S.A. faces contraction in GDP, but silver linings linger

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For Financial Advisors and their Clients

While the International Monetary Fund's (IMF) latest World Economic Outlook last week suggested a contraction of 8% in South Africa's economy in 2020, the current rates of recovery from government lockdowns on various sectors could see a contraction of as much as 10% in the country's GDP this year.

With this being said, South Africa's steady recovery from one of the most stringent lockdowns in the world (which has seen the economy currently running at around 80% of its pre-COVID capacity) should give some optimism for a rebound, according to Carmen Nel, economist and macro strategist at Matrix Fund Managers.

Speaking at a webinar hosted by Eugene Visagie, Client Portfolio Manager at Morningstar Investment Management South Africa, 'The state of the South African economy – where to from here?', Nel said many models were predicting a peak in virus infection rates in late July or early August, which meant the focus would now shift to what she called 'the alphabet soup of recovery'.

"We've heard much speculation about what the shape of the recovery will be, with talk of a W, a V, an L or even a swoosh/hockey stick. Right now, there's still a wide range of outcomes on the table, as we've started to see jitters in some markets around a second wave of infections, and this has caused some concern about the shape of our recovery," said Nel. (When referring the aforementioned 'W', 'V', 'L' or 'swoosh/hockey stick', it refers to how the line of recovery would look like on a chart.)

The sectoral impact of government lockdown regulations was severe, especially on industries like construction, which took a 14.2% hit, and tourism, where foreign tourism fell 30%. Spending has been more defensive in recent weeks, which raises questions around behavioural change, which could see a higher proportion of savings. While there was pre-emptive buying in March, and some pent-up demand coming through as lockdown restrictions ease, Nel predicts trade will be hit by a decline of around 10-15%, through a combination of lockdown and weakened demand from offshore.

"Right now, South Africa is doing what it can. Finance Minister Tito Mboweni's supplementary budget last week provided a couple of surprises: the market wasn't expecting the pace of the consolidation that the government showed, and the statement that the cabinet had endorsed accelerated reform was another positive. It was an incredibly ambitious budget statement, but we have to ask whether there is credibility, as the budget was quite vague on how we will fund longer-term consolidation," she said.

One of the major challenges facing the country remains unemployment, with substantial job losses driving the official unemployment rate to 30%. Job loss estimates range from 400,000 -

1.5 million. "Our view is that losses will be towards the lower end as the economy opens up again. If we lose 1.5 million jobs, that will mean half our labour force will be unemployed, which will put a tremendous strain on the UIF and grant system, and even raise questions around the need for a universal basic income grant," said Nel.

The topic of prescribed assets was also discussed in detail by Visagie and Nel, both highlighting that the Finance minister made it clear that there is not a large enough savings pool in S.A. to meet the government's spending requirements. In addition, no mention was made regarding the revising of current limits on regulation 28. There is a possibility that additional asset classes can be included for pension funds to invest in.

One of the silver linings of a recession will be that the current account deficit will narrow dramatically, or even realise a small surplus. At the same time, lower demand for foreign funding could signal some stability in exchange rates, with the weak rand actually helping South Africa's competitiveness. "The benefits of a weak currency are only effective if inflation remains low, and the S.A. Reserve Bank (SARB) has been successful in anchoring inflation expectations at relatively low levels, with meaningful downward trends in headline inflation since late 2017," said Nel.

The Rand remains hard to forecast because there are more than just South African fundamentals at play. Nel believes the Rand is currently undervalued by around 6%, with the dollar cycle being a 'very important' element to keep an eye on. The weakening dollar has helped emerging market currencies, and if global liquidity stays adequate, there is some scope for the rand to recover. While R17.30 is still 'cheapish', South Africa's fundamentals remain an extreme concern.

With central banks being the backstop of recoveries across the world, the SARB has provided around R300 billion in support to date, albeit some of it is temporary, while rate cuts have contributed an estimated R80 billion in stimulus – and we cannot rule out further rate cuts later in the year.

Visagie also highlighted that what this means is that cash in South Africa is no longer king, as the series of repo rate cuts have led to a collapse in treasury bill and money market rates. Nel added that the market is currently pricing in another 25 bps cut, with reversals only expected to start at the end of 2021. However, gold has benefited significantly from the collapse in real interest rates in the US, and domestic equities remain cheap.

"What South Africa needs more than anything right now is something to restore confidence. Business confidence is low, which means we need structural reform: anything that lowers the cost to households and businesses, and creates jobs," she said.

"At Morningstar, we believe that investors should stay focused on their long-term financial goals, remain calm and keep doing what you can to stick to your goals – for example, save more and keep on investing smartly," says Visagie.

Investing in the equity market is a long-term pursuit and is best used to reach long-term goals such as retirement. As the saying goes – a river cuts through a rock, not because if its power, but its persistence. "While noise and speculation can act as an emotional rollercoaster, your goals are unlikely to have materially changed and, therefore, your plan shouldn't either", he added.

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