Sygnals

May 2020

Market Review

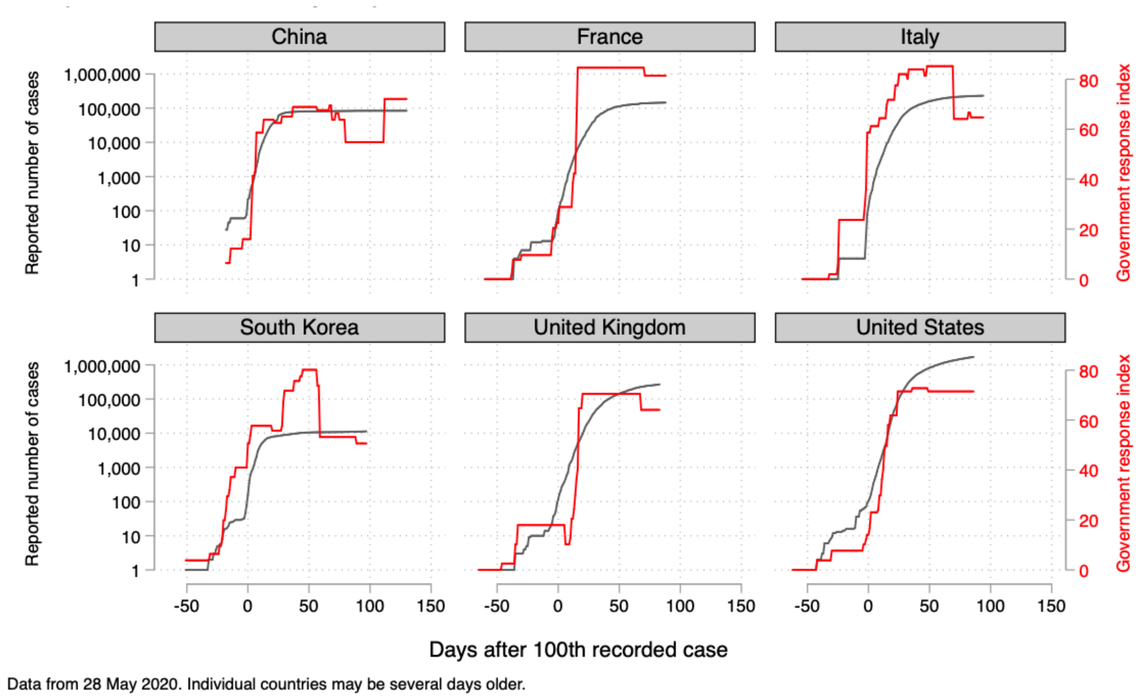
A slow emergence from lockdown

Global economies began their slow emergence from lockdown in May, evidenced by Google's Global Mobility Index, which reviews phone location data from 125 countries (you are being watched!). The Oxford Stringency Index reflects a similar story, with most countries dropping to around 70 out of 100 (see Chart 1). Markets rallied as a result of the opening up of economies, further clarity on fiscal support and the provision of additional liquidity. While a second wave of infections is a major concern, after four weeks into the relaxation process there has been little evidence of a resurgence, and analysis by UBS and JPMorgan actually shows a decrease in the daily infection rate in most countries post-lockdown, as social distancing and testing appear to have been effective. Optimism about vaccines is also increasing, as over 160 vaccines are now being researched, with five having started human trials and positive reports about American biotechnology company Moderna's vaccine and Gilead's remdesivir.

However, President Trump appears to have prioritised his re-election campaign over global wellbeing, and markets took a turn for the worse as US-Sino relations stressed, with the US Senate passing a bill barring certain Chinese companies from listing on American exchanges as Trump continues to blame China for the Covid-19 pandemic. Odds Shark shows Trump with a 55% chance of re-election against Biden's 45% odds. Sentiment deteriorated further as China's legislature approved national security laws for Hong Kong, which erodes Hong Kong's freedom, democracy and human rights. The US is threatening a range of sanctions in response.

