OVERBERG MARKET REPORT

Tuesday 8th September 2020

IN THIS WEEK'S BOTTOM LINE

Contributed by Gielie Fourie

- Interest rates are one of the most important drivers of the economy. Those who understand it, profit from it, those who do not, pay it. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Werner Erasmus

- The Absa Purchasing Managers' Index (PMI) posted a robust increase to 57.3 index points in August, up from 51.2 in July. The reading is at its highest level since March 2007 and marks the first time since 2016 that the index has spent four straight months above 50, which signals expansion. This points to a further improvement in conditions in the manufacturing sector as South Africa's COVID-19 lockdown restrictions eased further to Level 2 in August. As a result, both business activity and new sales orders rose in August. The improvement in demand was not only due to South Africa moving to a lower lockdown level but was also supported by an uptick in export orders. Production levels in some subsectors may indeed be back (or even exceed pre-COVID levels) in August, but overall activity is likely to still be lower. While activity and demand are clearly recovering from extremely low levels, the employment index remains significantly more subdued. This also underscores the point that the uptick in activity is not resulting in output that exceeds current production capacity. The inventories and employment indices continue to be the main drag on the headline PMI. Despite the PMI more than likely overstating the extent of the recovery, the PMI is encouraging, especially as it seems to be supported by both local and export demand. Furthermore, purchasing managers have turned notably more optimistic about future business conditions. The index tracking expected business conditions in six months' time, rose to the highest level in 18 months.

- New vehicle sales contracted in August by 26.3% year-on-year compared to a fall of 29.6% year-on-year in July. Sales were dragged down by passenger vehicles, which declined by 32.6% in August. The car rental industry remained severely depressed, accounting for only 0.04% (8 units) of passenger vehicle sales compared to 18% in August 2019. In contrast, sales of medium and heavy vehicles surprised on the upside, rising by 7.7% and 9%, respectively. Meanwhile, vehicle exports plunged by 46.9%, worse than the 29.6%

contraction in July. Activity in the new vehicle market is expected to remain low for the remainder of the year due to the uncertainties relating to the economic impact of the coronavirus pandemic and as consumers and businesses continue to adapt to short-term budget pressures. Furthermore, not only will the economy have to contend with consequences of the economic lockdown, it now has to deal with further rolling blackouts which come at the worst possible time for the South African economy. Eskom announced that the heightened risk of load-shedding will haunt the South African economy for another year. All this points to an already hard-hit economy with no expectations for a quick recovery any time soon.

- Consumer sentiment rebounded during the third quarter of 2020 following the shocking decline triggered by the COVID-19 pandemic and severe economic lockdowns in the second quarter. After crashing from -9 index points to a 35-year low of -33 in the second quarter, the FNB/BER Consumer Confidence Index (CCI) edged up only modestly to -23 during the third quarter. Bar the second quarter low of -33, the latest CCI reading remains the lowest on record since the first quarter of 1993 - a recessionary period of great uncertainty just before South Africa's first democratic election. The third quarter uptick in the index was due to increases in the household finances and time-to-buy durable goods sub-indices — which both reported major declines in the second quarter. Though confidence lifted slightly across all household income groups, it remained in depressed territory. The gradual lifting of restrictions to level 2 in August has finally allowed most consumers to go back to work and earn a living. Though restrictions on economic activity have eased and consumer confidence has recovered slightly, the modest improvement in confidence indicates that the Covid-19 pandemic and related lockdowns delivered a profound blow to consumers' willingness and ability to spend, and it may take years for consumer confidence and household income to recover fully.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Werner Erasmus

- Second-quarter Gross Domestic Product (GDP): Due Tuesday 8th September 2020. The Bloomberg consensus is for a GDP contraction of 49% quarter-on-quarter annualised, but analysts say early signs show a recovery in the third. Year-on-year, GDP is expected to fall 16.5% in the three months ending June, according to 11 economists surveyed.

- RMB/BER Business Confidence: Due Wednesday 9th September 2020. Business Confidence stood at a record low of 5 index points in the second quarter, with virtually all respondents unsatisfied with prevailing business conditions. Compared to the second-quarter, changes in COVID-19 regulations have allowed for more economic activity in the third quarter, but the allowance of more activity does not necessarily translate to higher demand, which is required to fuel a sustained recovery in confidence. Expectations are for the majority of RMB/BER Business Confidence survey respondents to have remained dissatisfied with prevailing business conditions in the third quarter amid significant capacity destruction and a lack of implementation in key structural reforms.

