
Corporate Bonds	SB JSE Credit Indices	Rand	54.6	0.31%	0.80%		
Inflation Linked Bonds	BESA CILI	Rand	262.6	0.38%	1.09%	1.00%	2.28%
Cash	STEFI Composite	Rand	445.1	0.13%	0.39%	0.97%	7.24%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	58.4	1.87%	0.74%	-11.47%	-12.79%
Gold	Gold Spot	US$	1 632.0	3.55%	2.64%	7.09%	22.16%
Platinum	Platinum Spot	US$	981.0	0.82%	2.40%	1.03%	19.20%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	15.00	-0.60%	0.03%	-6.67%	-6.53%
ZAR/Pound	ZAR/GBP	Rand	19.44	0.05%	1.90%	-4.53%	-5.92%
ZAR/Euro	ZAR/EUR	Rand	16.28	-0.79%	2.28%	-3.62%	-2.39%
Dollar/Euro	USD/EUR	US$	1.08	0.00%	2.78%	3.80%	4.63%
Dollar/Pound	USD/GBP	US$	1.30	0.70%	1.88%	2.65%	0.33%
Dollar/Yen	USD/JPY	US$	0.01	1.63%	2.98%	2.66%	0.77%

Source: I-Net, figures as at 21 February 2020

THE WEEK AHEAD

SOUTH AFRICA

- Budget Speech
- Producer inflation
- Credit growth
- Trade balance

US

- House price index
- New home sales
- Personal income and spending
- Personal consumption inflation

EUROPE

- Germany Ifo Business Climate
- Eurozone loan growth
- Eurozone Economic Sentiment
- Eurozone inflation

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.

WEALTH