INVESTMENT NOTE

GROSS DOMESTIC PROBLEMS

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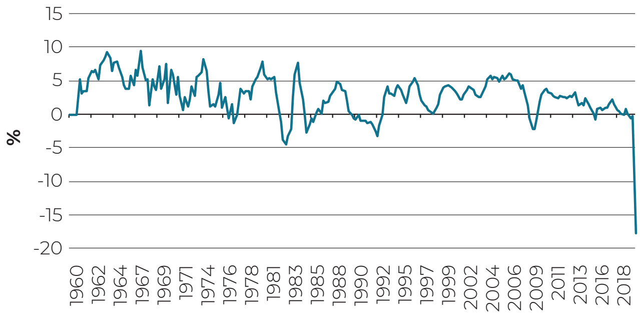
WEALTH

There's bad news, worse news and some good news. The bad news is that South Africa's economy more or less came to a standstill in the second quarter. The 51% annualised contraction is unlike anything we've ever experienced.

There has been some debate as to whether it was appropriate to annualise this particular quarterly growth number – to present the quarterly change as if it persisted for a whole year – given that it was so unusual. On an unannualised basis, the quarter-on-quarter decline was 16%. Compared to a year ago, the economy was 17% smaller in the second quarter in real terms. This was the worst year-on-year decline on record (chart 1).

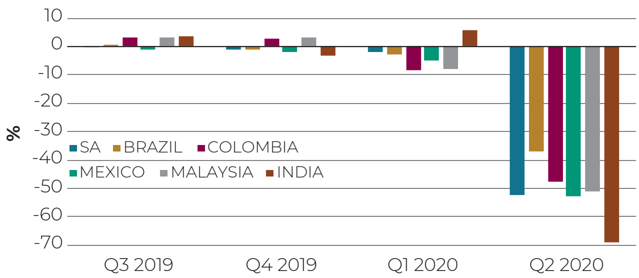
CHART 1: SA REAL GROSS DOMESTIC PRODUCT GROWTH, YEAR-ON-YEAR %



Source: Refinifiv Datastream

Stats SA and statistical agencies in some other countries (notably the US) have traditionally presented annualised quarterly growth rates, while others (notably in Europe and Japan) don't. The main thing is that growth rates should be analysed consistently over time, and that cross-country comparisons should be made on the same basis (as in chart 2, which shows declines of similar magnitudes in many of our peer countries). The underlying economic reality does not change whether growth rates are annualised or not.

CHART 2: REAL GDP GROWTH OF SELECTED EMERGING MARKETS, QUARTER-ON-QUARTER ANNUALISED



Source: Refinifiv Datastream

In the case of South Africa, that reality is that while the blow to the economy in the second quarter was due to a lockdown that has since mostly been lifted, the three prior quarters were also negative. And even before them, there was a long period of slow growth. This is the worse news: Covid-19 was only the latest of a series of blows to the domestic economy.

THE GREAT SHUTDOWN

South Africa had one of the strictest lockdowns anywhere in response to the coronavirus. Whether this was justified is a debate that will rage for years to come. In other countries the question will also be asked whether the cure wasn't worse than the disease. It is a complex issue. We don't know what an alternative scenario would look like, and if there really was a trade-off between lives and livelihoods. Sweden famously did not impose strict lockdowns, but its economy did not escape unscathed, and it certainly did not perform any better than its Nordic neighbours who did lock down.

To understand this, one has to remember that there are three elements to the economic shock from Covid-19. The first is obviously the lockdowns imposed by governments in most countries (apart from the likes of Sweden).

The second is that the countries and regions that didn't lock down couldn't trade freely with those that did. Tourists stopped visiting Sweden, for instance, blocked from travelling by their own respective governments. Another example: Canada took the virus a lot more seriously than the US did, but the border closure between the two countries impacts businesses on both sides. In other words, no country is immune from a global economic shock, irrespective of the decisions its government makes.

Third, consumer behaviour changed. While some people still think Covid-19 is nothing worse than a common cold, enough people were genuinely scared, even in Sweden, to minimise activity outside the home. Even with restrictions now lifted, many are wary of restaurants, gyms, shopping malls, theatres and other enclosed spaces. Or they have just become accustomed to working from home, changing their spending patterns accordingly. Since one person's spending is another's income, one person's savings is another's loss.

