

INVESTMENT STRATEGY

Q1 | 2020



THE ECONOMY

- Saudi Arabia cuts oil prices by most in 20 years; Brent crude falls below \$30/barrel.
- The WHO declares Covid-19 a pandemic, leading to lockdowns in various economies.
- China's jobless rate jumps to a record 6.2% due to Covid-19.
- US unemployment levels spike 'off the chart'.
- Treasury announces only 'sin tax' increases; some personal income tax relief; state wage bill cuts.
- SA enters a recession – its 3rd since 1994.
- Eskom starts to offer voluntary retrenchment.
- The RMB Business Confidence index stands at 18, its lowest point in 11 years.
- Government cancels 1 April state salary increases.
- Moody's downgrades SA government debt to non-investment grade.
- SA vehicle sales fall 29.7% in the year to March 2020.
- SA real GDP is expected to fall 5% in 2020.
- The rand weakens by 28% against the US dollar during the quarter.

EQUITIES

- Wall Street is hit by another Black Monday - its worst since 1987.
- The CBOE Volatility Index (VIX) exceeds 80 – last seen in 2008.
- Tongaat Hulett is down 60% on its first day of re-trading.
- Anglo Gold exits SA.
- Sasol loses more than half its value post the oil price collapse.
- Prosus rises 17.2%, supported by rand weakness.
- Implats is down 46.3% for the quarter.
- The SWIX index is down 23.3% and the ALSI down 21.4% for the quarter.
- Property, banks and life insurance are all down over 40%.
- Local equities are trading on a trailing PE ratio of 12.
- The MSCI World Index returns -21.1% in US dollar during the quarter.
- The Pacific excluding Japan region falls the most with a decline of 27.60% in US dollar.
- The global energy sector, plagued by an oversupply of oil and the coronavirus, falls 44.79%.
- Global real estate, traditionally viewed as a defensive sector, declines 23.36%.

FIXED INCOME

- The Fed cuts interest rates to 0-0.25%; announces 'unlimited' asset purchases.
- The ECB announces a Pandemic Emergency Purchase Programme of up to €750 billion.
- The Bank of England cuts interest rates to 0.1%; increases its bond purchase programme by £200 billion to £645 billion; announces £330 billion of loan guarantees.
- The US and German 10-year bond yields end the quarter at 0.67% and -0.47% respectively.
- Japanese 10-year bonds fail to rally; end the quarter at 0.012%.
- The SARB cuts the repo rate from 6.5% to 5.25% during the quarter.
- Yields on SA 10-year bonds spike above 12% in the days before the Moody's downgrade.
- The SARB launches a bond-buying programme to boost demand in credit markets.
- South Africa's banking regulator, the Prudential Authority, proposes that the minimum capital requirements and compulsory reserve funds for lenders are dropped to boost credit.
- Foreign investors sell almost R50 billion of local bonds.
- SA bonds are the worst performing fixed income market amongst EMs; ALBI falls 8.72% in Q1.
- The largest repricing is on fixed rate credit linked to the R2023; on 3-year bonds, where spreads widened by more than 200bps; and on Bank Additional Tier1 bonds.
- Global bonds return 27.3% in rand and -0.33% in US dollar for the quarter.
- The yield on the US 10-year T-bill falls from 1.91% to 0.54% at the start of March; move back to 1.20%; end Q1 at 0.67%.

Market view of the **SIM Balanced Fund**



The question of whether the market contraction offers a great entry point into equities depends on one's view of the economic impact that Covid-19 will have and whether any of that impact will be permanent. In a scenario in which economic activity returns to normality without massive permanent damage to the global economy – even if it takes six months or more – asset prices should mostly recover. Even if an entire year's normal 'income' should be written off, the fundamental value of any asset is the discounted value of all its future cash flows and the medium-term setback should not shave much off the valuation, whereas the massive global stimulus that was unleashed in response to Covid-19 should support future earnings prospects.

But if there is to be large-scale permanent damage to the economy, then a more severe knock to valuations would be justified. As the pandemic wears on, we have become more cautious about the outlook, based predominantly on the increased probability of widespread extensions of the global lockdowns and the increased economic impact they are likely to have. Since active cases of Covid-19 are still rising and daily new infections in most countries still far exceed the levels they were at when the lockdowns were first announced, it is difficult to see lockdowns being lifted rapidly. As extensions to lockdowns continue, the risk to job losses and corporate bankruptcies, and the negative feedback loop of both a supply and a demand shock feeds into the economy, rises – despite all the relief measures announced. The unprecedented jump in jobless claims in the US, accounting for roughly 10% of the labour force, in just three weeks is a stark reminder that the economic impact – and with it the knock-on effect on companies' earnings – could surprise on the negative side.

We won't know the full impact on the global economy for quite some time. Can the economic impact be as large as, or exceed that of, for example, the Global Financial Crisis? Yes, it can. The consensus expectation for the global recession we are in is rapidly being adjusted downward and is

already widely deemed to be the worst contraction since World War II. In addition, the exit strategies to lockdowns are yet to be defined and are unlikely to include any abrupt end to lockdowns, but rather a gradual lifting of official restrictions and an even more gradual lifting of personal/self-imposed protective measures. Consequently, it could potentially have long-lasting economic consequences. The reality remains that we simply don't know, yet the possibilities range from mildly to severely negative. As the pandemic unfolds, it will have the power to continue swaying financial markets wildly.

The same holds for the actual impact on equity earnings, which will also only become clear over time. Currently some large global brokers estimate earnings contractions as large as 70% or more. Such major earnings contractions in times of severe recessions (such as during the Great Depression, the Oil Crisis and the Global Financial Crisis) have historically led to very severe contractions in equity markets, with peak-to-trough falls ranging between 50% and almost 90% over periods spanning from 18 months to five years. The Global Corona Lockdown has the potential to be counted alongside these dramatic historical events in terms of its economic and earnings impact. Yet, measured by peak-to-trough decline, to date its impact on equity markets has been quite mild relative to other major events and it would be unprecedented if the entire contraction spanned merely one month. There is hence a material risk that equity markets thus far focused predominantly on the virus-related news flow and the stimulus packages and that it could still in future react negatively to actual economic and earnings disappointments and potential shocks.

Given this uncertainty over the economic and earnings outcome, we deem it appropriate to seek more asymmetry in the return prospects of our growth assets, and to pay for insurance to offset portions of potential further market declines – something we would generally otherwise be quite averse to doing.

Disclosure

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