Chart 1: Lockdown stringency and number of cases

Source: Oxford Covid-19 Government Response Tracker



South Africa moves to level 3 lockdown

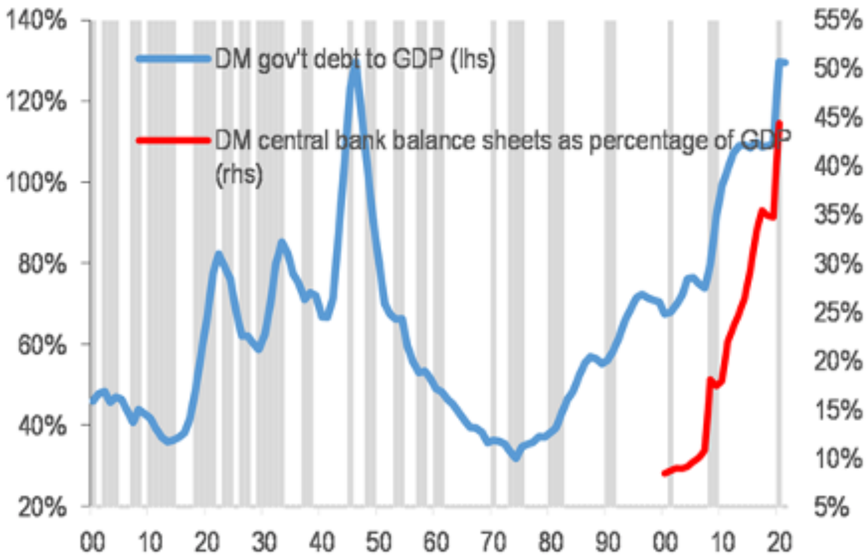
South Africa moved to coronavirus alert level 3 on 1 June, allowing an additional 8 million people to return to work. The SARB has done what it can to assist and cut the repo rate by 50 bps to 3.75%, a record low that makes a total of 3% cuts over the last year. The SA consumer has had much-needed relief with low oil prices accumulating a reduction of R4/litre this year, but it may prove to be too little too late. South Africa's small businesses are in deep trouble, with a new survey showing that as many as 75% face closure as a result of the Covid-19 lockdown. Small businesses account for 28% of jobs in South Africa, and with informal traders included, this rises to 47% (ABSA 21 May). South Africa's 2020 GDP growth is likely to contract by almost 10% in 2020, and we eagerly await government's third phase of "speedy economic reforms" and a decision on SAA which has been in business rescue for more than 5 months.

QE Infinity and the endgame for high debt

In response to the Great Financial Crisis of 2008, the world's major central banks adopted extraordinary monetary policies in the form of quantitative easing (QE) to prevent a deflationary debt spiral, and the Covid-19 pandemic has escalated that process. The pandemic-induced recession has also lifted sovereign indebtedness to a 70-year high (see Chart 2). Below we consider some of the long-term consequences of this and how to get out of this debt – to grow out of it or inflate out of it? Both, in fact, seem highly unlikely.

Chart 2: DM sovereign debt as a percentage of GDP

Source: JPM



1) Lower long-term growth

Higher fiscal spending boosts the economy over the short term, but the increase in government debt is a drag on growth over the longer term, as debt steals from the future. Higher debt results in higher saving and consequently lower spending and lower growth:

- Consumers save more, as they expect taxes to increase in the future to pay back the debt.
- Consumers increase their precautionary savings, as higher debt increases economic volatility.
- Consumers increase their retirement savings, as lower interest rates mean a larger retirement fund is required to maintain the same income.
- High debt results in lower government spending, as higher interest payments divert government resources from fixed asset investment.
- Lower interest rates reduce long-term growth potential, as it allows the number of inefficient zombie companies in the economy to grow.