- Current Account: Due Thursday 10th September 2020. After registering a current account surplus (as a percentage of GDP) of 1.3% in the first quarter of the year, another surplus is expected to have been recorded in the second quarter. The positive trade balance during the quarter amid higher precious metal prices and relatively contained international oil prices are among the main factors informing this expectation.

- Mining Production: Due Thursday 10th September 2020. Mining data for July is expected to show the positive effects of easing lockdown conditions but remain negative on a year-on-year basis. Month-on-month mining production is expected to increase 3% with a year-on-year decline of -24% expected.

- Manufacturing Production: Due Thursday 10th September 2020. Manufacturing production has been in decline since June last year as the sector continues to grapple with weak domestic demand and low global competitiveness. While the recent easing of lockdown restrictions may have provided some respite to manufacturing production in July on a sequential basis, the year-on-year reading is nevertheless expected to have remained deeply negative. For the sector to register a more material improvement, the implementation of structural reforms, particularly in electricity cost and supply, remain imperative.

GLOBAL

Contributed by Nick Downing

- The Nasdaq suffered its biggest daily decline since June on Thursday 3rd September, falling by 5% on the day, although the index is still up by 27% on the year. Selling was focussed on the mega-cap technology stocks which have flourished in the coronavirus environment. Technology enabled "growth" stocks such as Apple, Amazon, Tesla, Microsoft and Facebook tend to do well in a slow growth environment characterised by low bond yields. Their outperformance may derail if bond yields start rising sharply and/or the economy enjoys a standard cyclical recovery. In a year's time these glamour stocks are likely to face difficult year-on-year earnings comparisons after the bumper earnings base established this year, whereas the underperforming cyclical stocks will be coming off such a low base that earnings in 2021 could by contrast be very impressive. Last week's sharp decline in the tech-laden Nasdaq index could herald that the market top in the digital sector is close. Insiders seem to agree. US company executives sold their companies' shares in August at the fastest pace since November 2015, in sharp contrast to March and April when they were aggressively buying the market drop. The insider selling is concentrated in the Nasdaq stocks, with company executives taking advantage of sky-high valuations and the insatiable buying appetite of retail investors.

NORTH AMERICA

Contributed by Nick Downing

- Non-farm payrolls increased in August by 1.4 million, slightly down from the 1.7 million job increase in August but nonetheless a strong figure. The unemployment rate fell from 10.2% to 8.4%, marking the fourth straight monthly decline since peaking at 14.7% in April. Although unemployment remains far off the 50-year low of 3.5% recorded in February, it is now below the 10% peak registered at the height of the 2008/09 Global Financial Crisis. Jobless benefit claims in the week ended 29th August fell by a solid 130,000 to 881,000 the lowest level since April, although the decline is partly attributable to a change in calculation methodology to iron out the coronavirus effect on usual seasonal fluctuations. Still, it is a healthy improvement. The labour participation rate, measuring the percentage of the population actively seeking work, also improved in August, rising from 61.4% to 61.7%. Employment data is a lagging indicator, which can be predicted by forward-looking predictive survey measures such as purchasing managers' indices (PMIs). PMIs have been moving steadily higher since the height of the pandemic signalling further payroll improvements over coming months even if at a slower pace.

- Federal Reserve officials have been uncharacteristically outspoken about Congressional policy. Normally circumspect in their opinion on policy they are weighing-in strongly on the need for politicians to urgently roll-out additional fiscal support. The president of the Federal Reserve Bank of Chicago, Charles Evans, reflected the predominant view at the Fed, "Partisan politics threatens to endanger additional fiscal relief. A lack of action or an inadequate one presents a very significant downside risk to the economy today." Congress returns from its summer recess on 8th September to resume discussion on a fiscal support package. Republicans and Democrats have compromised their respective initial proposals of $1 trillion and $3.5 trillion but the chasm remains wide at $1.5 trillion and $2.5 trillion. As the presidential election approaches so does the sense of urgency from both parties. The stronger than expected employment data has also strengthened the Republicans' resolve in keeping a lid on fiscal expenditure.

