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WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 15th September 2020

IN THIS WEEK'S BOTTOM LINE

Contributed by Nick Downing

- The definition of a failed state, according to Wikipedia is "A political body that has disintegrated to a point where basic conditions and responsibilities of a sovereign government no longer function properly…..when a nation weakens and its standard of living declines, it introduces the possibility of total government collapse." Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- South Africa's second quarter real Gross Domestic Product (GDP) dropped by an annualised 51% quarter-on-quarter, seasonally adjusted and 16.4% on a non-annualised basis. This was mainly due to the impact of the coronavirus pandemic and South Africa's severe lockdown measures implemented by government on the 27th March to curb the spread of the Covid-19 pandemic. The latest GDP figure was worse than Bloomberg's consensus forecast of -47.2% and the Reserve Bank's forecast of -40.1%. This decline marks the steepest decline in South Africa's GDP since at least 1990. The economy is also currently experiencing its longest downward economic cycle since World War 2 with the latest GDP figure marking 4 consecutive quarters of decline. The agriculture, forestry and fishing industry were the only positive contributor to GDP growth, with an increase of 15.1%. The increase was mainly due to increased production of field crops and horticultural and animal products due to favourable rainfall. The sector was also able to continue operating during lockdown because of essential service status. The biggest drags on growth came from the construction, manufacturing, and mining sectors — which fell by 76.6%, 74.9% and 73.1%, respectively. The expenditure side of GDP saw a similar decline, dropping 52.3%. Household consumption contracted 49.8%. Consumption spending accounts for roughly two thirds of GDP, but households have faced widespread job losses and cuts to their income under the lockdown. Gross fixed capital formation, a proxy for investment in the economy, contracted for a second quarter, collapsing by 59.9%. The continued contraction will weigh on revenue collection and the government's efforts to stabilize debt and narrow the budget deficit. It will also make it more difficult to lower the ever-increasing unemployment rate of 30.1%. Without urgent reforms to help lift business confidence, South Africa risks a "self-reinforcing downward spiral" as more and more businesses restructure or close down, leading to greater job losses. Looking ahead, the solution to this economic downward spiral is the implementation of key structural reforms, to boost investor confidence and future investment. Top of this list is finding a solution to the country's electricity problem. Without stable electricity supply, all attempts to revive the economy will be nullified. More upbeat growth prospects in the second half of the year are expected due to the gradual easing of restrictions on economic activity as well as a low base in the second quarter.

- Business confidence, as measured by the RMB/BER Business Confidence Index, rebounded to 24 in the third quarter, up from its all-time low of 5 recorded in the second quarter. The second quarter saw the implementation of some of the strictest lockdowns globally, which severely impacted economic activity and overall business confidence. While the recovery in the third quarter is encouraging, overall sentiment remains depressed with the majority (eight out of every ten) of business executives surveyed regarding prevailing business conditions as unsatisfactory. Of the five sectors making up the composite RMB/BER BCI, wholesale and retail recorded the biggest recoveries from their quarter two readings. Wholesale confidence increased from 4 to 33 index points and retail confidence increased from 11 to 36 index points. The recovery in international trade and a vibrant agricultural sector boosted wholesale confidence with retail sales supported by a lift in confidence of better times ahead and progress made towards reducing costs. According to RMB, the third quarter figures suggest that the worst of the trough may be behind us, though there is much ground to recover. The bank further notes that although a lot of data are still outstanding, the latest developments point to a much-improved outcome where GDP can possibly increase by an annualised rate of 20%-25% in the third quarter – an encouraging outcome, but one that would still leave South Africa's GDP considerably smaller than it was last year.

- South Africa's mining production in July surprised to the upside. Consensus was for mining production to decline by 24% year-on-year, which was far off the actual 9.1% year-on-year contraction and 20.2% month-on-month increase recorded in July. The July figure marked the fifth consecutive month of annual decline in mining activity. The decline, however, was at a softer pace than previously recorded amidst the lockdown restrictions. The largest negative contributors to the mining production include: 'other' non-metallic minerals division (-44.9%), coal (-8.5%), iron ore (-19.0%), chromium ore (-32.5%), and gold (-10.2%). Seasonally adjusted mining production increased 20.2% in July compared with June, following month-on-month changes of -1.9% in June 2020 and 50.5% in May 2020. Mining production is expected to remain weak for the remainder of 2020 albeit at much better levels than experienced at the height of the lockdown. Weak global demand and unreliable electricity supply remain constraints on the full resumption of normal operations.