With a renewed nationwide lockdown very unlikely, even if there is another wave of infections, the second quarter was the low point for the economy. With the GDP report a snapshot of that three-month period, it is almost not worth dwelling on the specifics. As one would expect with many businesses shut, restrictions on what consumers could buy, and large declines in employment and income, the contraction was broad-based. The one sector that was spared was the agriculture, forestry and fishing industry, which posted strong growth.

GROWING AGAIN

So let's get to the good news: the economy is growing again. The statement 'the economy is in recession' is only true because we don't have official third quarter data yet. That will only be available in early December. The questions we have to ask ourselves are what kind of recovery are we experiencing, what kind of recovery is priced into financial markets, and what are policymakers doing to support it.

It seems very unlikely that the recovery will be led by consumer demand or government spending. Both households and the state are severely constrained financially. A spending injection from foreign tourists will have to wait until next year it seems. Policy support for households in the form of the additional social grant payments and the Unemployment Insurance Fund's temporary relief benefit are set to expire next month. Further interest rate reductions are possible and desirable, but most of the cuts to the repo rate in this cycle are behind us. At best another one or two tweaks lie ahead.

The recovery is instead likely to be led by agriculture, mining and manufacturing. A soft rand will tend to help these sectors by boosting export revenues, but these sectors are also the most exposed to the negative impact of loadshedding. Therefore, security of electricity supply should be top of any list of economic reforms.

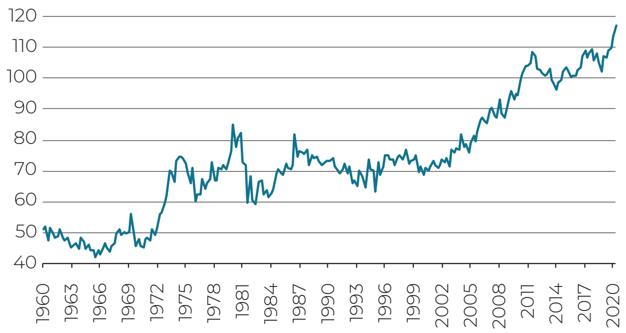
Unfortunately, progress is painfully slow. The 'emergency' round of electricity procurement was only opened in the last few weeks, despite being promised almost a year ago. These projects will only add to the grid mid-2021. Last week energy regulator Nersa also concurred on opening a bidding round to add an additional 11 000 MW of electricity capacity. These projects will take even longer to come to life. Still, slow progress is better than no progress.

The Agricultural Business Chamber expects the farming sector to grow around 10% this year, compared to a 7% contraction in 2019, supported by the second largest maize crop on record. Agricultural export prices are also favourable.

In fact, the terms of trade, the ratio of the total export price index and total import price index, is at a record level. To put it in very simplistic terms, think of how the gold price soared this year, while the oil price tanked. While a terms of trade improvement won't lead to rapid economic growth by itself, we've rarely experienced strong economic growth without it. It is a key ingredient.

To summarise then, the strength of the recovery will depend on the global economy, and to what extent we can fully engage with the global economy. Consumer demand is likely to remain constrained. The economic reforms that are being mooted, including increased infrastructure investment, will take time to be implemented.

CHART 3: SOUTH AFRICA'S TERMS OF TRADE



Source: Refinitiv Datastream

INVESTMENT IMPLICATIONS

How does all this translate into thinking about asset allocation? The first thing to note is that the above is largely reflected on markets. The news about the second quarter economic slump did not move markets since it was expected. There is no need in other words for investors to react to this news, as gloomy as it was.

Looking at the JSE, the better performance of global shares in general and the mining shares in particular is clear. In contrast, the shares of companies exposed to the domestic consumer are still down anywhere between 20% and 40% from the start of the year. These shares tend to screen very cheaply, but evidence of a sustainable economic turnaround will probably be required to unlock the value.

A weak economy will continue to put downward pressure on inflation and therefore short-term interest rates. The high real returns from the money market in recent years is a thing of the past. Investors will have to choose between capital stability and returns in a way that wasn't always the case.

Which brings us to bonds. Here there are two competing forces. The big driver in recent years has been concerns over the fiscal sustainability. Put simply, government's perceived creditworthiness has declined, and therefore its borrowing costs have risen. The weaker the economy, the bigger the risk to fiscal sustainability since tax revenues take longer to recover. But pulling in the opposite direction is lower inflation. Real bond yields are the highest of any notable emerging market, suggesting the fiscal worries are largely priced in.