- The Institute for Supply Management (ISM) manufacturing purchasing managers' index (PMI) surged higher in August from 54.2 to 56.0 well above the consensus forecast of 54.8 and its highest level since late 2018. Readings above 50 denote expansion. The PMI has enjoyed a V-shaped recovery since falling below 30 at the height of the coronavirus pandemic. While the employment sub-index remained in contractionary territory at 46.4, other sub-indices performed strongly. The production index gained from 62.1 to 63.3 and the forward-looking new orders index from 61.5 to 67.6 its highest level since 2004, emitting a strong signal of rising manufacturing activity over coming months. The survey data corroborates the IHS Markit PMI, which also enjoyed a strong gain in August from 50.9 to 53.6. PMIs are closely watched by economists and analysts as they reliably predict economic activity. The survey data is encouraging, confirming a broadening recovery in the economy's manufacturing sector.

- The US trade deficit widened in July by 19% month-on-month to $63.56 billion the largest deficit since July 2008. The goods deficit was the widest on record at $80.9 billion reflecting a recovery in US consumer spending. The services surplus failed to compensate due to continued global weakness in demand for services such as tourism. The trade deficit with China has remained stubbornly high, rising in the second quarter (Q2) to $75.8 billion from $21.4 billion in Q1. Surprisingly, President Trump has been quiet on the subject, perhaps due to his failure to live up to the pledges made in the 2016 election race. In contrast with 2016 when the trade deficit was uppermost in his election campaign, this time round he is being conspicuously quiet.

CHINA

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- China's exports grew in August by a stronger than expected 9.5% year-on-year, its third straight annual increase after growing by 7.2% in July and 0.5% in June. China's early normalisation from the coronavirus pandemic has helped the economy increase its share of global exports, which according to research firm Oxford Economics has risen from 13.9% in 2019 to 17.2% in the second quarter of 2020. Exports to the US increased in August by a massive 20% on the year, rising from the 12.6% increase in July, while imports from the US inched higher by just 1.8% down from July's 3.6% gain. China's trade surplus with the US widened in August to $34.24 billion the biggest surplus since July 2018, at the outset of the trade war between the two countries. However, the weak import numbers are partly due to lower prices of key commodity and agricultural imports. In volume terms, imports showed a healthier increase of close to 10% on the year. The data confirm that China's export driven economy is once again gaining momentum while also confirming the improving outlook for global trade generally.

JAPAN

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- Japan’s Consumer Confidence Index edged lower in August falling by 0.2 to 29.3. Consumer optimism was mostly down - Overall Livelihood (-0.3), Income Growth (0.1), Employment (-0.5) and Willingness to buy durable goods (+0.4). The percentage of respondents expecting prices to rise in the year ahead rose 1.4 percentage points to 75.1% while only 9.3% expect prices to go down, a decrease of 0.2 percentage points from July. Japan’s Cabinet Office also released the preliminary monthly indices of Business Conditions and kept its assessment of the coincident index, a measure of current business conditions, as “worsening” for a twelfth consecutive month despite both the leading (+3.1) and coincident (+1.8) indices edging higher. The slight increase was mainly due to improved conditions in the auto manufacturing industry and to some degree other industries after lifting covid-19 preventative measures. However, the three- and seven-month moving averages still point to a decline and hence the negative assessment. The run of twelve months of “worsening” conditions is the longest on record and has outlasted the 11 months during the global financial crisis.

EUROPE

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- France announced plans to breathe life back into its economy with a €100bn rescue package dubbed “France Relance”, which translates to France Relaunch. France’s ambitious plan, which will be 4% of GDP and four times the size of the national plan during the global financial crisis, will aim to invest in green projects such as renewable energy as well as transport and industrial innovation. It is the largest fiscal plan announced thus far in Europe in relative terms and complements Germany’s efforts of using extra fiscal spend to reach environmental goals. Nearly a third of the funds will be spent on “ecological transition” which includes €9bn on the development of a hydrogen industry and other environmentally friendly initiatives such as improving insulation in homes and public buildings. Nearly €5bn will go towards improving state railways. The government will furthermore spend a third on industrial competitiveness and innovation via lower production taxes and support for strategic business in the health and IT sectors. The last third will go towards “social and regional cohesion” focussing on employment projects and upskilling the youth. In contrast to Germany’s rescue package, France will aim to boost business investment rather than reinvigorate demand. France has already spent a significant amount on fighting the economic effects of the pandemic and it is expected that its debt will balloon to 120% of GDP from about 100% before the pandemic. The government expects the economy to shrink by 11% this year and to only recover to pre-pandemic levels by 2022. The recovery will be driven by the announced rescue plan which will be 40% funded from the European Commission’s €750bn recovery programme. The government pledged not to repeat past mistakes by increasing tax rates to recover the additional fiscal spend, but rather aim to boost growth.