- Manufacturing production in July saw the softest downturn in industrial activity since March. However, despite the fact that it recorded a third consecutive monthly increase, manufacturing production was still down 10.6% year-on-year in July. July marked the fourteenth month in a row that year-on-year output has shrunk with production down by over 26% from the highs in 2008. The largest contributions to the fall were from the food and beverages division (-11.4%), motor vehicles, parts and accessories and other transport equipment division (-26.9%), basic iron and steel, non-ferrous metal products, metal products and machinery division (-11.6%), wood and wood products, paper, publishing and printing division (-13.1%), and furniture and 'other' manufacturing division (-39.1%). Seasonally adjusted manufacturing production increased 7.6% in July 2020 compared with June 2020, following month-on-month changes of 17.9% in June 2020 and 29.7% in May 2020. The manufacturing sector has experienced numerous challenges, including a skills shortage, power constraints, policy inertia and labour ructions. These challenges have offset the improvement in export demand and the boost to the manufacturing sector's global competitiveness, which stems from a weaker rand.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Ingrid Breed

- Retail Sales: Due Wednesday 16 September 2020. Retail sales are expected to have fallen on a year-on-year basis for a fourth consecutive month in July, however, at a slower pace. Consensus forecast is that they declined 5% year-on-year and increased 3.3% month-on-month in July, compared with a 7% year-on-year decline and 6.4% month-on-month increase recorded in June. Although this improvement is expected amid the easing of lockdown restrictions, it will likely take some time for retail sales to recover more profoundly given the sharp downturn in consumers' income prospects.

- Reserve Bank policy meeting: Due Thursday 18 September 2020. Approximately 40% of economists are predicting a 25bps cut while 60% expect the repo rate to remain unchanged. South Africa has already had an aggressive 300bps worth of policy rate cuts in 2020. Despite the consensus forecast for no change in the repo rate, weaker than expected GDP and inflation, and the strengthening of the rand lend the possibility of a further rate cut at either the September or November policy meetings.

NORTH AMERICA

Contributed by Nick Downing

- The Congressional Budget Office reported that the budget deficit in the 12 months to end August measured 15.1% of GDP, a massive increase from 4.5% in the prior year period. Total public debt has surged over the past 6 months from $17.4 trillion to $20.8 trillion, which explains the reticence among Republicans for additional spending. Their latest proposal for a $500 billion support package was beaten before it even left the Senate, with derisory comments from the Democrat opposition. However, with the 10-year Treasury bond yield dropping by more than half over the last 6 months from 1.5% to 0.65%, the public debt financing cost has dropped by around 10% over the period despite rapid debt growth, providing considerable scope for further fiscal support. Fed Chairman Jerome Powell weighed in again last week on the need for continued government spending. Fiscal spending has become more of a political football than usual with the presidential election less than 6 weeks away. With further Congressional spending unlikely before then, the Fed will be under pressure to provide policy support at its policy setting meeting on 14-15th September, the last before the election and the first since the change to average inflation targeting. Besides updating its economic projections, last given in June, the Fed is expected to provide some form of policy forward guidance. In June the Fed projected interest rates would remain at zero until end 2022, but this horizon is likely to be extended until end 2023, especially as inflation overshoots are now not only permitted but actively encouraged. The Fed funds futures market predicts the first interest rate increase will only occur in the second half of 2024. Fed policy makers may note that on this day the 14th September, 12 years ago, Lehman Brothers went bankrupt, igniting the 2008/09 Global Financial Crisis.

- Economic data has been beating consensus forecasts contributing to the increased optimism expressed in the latest monthly Wall Street Journal economists' survey conducted in the first week of September. Compared with the prior month, the average forecast for third quarter annualised GDP growth increased from 18.3% to 23.9%, while the 2020 GDP decline forecast was moderated from 5.3% to 4.2%. Unemployment is expected to end the year at 8.1%, better than last month's average forecast of 9%. The forecasts are also keener than the Federal Reserve's June forecasts for 9.3% year-end unemployment and GDP contraction of 6.5% for the full year, both expected to be upgraded at this week's policy meeting. The wave of new Covid infections has abated and the mortality rate has reduced indicating better medical treatment, giving rise to optimism that further lockdowns will be avoided. However, there are risks to the improving economic outlook including failure by Congress to agree on additional fiscal spending, contested US election results, and growing friction with China. A sobering reminder that further economic gains will become harder to achieve, came from disappointing weekly initial jobless benefit claims figures. They remained unchanged at 884.000 raising concerns that the employment rebound is losing momentum, especially in the worst affected tourism and hospitality sectors.

