SELECT MANAGER

Newsletter

February 2020

AND AGAIN, THE CORONAVIRUS.

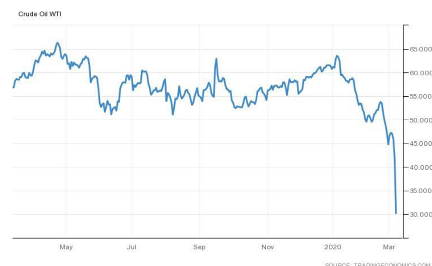
After the mid-month pullback experienced in January, markets began recovering at the start of February. Fears around the spreading of the coronavirus (COVID-19) subsided slightly, and investors started looking past the negative impact towards the support from stimulus already provided and stimulus still to come. Unfortunately, this was short-lived as reported cases of the virus outside of China (especially in Italy) suddenly increased at an alarming rate. Consequently, panic-selling took hold, making the last week of February one of the worst weeks for equity indices since the global financial crisis of 2008/2009.

Had it not been for the global fears and risk aversion that resulted from the above, South Africa would have been in a good position to see some upside throughout February and going into March. We were coming off a recent rate cut, the rand was arguably cheap at over R15.50 to the US dollar (considering our attractive real yield on offer), and Finance Minister, Tito Mboweni, provided a much better national budget than many would have expected. With a general expectation of significant increases in taxes and levies, as well as muted attempts to reduce expenditures, the resulting budget of consumer-friendly tax changes and a focus on initiatives to reduce government expenditures was a pleasant surprise. Some of the highlights from the budget include:

+ The budget deficit is expected to be 6.8% of GDP (2021), while Debt/GDP comes in at 65.6%.
+ Total expenditure reduction targeted at R261bn and aim to reduce wage bill by R160bn (approx. 3% of GDP).
+ Above inflation adjustment to personal income tax brackets, no change in value added tax (VAT).
+ No increase in dividend withholding tax or capital gains tax, while transfer duties for property purchases are reduced.
+ Tax free savings contribution limit increases to R36 000 pa, medical tax credits increase from R310 to R319 per month.
+ 25c increase in fuel levies, with sin tax increases of 74c for a box of 20 cigarettes, 61c per litre of sparkling wine, 14c per litre of unfortified wine and 8c per 340ml can of beer.

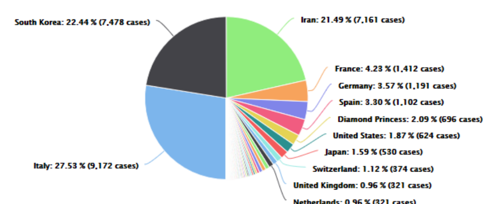
Positive surprises locally were completely outweighed by the global negative sentiment and the risk-off environment. Consequently, the local asset classes suffered for the month. Since February month-end, volatility and panic seems to have just been picking up the pace, as investors and market participants try to make sense of what has been happening. The US Fed announced an emergency cut in interest rate to near 0% during March, the first emergency cut since 2008. The cut came as a response to the rapidly spreading coronavirus (COVID-19), and as the impact on economic growth became apparent. The reaction was, however, completely the opposite of what was intended, as the sudden change in view by the Fed caused the market to question US economic health and consequently saw markets tumble even further.

In the second week of March, we also saw a major shock on the oil market, as Saudi Arabia launched a price war with Russia. This occurred after Russia refused to agree with supply cuts as suggested by Saudi Arabia after Russia felt that they are leaving the market open for US oil producers. This effectively led to Russia ditching the alliance and suggesting increased production. Saudi Arabia retaliated by reducing prices to preferred customers by between $4-$7 per barrel, and planning increased production, in order to gain market share. The global demand for oil was already muted due to the economic impact of the coronavirus (COVID-19) outbreak, especially from China, the largest oil importer. This price war added "oil" to the fire and saw oil crashing around 30% overnight, putting the cost of oil at around $30 per barrel. This was the biggest one-day drop since 1991 and put prices back to levels last seen in 2003. This move could likely prompt some deflation concerns going forward, and possibly provide support for additional monetary policy stimulus.



The latest data (as at 9 March 2020 at 20:00) on the coronavirus (COVID-19) indicates 114 078 cases, with 4004 deaths, and 62 834 people recovered. These figures point to a recovery/discharged ratio of 94% for finalised cases. Outside of China, the largest affected countries are Italy, South Korea, and Iran. Italy is a major concern, not only due to its very high rate of daily infections, but also the high rate of connectivity in Europe and thus the high risk of spreading. While the new strain, COVID-19, is significantly more infectious than SARS (as comparison), the fatality ratio is significantly less. The fatality ratio increases in older individuals, which is a concern for countries with an aging population and older demographic.

Distribution of cases outside of mainland China



Source: Worldometer - www.worldometers.info

Although these factors will have an impact on earnings and economic growth over the short- to medium-term, investors should be careful not to over-react. The combination of fears around coronavirus (COVID-19) and the oil-shock through the implosion of OPEC, together with already stretched global valuations, has seen investors react in haste, and likely overly so. The opportunities presented in these environments, where markets are sold down up to 20% in a week, could provide significant upside for long-term investors, as the payoff profile becomes asymmetric: higher probability of large upside rather than large further downside. Whether the upside comes in the form of a V shape (quick recovery), or a U shape (prolonged recovery), remains to be seen and will likely be data dependent.