



THE SKY HASN'T FALLEN

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A favourite of many children, and indeed adults, is the Adventures of Asterix series. I certainly spent many happy hours reading about the escapades of the indomitable Gauls from a small village in Northern France. Armed with a magic potion that gives them superhuman strength, they fear nothing, not even the might of Julius Caesar's Roman Empire. The only thing they somewhat superstitiously feared was the sky falling on their heads.

These are serious and uncertain times, and many people are experiencing great hardship and loss. In no way should we try to diminish this. But I do think it worth remembering that some of the big fears of many investors have not come to pass. The sky, in other words, did not fall on our heads.

- For the past few years, many commentators told us that a Moody's downgrade to junk status would be catastrophic. Well, South Africa was duly downgraded towards the end of the first quarter, but none of the dreaded consequences occurred in the subsequent months. On the contrary, bonds rallied, the rand appreciated and the Reserve Bank cut interest rates. Junk status is not a nice moniker for your country, but it has made no difference in how we live our lives.
- Markets slumped in February and March as the novel coronavirus spread rapidly outside China. But when the initial shock faded, and with plenty of policy support from the major central banks, equity markets rebounded strongly across the world, including South Africa. In fact, the JSE had the best quarter in almost 20 years, recovering a large part of the first quarter losses. While some people have completely written off local equities as an asset class, it in fact outperformed global equities during the quarter despite the gloomy local conditions. The stock market is not the economy.
- Morningstar data show that the average retail balanced fund returned 0.5% in the 12 months to end June. This is a very disappointing return in isolation, but in the context of the deepest local recession on record and a period of unprecedented global market volatility (exceeding even the 2008 episode), it is not a bad outcome. Looking ahead, we believe a typical South African balanced fund can deliver solid real returns. The most reliable indicator of future returns is current valuation, not current macro conditions. Local equity valuations are in line with long-term averages while property and bonds offer attractive yields in excess of inflation. Money market yields have declined considerably as the Reserve Bank has cut interest rates, but are still slightly ahead of inflation.
- Despite immense hardship, stresses and strains, the country hasn't fallen apart. This crisis has exposed serious shortcomings in government, and a number of senior leaders have not exactly covered themselves in glory. But the overall response has been as good as you can expect from a country with our level of resources, and even better than some richer ones. Credible leadership from President Ramaphosa made a big difference. We didn't get the coronavirus under control, but the initial success in flattening the curve bought crucial time. So far the worst-case scenarios predicted by the epidemiological models have not come to pass. This reflects the fact that all these models are only as good as the assumptions you feed into them and these assumptions are very uncertain given that the coronavirus is such a new threat. But it also reflects to some degree success in getting people to socially distance.



There are a few remaining sky-falling-on-our head scenarios that still haunt investors, particularly around the country's fiscal situation.

South Africa was in a weak fiscal position going into the crisis (hence the downgrades) and the drastically altered economic reality has necessitated a Supplemental Budget which laid our budget blues bare. Because the Treasury expects a 7.2% real contraction, tax revenue in the current fiscal year will be R302 billion less than was projected in February. The net result is that the main budget deficit – the difference between spending and revenue – will almost double from the February projection to R709 billion (or 14.7% of GDP). All this borrowing in turn means debt will accumulate rapidly. The public debt ratio is expected to jump from 63% last year to 82% next year. Government plans to introduce measures to raise economic growth and reduce borrowing, such that debt peaks at 87% in the 2023 fiscal year. This is somewhat optimistic, but the intention is good.

With the collapse in tax revenues this year, 21 cents of every tax rand collected will go towards interest payments. And it will remain there if all goes according to plan in the next few years. This returns us to the situation of the 1990s, where interest payments also consumed around 20% of tax revenue on average in the 1990s (some years much more). It declined to 10% by 2008 as debt and interest rates fell, but then quickly rose to 15% by the end of last year. The increase in the debt service burden will leave less money for spending in other important areas, but is not a crisis on its own. What will be important is how the remaining 79 cents is spent. There can be no tolerance for waste, and the state needs to be relentless on getting value for money.

So what are these big fears?

- The biggest risk to any bond investor is a default on the debt, in other words, a failure to pay interest or repay capital or both. This remains extremely unlikely. Fundamentally, the problem in South Africa is not that we lack money, but rather that we don't prioritise well and spend efficiently.
- Another risk often touted is that governments here and abroad will seek to inflate away the debt, pushing up inflation to reduce the real value of the bonds. But in a disinflationary global environment, it is not clear that this will be possible, even if this was the intention. StatsSA's data (collected with some difficulty during lockdown) shows that inflation in May was 2.1%, the lowest since 2004.

- Many investors are spooked by the prospect of prescribed assets, or the government forcing pension funds to lend it money at suppressed interest rates. Some people fear outright confiscation. We don't see this as likely, since it would be counterproductive. Many people also misinterpret the government's intention to encourage more investment in infrastructure and development projects. However, remember that even if prescribed assets were introduced, investors would still earn a return on such assets, even if it would lead to a sub-optimal overall allocation. Either way, no firm announcements have been made and there is no reason to hold off saving for retirement because of rumour and speculation.

Ultimately, a country that largely borrows in its own currency has a lot of leeway to avoid a fiscal crisis, however you want to define it. In the end, it is often a political choice.

Meanwhile, the real yield on longer-term government bonds is in the region of 7%. This is clearly pricing in a lot of bad news and offering a very attractive opportunity, especially now that the real yield on cash has declined substantially.

Unlike Asterix and his compatriots, we don't have the druid Getafix to concoct a magic potion and rid us of the coronavirus and our economic and fiscal problems. We'll have to do the hard work ourselves as a nation.

Investors also don't have magic potions. There are no shortcuts to wealth creation. There are also no crystal balls to predict the future. The key ingredients to investment success remain a long-term approach, appropriate diversification and buying assets that are undervalued. This is easier said than done, because applying these principles often goes against human instincts. These are, however, the key pillars of our investment philosophy. And while we cannot guarantee returns, we do promise that we will apply this philosophy consistently.



IZAK ODENDAAL
INVESTMENT SPECIALIST
OLD MUTUAL MULTI-MANAGERS