- Consumer price inflation (CPI) increased on a month-on-month basis for a third straight month in August, rising by 0.4%, following gains of 0.6% in both July and June. Core CPI, excluding food and energy prices due to their volatility, also increased in August by 0.4% on the month. Both headline and core CPI beat their August consensus forecasts of 0.3%. On a year-on-year basis, headline CPI picked-up from 1% to 1.3%, although well below the 2.5% inflation rate at the start of the year. Core CPI moved up from 1.6% to 1.7% on the year. Both measures remain below the Fed's 2% average target, and there are concerns that the rise in inflation may not be sustainable as it largely reflects inventory shortages which have largely been restocked. Significant labour market slack and spare industrial capacity, coupled with continued weak demand, are expected to cap the longer-term inflationary trend for the foreseeable future, at least for the next 12-18 months. The biggest contributor to the monthly CPI increase were used vehicle prices, which gained 5.4% on the month, their largest increase since 1969, contributing 40% to the CPI gain.

- The presidential election is just around the corner on 3rd November. In recent weeks the gap in support for candidates Trump and Biden has narrowed, raising anxiety that there will be a narrow victory and the potential for a contested result, the worst-case scenario. In this scenario, there would be a power vacuum as the courts arbitrate the outcome, with the potential for riots in parts of the country. The best outcome for the financial markets is a clear Biden victory but a split Congress, limiting the Democrats' power. Although Biden would burden the economy with higher taxes and regulation, which would impact company earnings, the upside to his presidency would be greater policy certainty, better international relations, a de-escalation of the trade war with China, and greater fiscal expenditure and infrastructure spending, which would boost economic growth. Biden's track record also shows him to be a moderate, unlikely to be swayed by the more radical elements in his party. Moreover, he is unlikely to raise taxes in the initial stages while the economy is still reeling from the pandemic. Traditionally, financial markets prefer a Republican presidency but this time round, the advantages are less clear, provided the Democrats do not win a clean sweep of the presidency, House of Representatives and Senate. Having gained 50% since their March low, US equities seem to be showing little concern over an expected Biden victory.

JAPAN

Contributed by Carel La Cock

- Japan's Ministry of Finance published the results of the July-September Business Outlook Survey which revealed that sentiment amongst manufacturers has improved. However, firms are planning to curtail capital spend for the rest of the year as corporate profitability remains under pressure following restrictive measures. The survey examines business leaders' outlook for the economy and their assessment of current conditions to keep track of developing economic trends. The survey covers nearly 15,000 businesses with at least ¥10m in assets from a range of sectors. The Business survey index (BSI) measures the difference of "up - down" compared to the last quarter with a reading below zero indicating pessimism. The BSI for Business conditions turned positive for larger businesses while smaller firms remained pessimistic, although less so than in the previous quarter. Domestic economic conditions remain a concern with the BSI still pointing to widespread pessimism. Whilst employment has improved, the BSI for large manufacturers was at -5.4% points. Sales in all industries are expected to decline 6.8% year-on-year with non-manufacturing (-6.4%) faring slightly better than manufacturing (-7.8%) where car sales are expected to fall 12.4%. Ordinary profits for the year are expected to be down 23.2% across all industries with manufacturing (-31.4%) impacted more by restrictive measures than non-manufacturing (-20.5%). Business investment for the year is expected to decline by 6.8% across all industries with a bigger decline in non-manufacturing (-8.1%) than in the manufacturing (-4.5%) sector. Overall, conditions are expected to keep improving although at a moderate pace with some risk factors. The survey exceeded expectations and most analyst agree that the outlook has improved sooner than anticipated.

EUROPE

Contributed by Carel La Cock

- The European Central Bank (ECB) has kept rates unchanged at -0.5% and reiterated that rates will remain low until inflation returns to its target of 2%. The ECB will continue with its €1,350bn pandemic emergency purchase programme (PEPP) until June 2021 or until it judges the crisis, caused by the pandemic, to have ended. Christine Lagarde, president of the ECB, said that the governing council will also monitor the exchange rate and the impact it has on inflation. The Euro is up more than 10% against the US dollar since the start of the year, lowering the costs of imports and putting downward pressure on inflation, but also hampering Europe's economic recovery by making exports less competitive. Europe has slipped into deflation for the first time in 4 years, according to the latest inflation figures, which showed consumer prices decreasing by 0.2% on the year in August compared to an increase of 0.4% on the year in July. Economists blame lower fuel prices, tax cuts in Germany and delayed summer sales. Despite lower monthly inflation, the ECB increased its forecast of inflation from an average 0.3% this year to 1% in 2021, up from a previous forecast of 0.8%, which now reflects the spending plans by European governments. The ECB expects the economy to rebound by 5% next year and to continue its growth path of 3.2% into 2022.

