# OVERBERG MARKET REPORT

Tuesday 12th January 2021

## IN THIS WEEK'S BOTTOM LINE

*Contributed by Nick Downing*

- It is troubling in a way that global markets have become so bullish and that the positive view has become so pervasive, as one wonders how the outlook can get any better. As the adage goes, the best time to invest is when bad news becomes less bad rather than when good news becomes less good. Read more in the Bottom Line.

## SOUTH AFRICA ECONOMIC REVIEW

*Contributed by Werner Erasmus*

- New vehicle sales declined 3.9% month-on-month in December, translating to a 10.1% year-on-year fall. Encouragingly, in the fourth quarter total new vehicle sales were about 12% higher than the previous quarter, although for the full year 2020, new vehicle sales were down by 29.1% following a 2.8% drop in 2019. Export sales fell by 29.8% in 2020 despite a 36.3% year-on-year surge in December. A recovery in vehicle sales is dependent on a growing economy, which at this stage is an unlikely scenario. Tough months remain before business and consumer confidence can be rebuilt. Prospects for faster growth over the medium-term are likely to be constrained by new waves of Covid-19 infections accompanied by stricter lockdown measures, persistent power-supply disruptions and the need for fiscal tightening. During the first quarter of 2021, the new vehicle market is expected to continue facing severe challenges including weak demand, rand exchange rate volatility and negative business and consumer sentiment. In summary, both domestic and export sales are expected to perform better in 2021, although it is unlikely that pre-Covid levels will be achieved this year.

- South African private sector activity was little changed in December, with the all-economy IHS Markit South Africa Purchasing Managers' Index (PMI) inching lower to 50.2 from 50.3 in November. The largest component of the PMI, the new orders index, revealed broadly unchanged sales volumes. Output was also largely flat. According to IHS Markit economist David Owen "South African businesses struggled to make gains in December, as weak demand and issues sourcing raw materials meant total output was broadly stable since November." Importantly, despite the downtick towards the end of the year, the fourth quarter's average PMI was still up compared to the previous quarter. While PMI data over the fourth quarter points to an easing of the downturn, demand indicators suggest that the economy still has far to go to recover from the pandemic.

- The seasonally adjusted Absa purchasing managers' index (PMI), which provides a measure of business conditions in the manufacturing sector, fell to its lowest level since July 2020, though it remained in positive territory. The PMI fell to 50.3 index points in December from 52.6 in November. Any reading below 50 indicates a contraction in activity, while a reading above 50 indicates expansion. The reading suggests that growth is levelling off in the manufacturing sector after solid month-on-month gains were recorded in the aftermath of April's lockdown-induced decline in activity. It is a concern that there has been a broad-based decline across subsectors, business activity and new sales orders, which indicates that both manufacturing demand and output are declining. Furthermore, the soft reading for December suggests that the manufacturing sector ended in 2020 on a weak note. Looking ahead, further obstacles such as the return of load shedding and recent tightening of virus containment measures, will continue to put pressure on the already struggling manufacturing sector, which accounts for about 14% of GDP.

## SOUTH AFRICA: THE WEEK AHEAD

***Contributed by Ingrid Breed***

- Manufacturing Production: Due Tuesday 12 January 2021. The manufacturing production sector is expected to reflect persistent weak domestic demand conditions. The consensus forecast is that during November manufacturing production declined 4.6% year-on-year and increased 1.8% month-on-month, compared with a 3.4% month-on-month decline and 2.6% year-on-year increase recorded in October.

- Retail Sales: Due Wednesday 13 January 2021. On the back of the sharp fall in physical store sales reported during Black Friday, retail sales for November are expected to disappoint. Consensus forecast is that during November retail sales contracted 0.5% month-on-month and 4.7% year-on-year compared with 1.8% month-on-month and 0.2% year-on-year declines recorded in October 2020. This expected deterioration will be the eighth consecutive month of decline in retail activity and is likely to persist until South Africa successfully executes a vaccine rollout and the economy starts to recover.

