SA FACES A TWO-YEAR JOURNEY TO WIN BACK COVID 19 LOST ECONOMIC GROUND

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Recovery from the coronavirus-induced economic and financial market meltdown could take some two years, according to Prescient Investment Management's research and baseline forecast.

The asset manager has outlined three different potential scenarios and their implications for asset classes and asset class returns. Their analysis points to a U-shaped recovery; however, it has never been more difficult predicting outcomes with any degree of certainty, and thus the V- and L-shaped recoveries are also essential to consider.

"The world is grappling with the worst plunge in economic output in living memory," says Prescient Head of Asset Allocation, Bastian Teichgreeber. "The coronavirus pandemic, and the lockdowns to contain it, affect both supply and demand in the various sectors of the economy in unusual and different ways."

He adds that while the scope and reach of the coronavirus crisis are unprecedented, Prescient has developed a range of scenarios to cover the potential roads to recovery we face and outlines what impact these will have on the economy and financial markets.

Looking back at a tough four months

After making new all-time highs as late as mid-February 2020, equity markets around the globe made headlines for the record pace at which they fell shortly after as a result of the global spread of the Covid-19 Pandemic. The price declines have been indiscriminate, with equities, listed property, bonds, credit, preference shares, inflation-linked bonds (ILBs), income assets, and the rand selling off in lockstep. Correlations moved to highs we have never seen before. During April and early May, however, we have seen a steep recovery, with markets posting record returns. The question that remains, given the global uncertainty around the coronavirus is where to from here?

The way forward

The world is grappling with the worst plunge in economic output in living memory. The coronavirus pandemic, and the lockdowns to contain it, affect both supply and demand in the various sectors of the economy in unusual and different ways. While the scope and reach of the coronavirus crisis are unprecedented, we investigate a set of scenarios to cover the potential scenarios we face and what impact these will have on the economy and financial markets.

The question everyone is asking is: How long will it take to return to the pre-corona GDP peak once the economy has hit bottom? Our base case, says Teichgreeber, is a U-shaped recovery in which losses incurred in the first two quarters of 2020 would be recovered within two years. "This might sound pessimistic to some and optimistic to others. The risks to our view are significant on the up and the downside." Prescient outlines three potential scenarios and how these would take shape once the crisis passes and how they would impact investments. In addition, to the base case, the asset allocation team assesses a more optimistic scenario of a V-shaped recovery, as well as a more pessimistic scenario of an L-shaped recovery.

- **A U-shaped recovery – base case**
  The base case assumes a slow increase in new infections throughout May, but also a levelling off of new infections after that. Says Teichgreeber: "We are convinced that the peak of daily new infections, certainly in Developed Markets, is now largely behind us." This base case assumes a continued low mortality rate among the mostly elderly population. Should this be the case, Prescient expects a deep recession through the second and third quarters of 2020, based on an assessment of the virus's fundamental impact, market reactions and the significant drag on economic activity globally. After that, a slow and gradual recovery is expected over the following months. Capital markets are expected to price in this recovery beforehand.

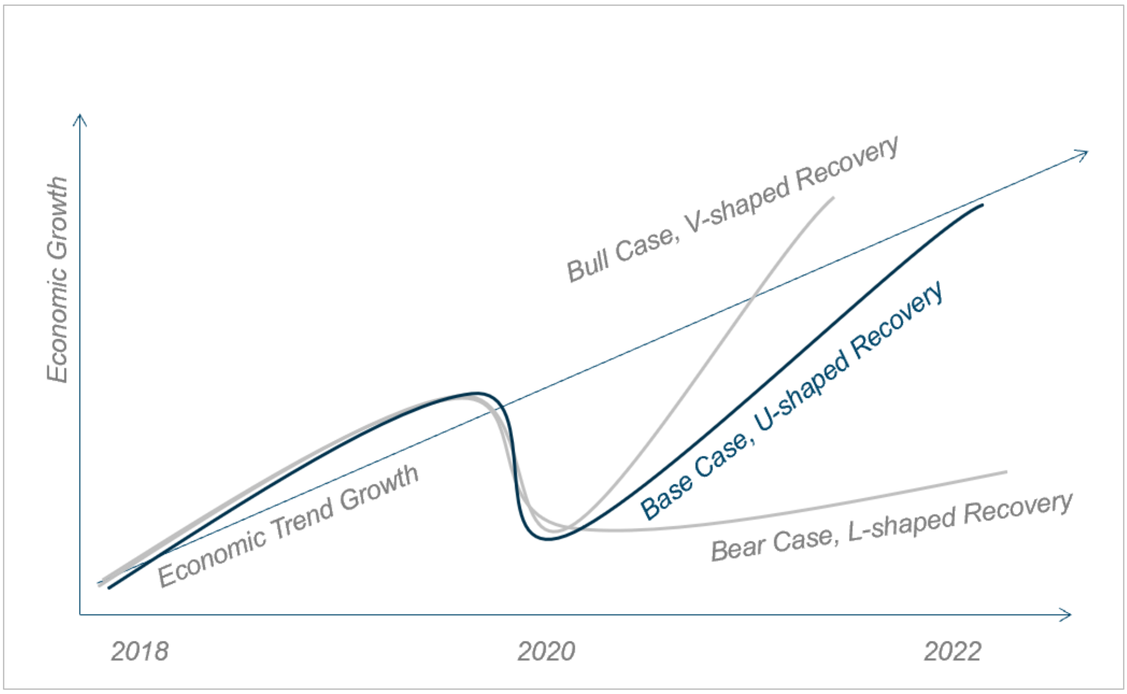
- **An L-shaped recovery – the bear case**
  The bear case assumes a continued spike in new infections in the US and a Trump Administration reluctant to deal with the problem more proactively. This scenario could lead to a second wave of lockdowns around the world, coupled with a fresh upsurge in infections hitting those countries that remain behind the trend on infections. A global liquidity crisis would ensue, followed by a more prolonged economic downturn. Risky assets would sell off further into a second dip, and markets would be rattled by more volatility, eventually finding a floor at a much lower level than seen in March 2020.