UNITED KINGDOM

Contributed by Carel La Cock

- The UK and Japan have agreed in principal on a new deal marking the first major post-Brexit trade deal for the UK. The deal, negotiated and agreed in record time, is claimed as a victory by Brexiters arguing that the UK got at least the same deal as Europe plus some additional concessions. The deal is expected to add as much as £15bn in additional trade per year. The deal will also allow the UK to fill up leftover EU agricultural quotas on products such as cheese, tea, and bread mixes. Furthermore, the deal is seen as a step towards joining the Trans-Pacific Partnership (TPP) which includes Japan, Canada, Australia, New Zealand, Vietnam, Mexico, Chile, Singapore, Malaysia, Peru, and Brunei. However, the deal will only add 0.07% to the UK's GDP compared to a 5% loss in GDP from leaving the EU, and analysts point out that British farmers could be left empty handed if all EU quotas are filled up by European producers. The deal comes at a crossroad for UK and EU negotiators, who are at loggerheads about the Brexit withdrawal agreement. The Internal Market Bill brought before parliament last week seeks to circumvent Article 10, making it possible for the UK government to "make provisions about the interpretation of Article 10". The bill has been condemned by European leaders. They have threatened legal action should the bill pass. Members of the ruling Conservative Party have rejected the bill leading to some commentators doubting if it will ever pass the House of Commons and House of Lords to be written into law. However, even if the bill fails, it has broken down trust in the negotiations and is threatening a constitutional crisis. Although talks will continue as planned, they have yielded few results and lead negotiator for Europe, Maros Sefcovic has given the UK until the end of the month to remove the contentious clause from the internal market bill. The move has dented any ambitions of a UK-US trade deal before the end of the year with US House speaker, Nancy Pelosi, saying there is "absolute no chance" of a deal if the legislation is passed. It is doubtful that the bill will be approved, but it shows the remarkable tactics the government is willing to employ to further the Brexit cause.

FAR EAST AND EMERGING MARKETS

Contributed by Carel La Cock

- In an article for the Financial Times, Steve Johnson highlights the benefits of active emerging market (EM) managers versus passive funds and argues that the simple act of removing all state-owned enterprises from an EM index will lead to outperforming that index over time. State-owned enterprises (SOEs) are companies in which the state holds a controlling stake. Examples include Eskom, Prasa, Transnet in South Africa and Petrobas in Brazil and many oil firms in Russia. SOEs comprise nearly 30% of the market capitalisation of EM compared to only 4% in developed markets, making EM index performance more sensitive to underperformance in SOEs. The majority of SOEs are run by bureaucrats or politicians and are rife with corruption, as experienced especially in South Africa. Many inefficient SOEs are propped up by governments to deliver social goals. EM SOEs tend to group in sectors such as energy, financial, materials, real estate, and utilities whereas developed market SOEs tend to focus on communications services, staples, healthcare, industrials, and technology. Furthermore, EM SOEs tend to be concentrated in strategic sectors with low return on equity compared to non-SOEs that cluster in high returning growth sectors such as technology and consumer discretionary. Analysts expect non-SOEs in EM to keep outperforming SOEs for the foreseeable future.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	- 1.33	56327
JSE Fini 15	- 35.16	10163
JSE Indi 25	+ 8.50	75196
JSE Resi 20	+ 15.20	56746
R/$	- 15.99	16.67
R/€	- 20.63	19.77
R/£	- 13.32	21.41
S&P 500	+ 7.73	3383
Nikkei	- 0.41	23559
Hang Seng	- 12.59	24640
FTSE 100	- 20.10	6026
DAX	- 0.42	13193
CAC 40	- 15.49	5051
MSCI Emerging	- 0.93	1104
MSCI World	+ 1.61	2396
Gold	+ 27.59	1945
Platinum	- 3.23	940
Brent oil	- 40.12	39.61

BOTTOM LINE

Contributed by Nick Downing

- The definition of a failed state, according to Wikipedia is “A political body that has disintegrated to a point where basic conditions and responsibilities of a sovereign government no longer function properly…..when a nation weakens and its standard of living declines, it introduces the possibility of total government collapse." Symptoms of a failed state include the "inability to provide public services." It is starting to sound frighteningly familiar. According to risk consultancy firm Eunomix Business and Economics, South Africa will be a failed state by 2030 "bar a meaningful change of trajectory." Eunomix states that "The economy is unsustainably narrow and shallow. It rests on a small and declining working population burdened by very high debt and taxes."