## NORTH AMERICA

*Contributed by Nick Downing*

- The two Senate elections in Georgia were won by the Democrats which gives the party a slim majority in the Upper House. Seats are evenly divided but vice-president elect Kamala Harris has the deciding vote. Control of the Senate paves the way for president-elect Joe Biden to implement the $3.9 trillion spending package he pledged prior to the election. This will come after the $900 billion aid package, recently implemented by President Trump, expires in mid-March. A significant portion will go towards infrastructure spending and Biden's clean energy agenda. Extra spending will boost economic growth prospects in the US and globally, especially benefiting cyclical sectors such as energy, commodities, banks and industrials as well as emerging markets. The cost will be increased US government debt issuance, stronger inflation and a weaker dollar. The breakeven rate between conventional 10-year US Treasury bonds and inflation-protected securities of the same maturity, which measures the expected annual inflation rate over the period, has spiked to 2% since the Senate run-off elections, the highest level since March 2018. Meanwhile the 10-year Treasury yield has jumped since the Senate election from 0.90% to 1.13%. A protracted yield increase is perhaps the biggest threat to the sustainability of the equity market rally, especially the richly valued technology shares. A consolation is that although the Senate is now controlled by the Democrats, the margin of control is so narrow that the more radical party policies are unlikely to gain traction. Moreover, landmark legislation requires a 60% vote threshold, which diminishes the risk of prohibitive tax increases and climate change bills.

- Nonfarm payrolls reduced in December by 140,000 marking the first decline since April, putting a halt to the past seven months' jobs market recovery. The unemployment rate remained unchanged at 6.7%, down dramatically from the April peak of 14.8% but almost double the pre-pandemic rate of 3.5%. Due to the resurgence in Covid infections and renewed restrictions, job losses were concentrated in the hospitality and leisure sectors, which shed 498,000 in December. However, manufacturing added 38,000 jobs and retailers were a bright spot with 121,000 job additions. The interruption in employment recovery is likely to be temporary with aggregate payroll growth due to resume once vaccination gathers momentum and the benefits of fiscal spending are felt. Research company IHS Markit predicts payrolls will increase by 6.7 million in 2021, but not enough to reverse the 9.4 million lost in 2020. While the longer-term outlook is encouraging, the December jobs data will prompt Joe Biden into implementing additional stimulus measures over and above the recent $900 billion fiscal package. According to Biden, "The bottom line is the jobs report shows we need to provide more immediate relief for working families and businesses, now."

- Minutes from the Federal Reserve's recent policy meeting on 15-16th December reveal increased confidence in the economic outlook, helped by the prospect of widespread vaccination, which could lead to a faster than expected acceleration in GDP growth. Nonetheless, the Fed remained committed to its ultra-accommodative monetary policy settings, comprising a fed funds rate of 0-0.25% until at least 2023 and asset purchases valued at $120 billion per month. The minutes indicated that the asset purchase programme may continue for longer than previously expected. The Fed's guidance changed from maintaining the programme over coming months to maintaining it until substantial further progress has been made towards broader employment and inflation goals. This suggests a similar threshold for a zero fed funds rate, which means asset purchases may be maintained until at least 2023 as well, as the Fed does not expect employment and inflation goals to be met for a number of years. However, there was limited support for altering the composition of asset purchases, which indicates that emphasis on buying longer-dated bonds or "yield curve control" remains some way off.

- The IHS Markit purchasing managers' index (PMI) measuring activity in the manufacturing sector, scaled a new six-year high in December rising from 56.7 to 57.1, well above the expansionary 50-level. However, according to the Markit report "Output expectations moderated slightly… as the post-election spike eased, and virus cases surged once again." Nonetheless, manufacturing activity remains buoyant in contrast to the worse affected service sector, which saw its PMI declining sharply from 58.4 to 54.8 due to the impact of social distancing regulations. Fortunately, the setback in the services sector is likely to be short-lived as consumer-facing businesses are expected to return rapidly to normal activity levels in line with widespread vaccination.

