ECONOMIC AND MARKET OVERVIEW

analytics

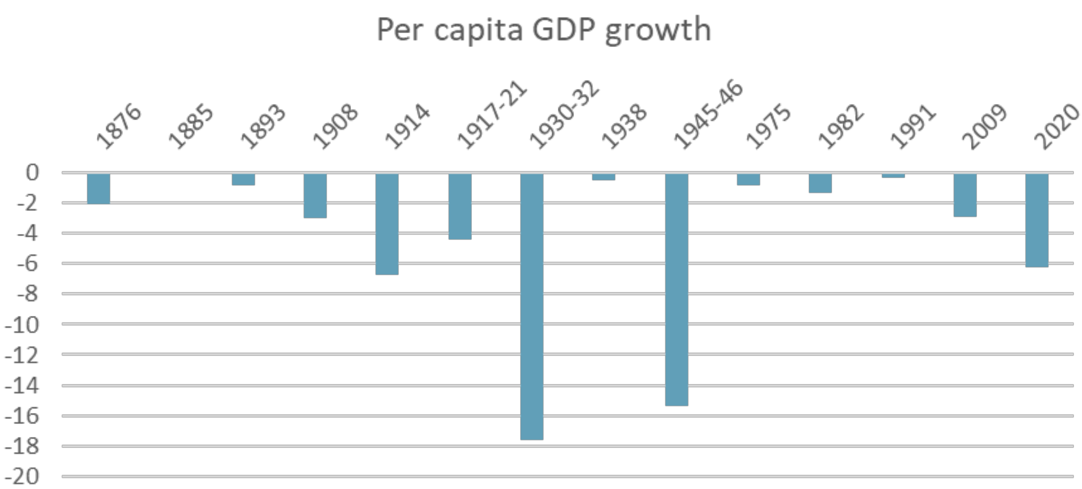
July 2020

Global

Many countries are struggling to find the most optimal way of reopening their economies after undergoing one or another form of lockdown. The International Monetary Fund published their quarterly World Economic Outlook on 24 June and now estimate a 4.9% contraction in the global economy. This was revised downwards from their previous estimate of -3%.

The COVID-19 pandemic has had a greater negative impact on activity in the first half of 2020 than initially anticipated, and the recovery is projected to be more gradual than previously forecast. In 2021 global growth is projected to be 5.4%. Overall, this would leave 2021 GDP some 6½ percentage points lower than in the pre-COVID-19 projections of January 2020. The adverse impact on low-income households is particularly acute, imperiling the significant progress made in reducing extreme poverty in the world since the 1990s.

According to the World Bank, the reduction in economic output per person compares to that of the First World War, and is overshadowed only by the Great Depression and the World War II:



Source: Bolt et al. (2018); Kose, Sugawara, and Terrones (2019, 2020); World Bank.

The fiscal (and to a lesser extent monetary) response to cushion the economic blow has been rapid and significant around the world. It will, however, lead to a significant increase in government debt for developed and emerging markets alike. The servicing cost of this debt may not be today's problem due to the current low interest rate environment in most countries, but it could become a real risk to global growth if interest rates begin to rise in the future.

The following chart depicts how debt to GDP levels are expected to increase over the next few years, along with the prevailing interest rate on each country's ten-year government bond. While many developed countries can stomach a high debt to GDP ratio now, it could become an issue when interest rates start to rise as inflation picks up. This may be a result of the reversal in the globalisation trend due not only to the Covid-19 pandemic, but also increased protectionism and trade disputes.