UNITED KINGDOM

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- House prices in the United Kingdom have soared to record levels in contrast with the economic reality facing large swaths of the population amid the worst economic downturn in history. The latest Halifax House Price Index showed that house prices increased in August by 1.6% on the month and were up 5.2% compared to the previous year, putting the average house price at £245,747. Residential transactions in July were 14.5% higher than in June and mortgage approval rates were 66% higher in July than the previous month, returning to pre-pandemic levels. Much of the higher transaction volume can be explained by pent up demand during the lockdown period and the stamp duty holiday on properties under £500,000 which runs until March. Another reason why the property market keeps rising is that in contrast to the global financial crisis, this economic slump was not caused by a housing market bubble. Although property values are high in terms of income levels, they are not overly stretched given current low interest rates and mortgages have been supported by the government's furlough schemes and banks' mortgage holiday initiatives. Potential buyers not affected by the pandemic are looking to move to bigger properties with evidence from London suggesting a rise in demand for bigger properties with the potential of a home office while demand for one-bedroom flats has declined. There has also been an increase in prices for properties along the coast and the countryside as buyers are less concerned about proximity to work, anticipating that working from home on more days will become the norm. However, analysts warn that the property market will not be immune to the underlying economic factors indefinitely and that once furloughed schemes and mortgage holidays end there will be downward pressure on the housing market.

FAR EAST AND EMERGING MARKETS

Contributed by Carel La Cock

- The US, EU, Japan and Taiwan are spearheading an initiative to rebuild global supply chains and diversify them away from China to reduce the risk of disruption, as seen during last year's US-China trade war and the covid-19 pandemic. Delegates from the above-mentioned countries met at a conference in Taipei and urged other nations to collaborate in efforts to diversify and secure supply chains. The initiative will be a further blow to US-China relations, but a boon for Taiwan and other developing Asian countries such as Vietnam, Thailand, and South Korea. US sanctions on Huawei have caused a major disruption to the global supply of smartphone chips and semiconductors. Manufacturers of these components using US software and equipment may not sell to Huawei without a licence. Since US equipment is widely used by the world's biggest producers, it effectively cuts off supply to Huawei which has been striving to become the world's largest phone and 5G equipment producer. MediaTek, the Taiwanese chip maker, traded 10% lower after the announcement and will be impacted by the loss in demand from Huawei. Some commentators say that the latest sanctions by the US are unwarranted and warn that there could be a much wider impact if China decides to retaliate. Although there is no denial that a more diversified supply chain will brace against future disruptions, an escalation in the US-China trade dispute caused by it would be devastating for the global economy still reeling from the coronavirus pandemic.

KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	- 4.70	54400
JSE Fini 15	- 39.35	9507
JSE Indi 25	+ 4.47	72400
JSE Resi 20	+ 12.72	55524
R/$	- 16.39	16.74
R/€	- 20.67	19.78
R/£	- 15.82	22.04
S&P 500	+ 6.07	3426
Nikkei	- 2.40	23089
Hang Seng	- 12.77	24589
FTSE 100	- 21.28	5937
DAX	- 1.12	13100
CAC 40	- 15.46	5053
MSCI Emerging	- 1.80	1094
MSCI World	+ 2.10	2408
Gold	+ 26.63	1930

Platinum	- 7.04	902
Brent oil	- 36.43	42.05

BOTTOM LINE

Contributed by Gielie Fourie

- THE SA RESERVE BANK (SARB) AND MONETARY POLICY: Following the “abnormal monetary and financial conditions” in the wake of World War I, the SARB was established in 1921. Monetary policy comprises the measures used by the SARB to achieve its economic objectives of achieving, and maintaining, price stability in the interest of balanced and sustainable economic growth in SA. Its four main objectives are to regulate and stabilise (1) price fluctuations, in other words controlling **inflation**, (2) the balance of payments, (3) the international value of the Rand, and (4) employment. If monetary policies can stabilise these four variables over the short term, they will create the right environment for the economy to grow over the long term. Three monetary “tools” are available to the SARB to implement monetary policy – they include control over (1) interest rates, (2) money supply, and (3) credit extension by the banks. We will look at the two functions of controlling inflation and interest rates.