## CHINA

*Contributed by Nick Downing*

- Following the first negative consumer price inflation (CPI) reading since 2009, in November when CPI registered -0.5% year-on-year, CPI returned to positive territory in December with a reading of 0.2%. The stronger inflationary reading eased concerns over prolonged weakness in domestic demand. Core CPI, which excludes food and energy prices, remained positive although slipped from 0.5% to 0.4%, while producer price inflation remained negative but improved considerable from -1.5% to -0.4%. The data signals a steady recovery in domestic demand, especially at the household level, which should help the economy avoid a deflationary spiral. According to Julian Pritchard-Evans, senior China economist at Capital Economics, "With economic activity set to remain strong and underlying inflation likely to continue rising, we think the People's Bank of China (PBOC) will tighten policy this year." Any further increase in the PBOC's Medium-Term Lending rate, which at 2.95% is already considerably above the US fed funds rate at 0-0.25%, should ensure that the yuan continues to gain against the US dollar over the course of 2021.

## JAPAN

*Contributed by Carel la Cock*

- Japan's Consumer Confidence Index declined for the first time since August, falling by 1.9 points to 31.8. Consumer optimism was down across all sentiment sectors: Overall Livelihood (-1.8), Income Growth (-0.7), Employment (-2.9) and Willingness to buy durable goods (-1.9). The percentage of respondents expecting prices to rise in the year ahead fell by 2.5% points from 68.4% in November to 65.9% in December, marking the lowest level in more than five years, while 12.4% of respondents expect prices to go down, up by 2.7% from November. Overall, participants in the survey expect the impact of the second wave of covid-19 to have a deeper and longer impact on global trade, which will be a headwind for Japan's export driven economy.

## EUROPE

*Contributed by Carel la Cock*

- Unemployment eased marginally in November to 8.4% despite analysts' expectations that the figure could spike to 10% by the spring. Compared to a year ago, unemployment is only 1% higher, from 7.4% in November 2019. Youth unemployment has crept back up after easing in the third quarter and stood at 18.4% in November. Spain (16.4%), Italy (8.9%) and France (8.8%) reported the worst figures amongst the large European nations, while much better employment conditions existed in Germany with unemployment at 4.5% in November, unchanged in the last three months. Higher unemployment together with lockdown measures to curb the second wave of covid-19 has impacted retail volumes which were down 6.1% month-on-month in November following a 1.4% monthly increase in October. Compared to a year earlier, retail volumes were down 2.9%. The fall in retail volumes was especially acute for automated fuels (-10.6%) and non-food products (-8.9%). France (-18.0%), Belgium (-15.9) and Austria (-9.9%) reported the largest monthly declines in retail volumes, while the Netherlands (+2.6%), Croatia (+2.5%) and Germany (+1.9%) experienced better fortunes. Compared to a year earlier a similar picture emerged with France (-15.7%) and Germany (+8.8%) on opposite sides of the spectrum, highlighting the continued diverging paths of the two biggest economies in Europe.

## UNITED KINGDOM

*Contributed by Carel la Cock*

- UK retail sales in the lead-up to the festive season were 1.8% higher than the prior year but the reading belies the impact of lockdown measures on high street retailers. Non-food sales in bricks-and-mortar stores were down 25% in the last quarter of 2020 compared with a year earlier, driven in large part by declines in clothing, footwear and health and beauty products. In contrast, food sales were up 7.3% on the previous year as many consumers gifted food items for Christmas. Although online shopping increased, it could not offset the fall in overall retail sales which were down 0.3% for the year, marking the worst performance in 25 years according to data from British Retail Consortium and KPMG. There is concern for the hospitality sector post the latest lockdown measures as consumers are unlikely to suddenly spend pent-up savings. Consuming services in hospitality takes time and it could take many months to restore normality. Regional retailers have seen an improvement in sales as they experienced a shift in consumer footfall from city centres to local shops, a trend that is likely to continue as more people work from home in the future.