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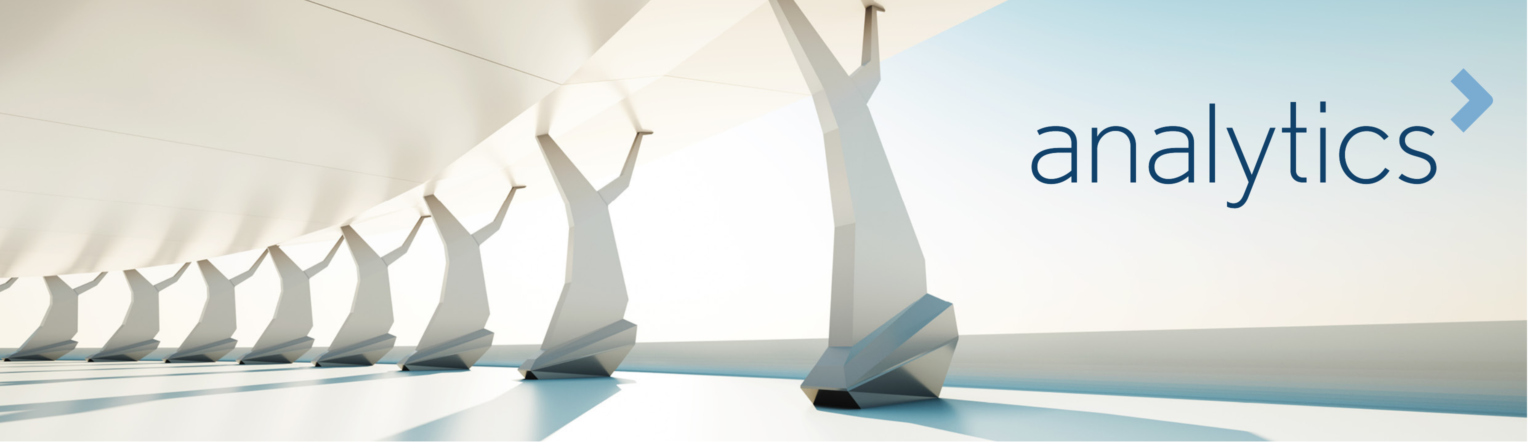
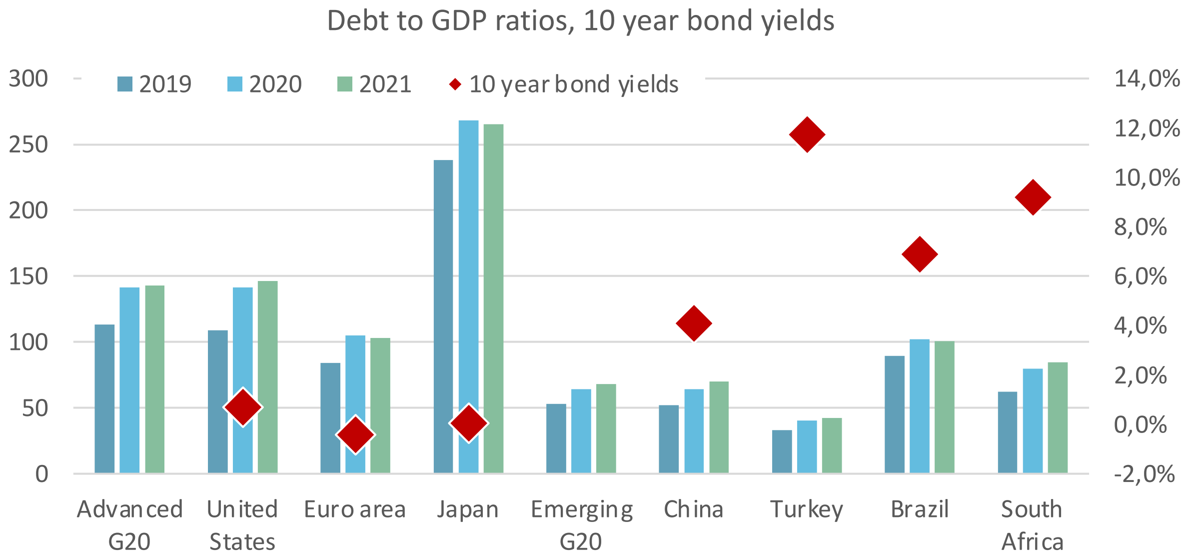
With the Covid-19 pandemic dominating the news and recent volatility on world stock markets, you may have heard a lot about **market timing** again.

Not only were they **wrong about the events** but they were also **wrong about the market's reaction** to events.