- **A V-shaped recovery – the bull case**
  Prescient's bull case is based on positive surprises, including a potential cure to the virus, more promising results in vaccine tests, national lockdowns already in place leading to low new infection rates while managing to minimise the extent of the economic slowdown. The improved global sentiment as a result of this more favourable prognosis leads to a sharp economic recovery, spurred by easy financial conditions and fiscal stimuli around the globe. Risky assets would return to their pre-crisis levels within the next 9 to 12 months in this recovery scenario.

In the chart below, Prescient illustrates these different scenarios and plots economic growth against trend growth. In the bear case, Teichgreeber doesn't expect a return to trend growth anytime soon because of the extent of the economic damage and long-lasting impact on global demand.

The base case assumes the economic trough is reached towards the back half of the year. However, Teichgreeber does expect the recovery to be gradual. "In terms of our base case, we estimate it will take two years to return to trend growth."

In our bull case, says Teichgreeber, we estimate a much quicker recovery. "We estimate that if a cure is developed soon, productive capital that has been switched off could be just switched on again. In this case, our estimated time to reach trend growth would be less than a year."



Source: Prescient Investment Management May 2020

Implications for asset class returns

Prescient outlines the potential impact these three scenarios could have on asset class returns in the tables below, with the disclaimer that they are based on our assumptions and thus subject to both upside and downside risks because outcomes during this crisis are particularly challenging to predict and subject to change.

Asset Class	Expected Return (ZAR)
SA Cash	Currently 3 to 4 more cuts priced into the money market, we expect this to hold, irrespective of market conditions.
SA Income	In our base case, we expect income assets to earn a positive carry of 1.5 percent vs SA Cash. In our bear case, we assume spread widening and therefore adjust the base case number down by 0.5 percent. In our bull case, we assume spread tightening and accordingly adjust the returns upwards by 0.5 percent
SA Inflation-Linked Bonds	We use a real yield starting point of 4.3 percent. We assume the real yield to stay flat in our base case, and we assume real yields to widen to 5.3 percent in a bear case and to narrow to 3.3 percent in our bull case. We expect inflation at 4.5 percent, irrespective of the scenario. The assumed duration of the Inflation Linked Bond Index is 8.8 years. We ignore any roll-down effects.
SA Bonds	We use a nominal yield starting point of 11.0 percent, and we assume this yield to come in by 1.0 percent in our base case, we assume the yield to widen by 3.0 percent in our bear case and narrow by 3.0 percent in our bull case. The assumed duration of the All Bond Index is 6.4 years.
SA Credit	We use income assets plus a spread of 3.0 percent as a starting point. In our base cases, this carry is earned on top of the income yield. In our bear case, we assume spread widening of 3.0 percent, in our bull case we assume spread tightening of 2.0 percent. We assume a spread duration of 5 years.
SA Preference Shares	We use a starting point of a nominal yield of 12.0 percent in the Preference Share Index. In our base case, we assume these yields to compress to 10.0 percent. Given the strong credit quality of our Big 4 Banks, we see a maximum dividend yield of 14.0 percent in the preference Share Index in our bear case. We see yields tightening back to 9.0 percent in a