2) Disinflation not inflation

Despite all the stimulus, disinflation is more likely than inflation, as recessions have disinflationary impacts on economies that last for at least a couple of years. Consumers and businesses become more risk averse, and it takes time to rebuild savings and buffers. In fact, the 2008 Great Financial Crisis (GFC) led to a step down in inflation, with pre-Covid levels of inflation well below target for most DMs despite QE. Central banks can increase the monetary base by buying bonds, but they cannot control the velocity of money; they cannot force people to spend and banks to lend.

3) The road to hell is paved with more debt

Japan has been fighting deflation for 30 years with monetary and fiscal support: using fiscal support, Japanese government debt has risen to a record high of 230% of GDP. The Bank of Japan used monetary support (BOJ) to launch its QE in October 1997. The central bank balance sheet is now 115% of GDP and the BOJ owns almost 50% of Japanese government bonds, blurring the lines between monetary and fiscal policy.

After all that stimulus, Japan still shows no signs of inflation and interest rates have continued to fall. Asset prices are still below 1989 levels and relative PEs have also continued to fall. Japan has not inflated or grown its way out of debt, but instead has simply taken on more debt.

No debt has been cancelled despite this indirect monetisation, and consequently Japan's efforts have not led to inflation or currency and bond sell-offs. While the promise remains that the debt will be paid down through future austerity, over 20 years Japan has sold back none of the bonds it bought, and it is unlikely to do so.

Conclusion

QE and fiscal spending are unlikely to cause inflation in developed markets already affected by slowing growth, rising debt and ageing demographics as long as the promise remains to pay back that debt. In fact, like Japan, these markets will have to print more money, creating more debt and effectively maintaining the economy on life support, with lower rates for longer, lower growth and an ongoing search for yield.

Key indicators

		1 mo.	*3 mos.*	*6 mos.*	*1 yr.*	*2 yrs.*	*3 yrs.*	*5 yrs.*	*10 yrs.*
J203T	**FTSE/JSE All Share Index**	0,3%	0,5%	-7,1%	-6,0%	-1,9%	1,3%	2,5%	9,7%
J200T	**FTSE/JSE Top 40 Index**	0,4%	3,1%	-3,5%	-2,8%	0,0%	2,8%	3,2%	10,0%
J210T	**FTSE/JSE Resources 10 Index**	5,6%	14,7%	4,5%	13,4%	13,8%	19,5%	6,3%	3,3%
J211T	**FTSE/JSE Industrials 25 Index**	-1,6%	6,0%	3,8%	3,3%	0,4%	0,1%	3,1%	15,0%
J212T	**FTSE/JSE Financials 15 Index**	-4,7%	-25,3%	-34,9%	-38,0%	-18,9%	-8,2%	-5,5%	7,3%
J403T	**FTSE/JSE SWIX Index**	-1,0%	-3,0%	-10,1%	-10,4%	-5,0%	-1,9%	0,6%	9,4%
J433T	**FTSE/JSE Capped SWIX Index**	-0,4%	-5,3%	-13,9%	-14,2%	-7,9%	-4,2%	-1,2%	-
J303T	**FTSE/JSE CAPI Index**	0,7%	-0,4%	-8,8%	-7,6%	-3,2%	0,3%	1,9%	9,4%
J253T	**FTSE/JSE SA Listed Property Index**	-0,8%	-32,6%	-46,1%	-45,9%	-28,2%	-21,6%	-11,4%	3,5%
ALBI	**JSE All Bond Composite Index**	7,1%	0,4%	3,5%	6,4%	7,1%	8,2%	7,7%	8,5%
STeFI	**STeFI Index**	0,5%	1,6%	3,3%	7,0%	7,1%	7,2%	7,2%	6,5%
	MSCI World Index In SA Rands	0,6%	12,8%	13,7%	28,8%	21,6%	17,0%	14,0%	18,8%
	Rand/US Dollar Exchange Rate	-4,0%	11,8%	20,3%	20,6%	17,8%	10,5%	7,7%	8,7%
	Rand/Euro Exchange Rate	-2,5%	12,5%	21,4%	20,1%	14,9%	10,1%	8,0%	7,6%

Note: Headline CPI and PPI figures are unavailable for May.