Source: International Monetary Fund

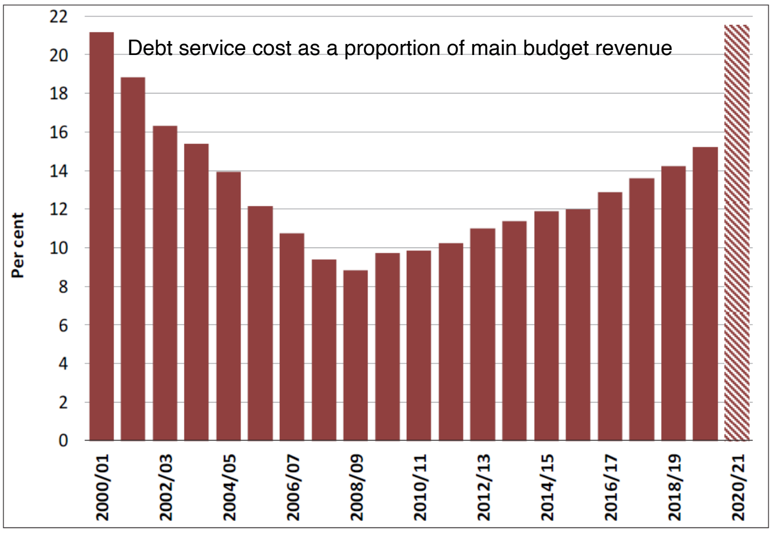
South Africa

Finance Minister Tito Mboweni tabled his supplementary budget on 24 June. This budget provided more clarity on the expected change in government finances as a result of the Covid-19 induced economic slowdown.

National Treasury now expects the South African economy to contract by over 7% in real terms this year. All economic sectors have experienced a sharp downturn and small businesses in particular face extreme pressure. Millions of jobs are at risk and millions of households are experiencing increased hardship. Tax revenue projections are down sharply.

The Minister also noted that the epidemiological path and economic consequences of the pandemic are both highly uncertain and evolving rapidly, necessitating rapid adjustments in policy and forecasts. Over the past three months, government has prioritised public health to save lives. It also took the difficult step of severely restricting economic activity at a time when GDP growth was already weak. South Africa's R500 billion fiscal relief package is designed to help households and businesses to weather the short-term effects of the crisis.

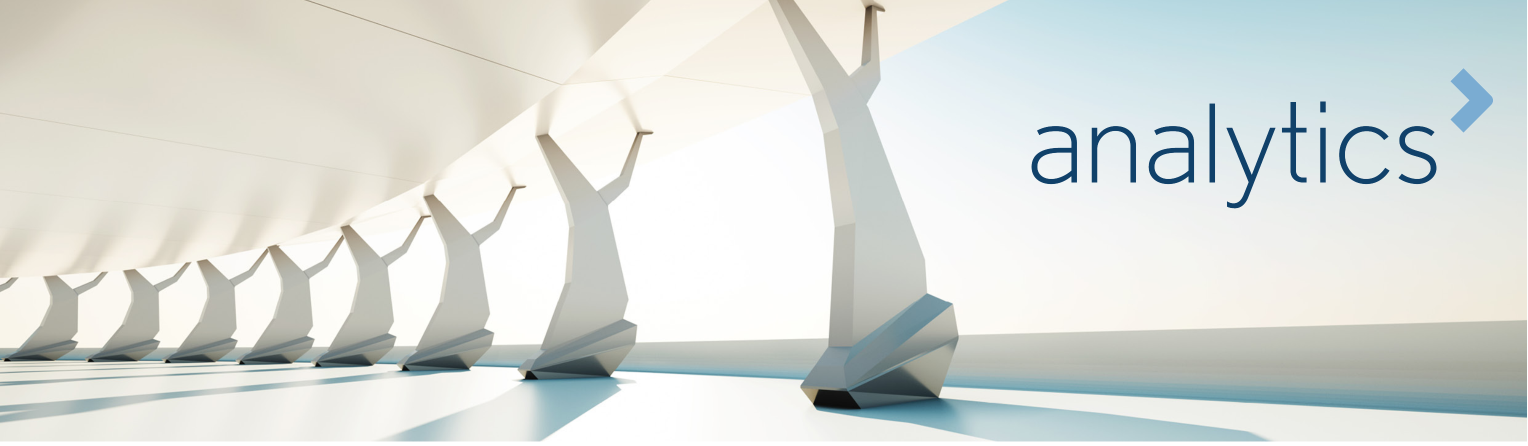
The cost to the South African taxpayer is going to be significant and lasting. The graph alongside shows debt service cost as a proportion of main budget revenue. In essence, 21 cents in every tax rand will go towards servicing South Africa's government debt, compared to less than ten cents at the end of the Mbeki administration.