## EMERGING MARKETS AND THE FAR EAST

*Contributed by Carel la Cock*

- Ford, the US automaker, has announced that it will cease manufacturing in Brazil ending over a century of production in South America's largest economy. The announcement follows a period of low demand in the region and higher industrial costs brought on by devaluing regional currencies and idle capacity during the first wave of the global covid-19 pandemic. Closure of the four manufacturing plants in Brazil will affect up to 5,000 jobs at a time when the Brazilian economy is already reeling from the pandemic and will exacerbate conditions in the auto industry in Brazil, which only utilised 40% of its production capacity in 2020. Brazil's government has opened the fiscal taps in 2020 to help ease the impact from the pandemic, but even its own appointed head of the central bank, Roberto Campos Neto has raised concerns over the current level of debt, at nearly 94% of GDP and the highest amongst emerging market peers. Some analysts fear that President Jair Bolsonaro will embark on further welfare spending as his re-election draws near, building on a strategy that has worked well during the covid-19 pandemic when approval ratings jumped. Most of Brazil's debt is issued in local currency, but the yield curve has steepened sharply in recent months with a spread of over 5% between long- and short-dated rates. The government has focussed its bond issuance at the short end with the average maturity on domestic federal public debt as low as 3.57 years and some fear that there could be an issue with rolling that short-term debt forward in the first quarter of this year. The market risk of unfettered spending in 2021 could drive yields higher unless credible reforms are implemented soon.

## KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

| | | |
|---|---|---|
| JSE All Share | + 7.32 | 63759 |
| JSE Fini 15 | + 0.26 | 12092 |
| JSE Indi 25 | + 6.57 | 83021 |
| JSE Resi 20 | + 13.02 | 65071 |
| R/$ | - 5.51 | 15.55 |
| R/€ | - 5.02 | 18.90 |
| R/£ | - 4.47 | 21.02 |
| S&P 500 | + 1.16 | 3799 |
| Nikkei | + 2.53 | 28139 |
| Hang Seng | + 2.49 | 27908 |
| FTSE 100 | + 5.23 | 6798 |
| DAX | + 1.59 | 13936 |
| CAC 40 | + 2.00 | 5662 |
| MSCI Emerging | + 4.52 | 1349 |
| MSCI World | + 1.49 | 2730 |
| Gold | - 2.35 | 1849 |
| Platinum | - 2.03 | 1048 |
| Brent oil | + 8.09 | 55.99 |

## BOTTOM LINE

*Contributed by Nick Downing*

- November was one of the best months ever for global equity markets. Markets powered ahead on news of far better than expected vaccine trials and a smooth US presidential election. Vaccines are already being administered and should bring the global pandemic to an end by the middle of 2021. The US election delivered Congress to the Democrats but only just. A wafer-thin majority in the Senate is dependent on a casting vote from president-elect Kamala Harris. This is close to an ideal outcome for market confidence as more extreme policy initiatives such as tax increases and regulations, espoused by the Democrats, will likely be blocked. With a Biden presidency, global trade frictions are likely to abate or at the very least trade negotiations will become more predictable.

- Effective vaccines were announced in quick succession by three different pharmaceutical firms, Pfizer, Moderna and Astrazeneca. There are risks that the Covid virus may mutate into a different strain or that an insufficient number of people will willingly be vaccinated to bring about herd immunity, but these risks are trivial compared to the potential benefits. Social mobility will return to normal and with it, consumer spending and business investment.

- A powerful cyclical economic recovery is on the horizon. Due to the pandemic, inventory levels across the world are depleted which is typically a precursor to a surge in supply-side activity as stocks are replenished. Moreover, there is enormous pent-up demand to make-up for the lack of spending over the past year. Household savings are at elevated levels, due to the combination of Covid rescue packages and a lack of consumer expenditure, providing an enormous reserve of spending capacity. Excess savings are estimated at 3-7% of global GDP. Historically, consumers and businesses go on a spending spree in the period following a pandemic. The Spanish flue in 1919 was followed by the “roaring 20s”. The European Bubonic plague in the $14^{th}$ century preceded one of the biggest booms Europe ever experienced.