	bull case. We estimated an interest rate duration of 8.0 years for the Preference Share Index.
SA Property	*With a dividend yield of 18.0 percent, our base case for Listed Property is that we should see these dividends coming through and that in return we don't see any recovery in the price. While very difficult to assess, we assume another 30.0 percent downside in a bear case and a 30.0 percent recovery in a bull case.*
SA Equities	*In South Africa, Equities have fallen below their long-term PE ratio but still are exposed to downside risks due to tighter financial conditions and a weaker economy globally. Our base case includes a recovery of 15.0 percent. Our bull case assumes a recovery back to the all-time highs. Our bear case shows another 20.0 percent downside from current levels.*
SA Alternatives	*We assume our Prescient Evolution Clean Energy and Infrastructure Debt Fund to return inflation plus 5.5 percent, irrespective of the scenario.*
Asset Class	***Expected Return (USD)***
DM Cash	*We assume US Cash to return 0.0 percent.*
DM Treasuries	*In our base case, we expect US interest rates to move higher moderately so that the total return for the next 12 months is zero. In our bull case, we expect interest rates to move back to 1.2 percent, leading to a negative total return for US Treasuries of ca. 1.5 percent. In our bear case, US Treasuries fall further towards zero. We don't expect significant negative interest rates in the States, so our total return would equate to about 2.5 percent.*
DM IG Corp	*Our starting point is a nominal yield of 2.8 percent. In our base case, we expect credit spreads to compress marginally and interest rates, in turn, to move higher modestly. We arrive at a total return estimate of 3.8 percent. In our bear case, we expect yields to move higher but spreads to widen. Spread widening will overcompensate the lower level of interest rates, which is why our total return assumptions go down to only 0.6 percent. In our bull case, in return, we expect spread tightening and slightly higher interest rates, the expected return goes to 5.8 percent. We assume a duration of 9 years for the index.*
DM HY Corp	*Our starting point is a nominal yield of 6.4 percent. In our base case, we expect credit spreads to compress marginally and interest rates, in turn, to move higher modestly. We arrive at a total return estimate of 7.4 percent. In our bear case, we expect yields to move higher but spreads to widen. Spread widening will overcompensate the lower level of interest rates, which is why our total return assumptions go down to -2.0 percent. In our bull case, in return, we expect spread tightening and slightly higher interest rates, the expected return goes to 12.5 percent. We assume a duration of 3.8 years for the index.*
DM Equities	*Our base case assumes that Equities continue their recovery, however, in a much shallower way than before. DM Equities once again screen expensive on a wide set of valuation metrics. We expect an additional 8.0 percent from current levels, assuming our base case of a U-shaped recovery materialises. For our bear case, we see significantly more downside for DM Equities, assuming an additional 27.0 percent drop. In case of a V-shaped recovery, our bull case, we expect DM Equities to return to their all-time high, which would mean an additional 13.0 percent from current levels.*
DM Small Caps	*We base our assumptions for Small Caps around our DM Equity assumptions. We are convinced that Small Caps have a higher beta to news around Covid-19. In a bear case, we expect 30.0 percent more downside, in a base case, we expect a 12.0 percent recovery, in our bull case, we expect a 22.0 percent recovery.*

DM *= Developed Markets*
EM *= Emerging Markets*

EM Equities	*As for DM Small Caps, we base our assumptions for EM Equities around our DM Equity assumptions. We are convinced that EM Equities have a higher beta to news around Covid-19. In a bear case, we expect 30.0 percent more downside, in a base case, we expect a 15.0 percent recovery, in our bull case, we expect a 25.0 percent recovery.*
EM Small Caps	*As for DM Small Caps, we base our assumptions for EM Small Caps around our DM Equity assumptions. We are convinced that EM Small Caps have a higher beta to news around Covid-19. In a bear case, we expect 35.0 percent more downside, in a base case, we expect a 20.0 percent recovery, in our bull case, we expect a 35.0 percent recovery.*

**** The forecasts above and in the graph below are based on reasonable assumptions and are not guaranteed to occur and provided for illustrative purposes only.***

Expected Returns, Local Assets, Rands	*Bear Case*	*Base Case*	*Bull Case*
SA Cash	4.5%	4.5%	4.5%
SA Income	5.5%	6.0%	6.5%
SA ILBs	0.0%	8.8%	17.6%
SA Bonds	-8.2%	17.4%	30.2%
SA Credit	-1.0%	9.0%	19.0%
SA Prefs	-4.0%	28.0%	36.0%
SA Property	-10.0%	20.0%	50.0%
SA Equities	-20.0%	15.0%	30.0%
SA Alternatives	10.0%	10.0%	10.0%

Expected Returns, Offshore Assets, Dollar	*Bear Case*	*Base Case*	*Bull Case*
DM Cash	0.0%	0.0%	0.0%
DM Treasuries	2.5%	0.0%	-1.5%
DM IG Corp	0.6%	2.8%	5.1%
DM HY Corp	-2.0%	7.4%	12.5%
DM Equities	-27.0%	8.0%	13.0%
DM Small Caps	-30.0%	12.0%	22.0%
EM Equities	-30.0%	15.0%	25.0%
EM Small Caps	-35.0%	20.0%	35.0%

* Given the 12m investment horizon, all views deviate from our long-term capital market assumptions

****Source: Prescient Investment Management May 2020***

Looking positively into a post-corona world

With lockdowns being eased globally step by step, Teichgreeber says many activities that were switched off will be switched on again in lockstep. Still, some activities will be restrained for much longer.

Fiscal stimulus, as well as monetary policy, will partly offset some of the hesitations to spend by consumers and companies. Financial conditions will ease. However, an event the scale of the coronavirus pandemic will almost certainly have profound economic, financial and political effects that will be felt for a long time.

Says Bastian: "We do, however, remain optimistic. A crisis can be the mother of invention. The coronavirus shock is likely to spur innovation in many fields. In the long run, the resulting jolt to productivity may be more profound than the drags."

Ends.

About Prescient:

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