Source: National Treasury

Market Performance

In their monthly market overview Visio Capital reported that investor risk appetite continued to improve in June with global investors turning their focus to emerging market equities. While economic activity has started to normalise in major economies "the extent of the recent rebound in financial market sentiment appears disconnected from shifts in underlying economic prospects" (IMF), a phenomenon explained by the unprecedented policy stimulus by monetary and fiscal authorities around the world.



Domestic equities had a strong month (7.7%) with all sectors recording positive returns. SA bonds (-1.2%) took a breather in June after two strong months as the supplementary budget provided further bad news on South Africa's fiscal position. Bonds continue to be the best performing domestic asset class over the last 5 years (7.5% p.a.) as inflation continues to moderate despite rising levels of government debt.

Tantalum Capital reported that globally the Euro and most emerging market currencies recovered ground against the greenback. The gold price remained strong, as too did copper and oil. Global equities, as measured by the MSCI All Country World Index, gained 3.2% in US Dollar terms, while emerging market equities ended the month even higher with a return of 7.4% (in USD).

The property sector rebounded in June to record its strongest month in 12 years – Redefine (+72.4%) making up 5.2% of the sectors 13.4% return as it entered discussions to sell part of its business. The asset class is, however, still more than 45% down over the last twelve months and many property companies are likely to struggle as not only small and medium enterprises but also large companies that are exposed to the South African economy struggle to make ends meet.

MARKET INDICES [1] (All returns in Rand except where otherwise indicated)	30 June 2020		
	3 months	12 months	5 years
SA equities (JSE All Share Index)	23.2%	-3.3%	4.2%
SA property (S&P SA Reit Index)	17.1%	-45.5%	-9.5%
SA bonds (SA All Bond Index)	9.9%	2.9%	7.5%
SA cash (STeFI)	1.5%	6.9%	7.2%
Global developed equities (MSCI World Index)	16.3%	27.4%	15.5%
Emerging market equities (MSCI Emerging Markets Index)	15.0%	19.5%	10.9%
Global bonds (Bloomberg Barclays Global Aggregate)	0.5%	28.4%	11.3%
Rand/dollar [2]	-2.7%	23.2%	7.4%
Rand/sterling	-3.1%	19.6%	2.4%
Rand/euro	-0.4%	21.5%	7.6%
Gold Price (USD)	13.2%	27.2%	8.9%
Oil Price (Brent Crude, USD)	81.0%	-38.2%	-8.3%

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 - There are only two types of investors

An article by Terry Smith, chief executive of Fundsmith LLP

This article first appeared in the Financial Times on 2 July 2020

There are only two types of investors

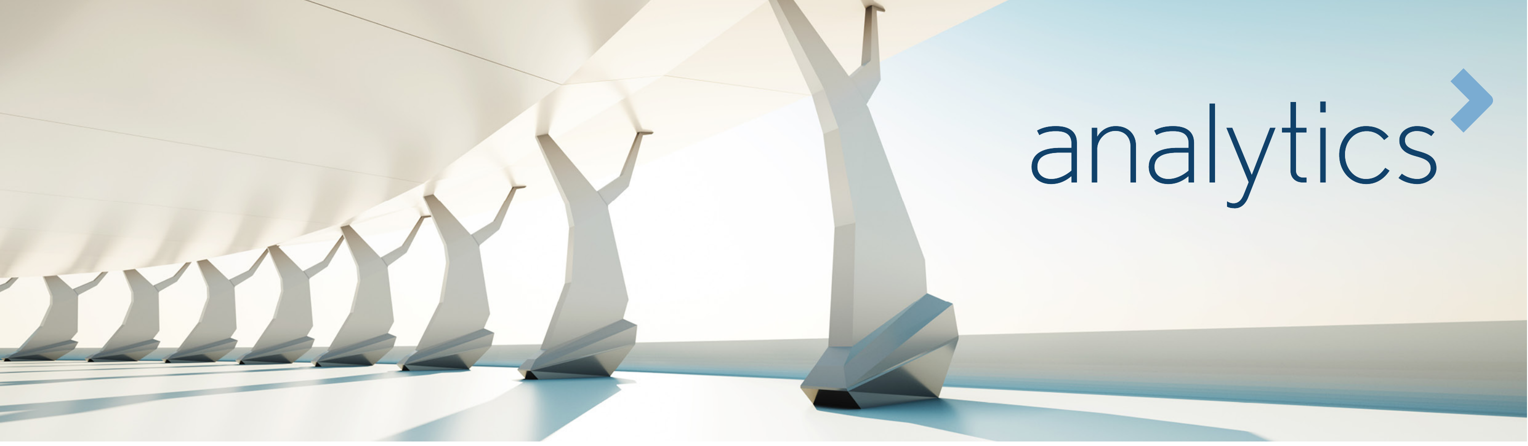
There is a lot to lose and little to gain from market timing