- FISCAL POLICY – MONEY, TAXES AND SPENDING: Fiscal and monetary policies are often confused. One of the functions of monetary policy is to control money supply. The SARB is responsible for “printing and minting” money – after all, it owns the South African Mint. On the other hand, the functions of fiscal policy are (1) the collection of revenue through taxes and (2) expenditure (fiscal spending). Monetary policy and fiscal policy are fully segregated. Both monetary policy and fiscal policy fall under the same government department, namely the National Treasury, and the same minister, the Minister of Finance Tito Mboweni. Mboweni wears two hats: (1) he is the Political Head (with no management functions) of the SARB and (2) he is responsible for the annual budget. Mboweni has the experience - he has served ten years as Governor of the Reserve Bank. Mboweni has no control over interest rates – which is part of monetary policy. Interest rates are determined by the Governor of the SARB, three deputy governors and a senior official. Mboweni has full control over taxes and government spending – which is part of fiscal policy.

- LOW INFLATION AND LOW INTEREST RATES: The Covid-19 pandemic caused the economy to contract severely. We are now in the third quarter of a prolonged recession – a fourth quarter of economic contraction is sure to follow. Inflation dropped to 2.1% in May 2020, the lowest in many years. This forced the SARB to drop interest rates – the prime interest rate is now standing at 7.0%. RSA 5-Year government bonds now yield a low 7.24%. For investors this is critical. The dividend yields of many blue-chip shares on the JSE handsomely beat 7.24%. In addition, there is (1) the attraction of capital growth, plus (2) currency protection (Rand hedge) when companies do business abroad. The average dividend yield for the JSE All Share Index (ALSI) is an attractive 3.90%. British American Tobacco (BATS) has a dividend yield (DY) of 7.24%. Other high yielders are: Property giant Growthpoint DY 17.7%, FirstRand (FNB) DY 8.25%, Storage company Stor-Age DY 9.0%, Coronation DY 8.7%, Lewis DY 13.3%, Nedbank DY 7.65%, Liberty Life DY 7.8%. The list goes on. Preference shares (Prefs) are also providing generous returns – Nedbank Prefs have a DY of 11.15%, Investec Prefs have a DY of 13.78%. It is possible to construct a diversified portfolio of high yielding shares. Do not waste the opportunities created by this recession. The window of this opportunity is closing.

- HIGH INFLATION AND HIGH INTEREST RATES: Let us look at the 1980s as an example. In the 1980s we experienced a foreign debt crisis and politics were in a mess with poor governance and widespread, violent, social unrest. GDP fell to the levels of 1970. In 1981 and 1984 the JSE had negative growth. SA had to repay billions of Rands to its foreign creditors, causing a massive outflow of capital. Fiscal policy became restrictive, and monetary policy even more so. In 1984 inflation peaked at 18.41%. Our prime interest rate shot up to 25%. It means that you had to repay your capital every 4 years – on top of it, you still had to pay interest. The monetary policy worked well, perhaps too well. There was a heavy price to pay - many businesses went to the wall. The JSE crashed in 1987 – it dropped 20% in a single day. The start of the 2020s is looking very similar to the situation in the 1980s in terms of policy uncertainly but financial conditions are staggeringly better. It is advisable to take advantage of the current low interest rate environment with a diversified portfolio of high yielding stocks bought at bargain prices.

- SUMMARY: The current recession will not last forever. It is also not as bad as people think it is. The dark decade of the 1980s was far worse – it has been confirmed by several captains of industry, like Laurie Dippenaar, Paul Harris, and GT Ferreira of Rand Merchant Bank (RMB). They should know – they founded RMB in those dark years, in 1987, and what a big success it was. They became billionaires. We should ignore the “noise”. Charlie Bilello, a USA researcher recently remarked: “Daily financial news is primarily a form of entertainment. It should play no role in how you manage your portfolio. Your job is to remain invested for the long run”. Use the low inflation and interest rates to your advantage – they create rare investment opportunities. It is time to start nibbling at the low hanging fruit. If you focus on the inches, you will win by a mile.

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