- The Covid pandemic has accelerated the arrival of the tipping point, beyond which there is a rapid and irretrievable deterioration in state finances. In this year's February Budget, Finance Minister Tito Mboweni projected a 6.8% budget deficit in the 2021 financial year. The revised figure is 14.6%. Mboweni's National Treasury is hoping or perhaps praying that the debt to GDP ratio will peak at 87.4% in FY 2024, but this is contingent on cuts in public sector wages, cuts in support for state-owned enterprises, and cuts in social benefits. Mboweni is a lone voice in the ANC, lacking the necessary support even from President Ramaphosa. Without a firm hand on budgeted expenditure, the debt-to-GDP will surge to 140% by FY 2024.

- Containing public expenditure will be a formidable task as it faces massive resistance from the ANC gravy train and from labour unions. South African Airways is a good example. Mboweni has called for the national airline to be closed down or privatised and there was a flurry of optimism when SAA was placed under business rescue, but political interference has kept the airline alive and it is currently asking for yet more financial assistance of R10 billion. Other SOEs are also queuing for funds, including the Post Office and the SABC. The unions are already in court fighting the government's wage decision, strikes are promised, and the legal wrangle will undoubtedly delay any constructive developments. One can sympathise with the unions who wonder why they should pay for the mess created by the government's corruption. The chances of expenditure cuts remain very slim.

- What are the chances of raising tax revenue? The government could mobilise the enormous savings in the economy's private sector. This could be forced via prescribed asset investments and tax increases but this "low road" route is unlikely, for as long as President Ramaphosa maintains his grip on power. The "high road" would be to encourage voluntary investment from households, businesses and foreigners through meaningful structural reforms such as privatisation and deregulation.

- What stands in the way of meaningful structural reforms? The unions, political factions within the ANC tripartite alliance, the government's gravy train, and the ideology of the ANC, which is steeped in the communist doctrines of state control. Ramaphosa's faces a formidable task. The recent Nedlac (National Economic Development and Labour Council) meeting in mid-August was not encouraging. The government's economic proposals were fragmented and lacked any sense of urgency, without any roadmap for implementation. According to Business Leadership South Africa (BLSA) CEO Busi Mavuso, the government's economic plan "appeared to have been pulled together at the last minute from a variety of different sources without any discussion between them."

- Some political analysts are excited that Ramaphosa is finally flexing his authority with his recent win against corruption at the National Executive Committee (NEC) meeting at the end of August. Henceforth, officials will automatically have to stand down from government posts and senior ANC positions if charged with corruption. This is a break from the previous policy of being innocent until proven guilty. According to Standard Bank senior political analyst Simon Freemantle, "The NEC outcome was perhaps the most notable single indication of the president's authority since his 2017 ascent." Perhaps this could be the tipping point for the president to take a stronger stand on structural reforms.

- If Ramaphosa is unable to implement structural reforms, the IMF will. The gravy train will come to a sudden halt if economic policy is dictated by the IMF so understandably there is considerable political resistance from the ANC to any formal bailout. The president may yet bring about structural reforms by threatening his comrades with IMF medicine as an alternative. With the Sword of Damocles hanging over them the ANC will be incentivised to put their ideologies aside in favour of a home-grown structural reform programme, rather than one prescribed by the Washington based institution. The IMF's $4.3 billion Covid loan came without any conditions but any formal budget support package in the future will include draconian conditions. These conditions would include sustainable reduction in expenditure, the restructuring of SOEs through disposals and private sector participation and bold structural reforms to boost economic growth.

- Foreigners have already sold out of South African local currency en masse, pushing bond yields sharply higher relative to other emerging market bond yields. They are amongst the highest in the emerging market universe. Foreigners hold just 30% of local currency sovereign bonds, far below the long-term average of 45%. Talk of a failed state means the threat of a formal IMF budget support package has arrived. IMF conditions will be imminent unless the South African government takes matters into its own hands.