I last wrote about the problems of so-called market timing in the Financial Times in 2013 (Market timing: don't try this at home).

With the Covid-19 pandemic dominating the news and recent volatility on world stock markets, you may have heard a lot about market timing again.

Advisers and financial commentators will probably not use that actual term. What they will talk about is whether you should sell some or all of your equity investments because of the economic effects of the coronavirus and the subsequent effect on the markets.

All of this is what is termed "market timing" in the jargon of the investment trade — holding back investment or taking some or all of your money out of the market when you anticipate a fall.



The word “anticipate” indicates the first problem with this approach. Most people whom I encounter take their money out during or after a fall — as they did in March. They are doing the equivalent of driving whilst looking in the rear view mirror (or at best, out of the side window of the car). You need to look out of the windscreen in order to have the best chance of driving safely. The trouble with doing that in terms of the stock market is that the visibility is often so poor, it feels like driving in fog.

Such approaches to investment are almost all futile. Markets are second order systems. What this means is that in order to successfully implement such market timing strategies you not only have to be able to predict events — interest rate rises, wars, oil price shocks, the impact of the coronavirus, the outcome of elections and referendums — you also need to know what the market was expecting, how it will react and get your timing right. Tricky.

However, there are quite long periods when the market falls and takes a long time to regain previous highs. How shall we judge whether you should try to take advantage of this?

Take the market (in this case the Dow Jones Industrial Average Index — the Dow — which I will use because there is data on this strategy courtesy of YCharts) from 1970-2020. This is a period of 50 years which spans inflationary and deflationary cycles, and which has seen several crises and crashes as well as bull markets. It seems like a long and fair sample period.

Imagine that over this 50-year period there were two competing investment strategies. One is to invest an equal amount every trading day throughout the period irrespective of market conditions — so-called pound (or dollar) cost averaging which many investors actually apply by making regular contributions into a pension, Isa or regular savings plan.

The other strategy requires enough foresight for the investor to invest the same amount daily, but to stop investing when the market turns down and save the cash. This money is only invested when the Dow makes a new bottom, hitting its low point in any period of decline (hence why it’s known as an “absolute bottom buying strategy”).

In my view, this is a somewhat more realistic example of how you might apply foresight, rather than measuring what would happen if you had such certainty about the future you were able to sell everything just before the market turned down and then buy it back at the bottom.

Over the 50-year period, the second strategy would have produced returns 22 per cent higher than the first. It sounds impressive — perhaps a little less so when you break it down to an 0.4 per cent outperformance per year. But think of the time and effort you would have to spend monitoring markets to get those calls just right.

Compare and contrast this with the rise in the market since I last wrote about this subject in March 2013. The Dow is up just over 150 per cent in total, averaging 13.3 per cent per annum. Imagine if you had acted on market fears and taken your money out of equities or stopped investing ahead of that performance. Should you risk foregoing any significant portion of that gain for a maximum upside of 0.4 per cent per year?

In reality, attempts to implement the second strategy will almost certainly cause harm to your net worth as nobody has perfect foresight. In your desire to time the markets, you will stop investing, or worse, sell and take money out when you expect the market to go down, and instead it goes up.

Think back to Brexit and Trump’s election. We were told by most commentators that they would not happen, but if they did, the markets would plunge. Not only were they wrong about the events but they were also wrong about the market’s reaction to events. The markets soared.

When it comes to so-called market timing there are only two sorts of people: those who can’t do it, and those who know they can’t do it. It’s safer and more profitable to be in the latter camp.

Terry Smith is the chief executive of Fundsmith LLP; the views expressed are personal.