- Monetary policy will remain ultra-accommodative. Central banks now view deflation rather than inflation as the biggest threat to the global economy. The Federal Reserve is committed to maintaining the fed funds interest rate at zero until 2023 and has adopted a new “Average Inflation Targeting” (AIT) policy framework. Under this framework, the Fed will actively encourage inflation to over-shoot its 2% target for periods of time to make up for the prolonged episodes of sub-2% inflation. Inflation has languished below 2% for the bulk of the past decade. The world’s major central banks are expected to follow suit and adopt AIT frameworks, cementing the prospect of continued zero interest rate policy across the board. Moreover, central banks will continue injecting massive quantities of liquidity into the world’s financial system. In 2020, liquidity injections totaled a bewildering $20 trillion, 25% of global GDP and central banks will keep the taps open in 2021, having pledged liquidity expansion of an additional 10% of global GDP.

- Fiscal support is also being pledged. Following the mistakes made after the 2008/09 Global Financial Crisis, when the nascent economic recovery was cut short by ill-timed austerity, governments will be wary of removing fiscal support too soon. Encouraged by the IMF and the World Bank and based on policy decisions taken so far it appears governments will want to keep the "reflation bridge" open for as long as it takes to ensure the cyclical economic recovery becomes self-sustaining beyond the initial burst of pent-up spending and inventory restocking.

- The combination of a powerful cyclical economic recovery backed by reduced political and trade uncertainty and accompanied by reflation commitments from central banks and government spending has been described by investment analysts as a "market nirvana". It is troubling in a way that markets have become so bullish and that the positive view has become so pervasive, as one wonders how the outlook can get any better. As the adage goes, the best time to invest is when bad news becomes less bad rather than when good news becomes less good.

- As always there are known risks to the buoyant outlook. There could be complications with the vaccine rollout. Governments may get cold feet and withdraw fiscal support, especially amid surging budget deficits and government debt. Although unlikely, given the enormous spare capacity in global production facilities and massive unemployment levels, inflation could rise sharply if driven by service sectors where capacity has been ravaged by the pandemic. The base effect of extremely low inflation readings at the height of the pandemic may amplify the inflation data for a period and rattle markets.

- A potential spike in longer-dated bond yields is the greatest risk to market confidence. The closely watched US 10-year Treasury bond yield has risen steadily from a low point of 0.5% in early August to 0.9% at the end of December, rising in line with the strong rebound in US GDP growth in the third quarter, improving global economic prospects and uptick in inflation. Central banks determine the level of short-term interest rates, which they have pledged to maintain at the zero bound, but they have less control over longer-dated yields, even with quantitative easing programmes and the ability to direct asset purchases at the longer end of the yield curve. Having been suppressed by so much quantitative easing, the 10-year yield may jump to above 2%, especially as new bond issuance is expected to exceed asset purchases in 2021. A spike in bond yields would be detrimental to the "Covid winners", the technology enabled shares which performed so well in 2020. These shares now trade at extremely elevated prices. With stratospheric price-earnings multiples and discounting so many years growth into the future, even a moderate increase in the risk-free discount rate (10-year Treasury bond yield) would have an outsized impact on their valuations.

- However, certain markets and sectors typically flourish when bond yields rise especially if there is a steepening in the yield curve, which is likely to occur with central banks anchoring short-term interest rates at zero. Banks and financials, which underperformed dismally in 2020 and over the past decade, should be a key beneficiary. Other “value” and “cyclical” sectors should also perform well, including materials and commodities, construction, heavy industry and transportation as well as consumer discretionary. The travel and hospitality sectors, worst affected by social distancing, should also benefit from the great rotation out of “growth” into “value” shares. Rotation is the lifeblood of bull markets. The baton will likely pass from last year’s leaders to the Covid laggards, but in aggregate equity markets are poised to scale new highs in 2021.