Therefore, as bleak as things seem for the local economy, and as much as risks abound, there are still local investment opportunities that should be considered in the context of diversified portfolios.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 368.0	-1.33%	-3.58%	0.42%	7.93%
United States	S&P 500	US$	3 341.0	-2.51%	-4.54%	3.40%	11.33%
Europe	MSCI Europe	US$	1 643.0	1.99%	-0.54%	-7.90%	-0.12%
Britain	FTSE 100	US$	7 719.0	0.23%	-3.16%	-22.83%	-14.70%
Germany	DAX	US$	1 459.0	2.75%	1.54%	-1.34%	14.79%
Japan	Nikkei 225	US$	220.5	0.93%	-1.30%	1.29%	10.12%
Emerging Markets	MSCI Emerging Markets	US$	1 092.0	-0.64%	-0.82%	-2.06%	7.37%
Brazil	MSCI Brazil	US$	1 528.0	-2.86%	2.55%	-35.61%	-28.53%
China	MSCI China	US$	96.7	-2.59%	-3.68%	13.58%	24.84%
India	MSCI India	US$	568.2	1.72%	2.20%	-4.02%	4.64%
South Africa	MSCI South Africa	US$	382.0	4.09%	2.14%	-20.08%	-16.41%

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	56 088.0	4.10%	1.10%	-1.74%	-0.28%
All Share	All Share (Total Return)	Rand	8 704.0	4.15%	1.46%	0.50%	2.88%
TOP 40/Large Caps	Top 40	Rand	7 992.0	4.08%	1.34%	4.10%	5.87%
Mid Caps	Mid Cap	Rand	13 666.0	5.56%	3.78%	-22.84%	-12.03%
Small Companies	Small Cap	Rand	14 273.0	4.32%	2.13%	-17.11%	-15.75%
Resources	Resource 20	Rand	3 988.5	3.74%	2.16%	18.21%	34.28%
Industrials	Industrial 25	Rand	15 017.0	3.54%	0.17%	8.97%	4.02%
Financials	Financial 15	Rand	6 367.0	7.68%	4.70%	-32.22%	-31.21%
Listed Property	SA Listed Property	Rand	1 015.4	0.12%	-2.08%	-45.90%	-44.93%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	541.5	-0.36%	-0.26%	5.83%	6.18%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	712.5	-0.42%	0.14%	2.01%	3.32%
Government Bonds	BESA GOVI	Rand	703.9	-0.42%	0.13%	1.89%	3.10%
Corporate Bonds	SB JSE Credit Indices	Rand					
Inflation Linked Bonds	BESA CILI	Rand	260.7	-0.63%	-0.20%	0.25%	-0.23%
Cash	STEFI Composite	Rand	459.1	0.08%	0.13%	4.15%	6.35%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	40.1	-9.10%	-10.98%	-39.30%	-36.41%
Gold	Gold Spot	US$	1 942.0	0.36%	-0.82%	27.43%	30.34%
Platinum	Platinum Spot	US$	926.0	2.43%	-0.43%	-4.63%	-1.28%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	16.75	-0.94%	1.15%	-16.41%	-12.35%
ZAR/Pound	ZAR/GBP	Rand	21.43	2.80%	5.65%	-13.39%	-15.54%
ZAR/Euro	ZAR/EUR	Rand	19.84	-1.02%	1.91%	-20.92%	-18.50%
Dollar/Euro	USD/EUR	US$	1.18	0.00%	1.19%	-5.00%	-6.78%
Dollar/Pound	USD/GBP	US$	1.28	3.78%	4.72%	3.94%	-3.88%
Dollar/Yen	USD/JPY	US$	0.01	-0.06%	0.24%	-2.31%	-1.58%

Source: I-Net, figures as at 11 September 2020

THE WEEK AHEAD

SOUTH AFRICA

- SA Reserve Bank interest rate decision
- Retail sales

US

- Industrial production
- Retail sales
- Housing starts and building permits

EUROPE

- Eurozone industrial production
- Germany ZEW Economic Sentiment Index
- Bank of England interest rate decision

CHINA

- Industrial production
- Retail sales
- Fixed asset investment

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WEALTH