RECONCILING THE MARKET REBOUND AND UNDERLYING ECONOMIC WEAKNESS

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When considering the current equity index levels alongside emerging economic numbers, there appears to be a somewhat contradictory trend between the two. Consider the FTSE/JSE Top 40 Index for instance. At the time of writing, it was trading at only c.12% below pre-Covid-19 highs, but at a healthy c.35% off the lows. When charted, this price action paints the almost picture-perfect V-shape which was previously dismissed as a distant improbability, given the double-edged nature of this pandemic.

On the one side is an immediate health crisis threatening the *lives* of all those falling victim to the disease. On the other side is a gradual but imminent economic crisis threatening the *livelihoods* of all of those who survive. Some market participants have estimated that the South African economy will shrink by as much as 10% this year, and that nearly one in three people within the labour force will be unemployed – not to mention those who will remain employed, but will have to get by on a fraction of their current wages. How is it then that within this fog of economic uncertainty, market indices have bounced this definitively?

Could it perhaps be that the market is perceiving the worst of the crisis to be behind us?

While many jurisdictions *are* moving towards reopening and allowing some resumption of economic activity, without an effective and widely available vaccine, the health crisis – which precipitated the economic crisis – remains far from over. An ever-present health problem poses the risk of a flare-up of new infections, which could trigger the suspension of the economy again. China is a good example of such a scenario, the city of Shulan is currently under a strict lockdown amid fears of a second wave of infections in the country.

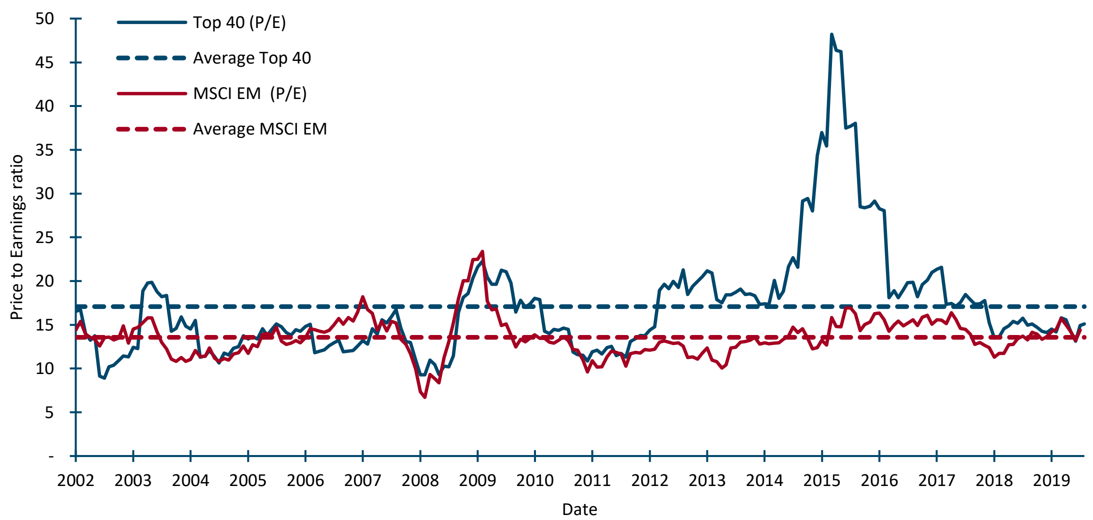
Furthermore, despite intense efforts to swiftly develop a vaccine, there's evidence indicating that medical professionals are still faced with more questions regarding the virus than answers. For example, it was initially reported that mostly advanced age groups with pre-existing health conditions seemed to be at risk. However, more recently, reports started emerging of children displaying rare Kawasaki-like disease symptoms linked to the coronavirus. Reports like these confirm just how little is currently known about the virus and suggest that we are in still in the infancy of this health crisis.

The argument that the worst is over is therefore somewhat hopeful.

Could it be that all the bad news is already incorporated in the price?

Free and efficient markets are forward-looking. This means asset prices reflect all the current and *expected* information about companies and their earnings. Perhaps the expected negative impact on earnings has been overstated and the markets are rallying to fair value. Let us consider the Top 40 Index again: it's currently trading at an earnings multiple of c.15 times. Since 2002, it has traded at an average multiple of c.17 times. Assuming the long-term average is fair, the current market level is implying a 12% *decline* in aggregate earnings over the next year. Given that the Gross Domestic Product (GDP) is forecasted to decline by a similar margin (c.10%) this year, this appears to be plausible.

The c.17 times average long-term multiple is however relatively more expensive than emerging market peers that have traded at an average of c.13 times over the same period. If we then assume that the average emerging market multiple is fair, the current index level is implying a 15% *increase* in earnings over the next year. Given that the compounded annual growth rate (CAGR) in aggregate Top 40 earnings over that period has been c.11%, a 15% increase in earnings over the next year seems a bit folly in this environment.



Sources: Bloomberg, Prescient, May 2020

The argument that all the bad news is priced in also seems to be somewhat porous.

Could it be that fiscal and monetary responses to the crisis are leading the charge?

Both government and monetary authorities around the world have taken targeted actions at historic magnitudes to soften the economic fallout. Locally, the South African Reserve Bank (SARB) has introduced a range of liquidity boosting measures over and above lowering interest rates by massive 250 basis points to take the repo rate to all-time lows (currently 3.75%). On the fiscal side, the government announced an enormous ZAR500 billion support package to help the most vulnerable members of society and businesses. While the significance of the response and the decisiveness of the leadership behind it have been commendable, lower interest rates and government spending on things like income replacement and loan guarantees should predominantly only give businesses and consumers a longer runway to *survive* – not necessarily to take off and *thrive*. It's a distinction that is as subtle as that between *relief* and *stimulus* measures.

In addition, the blueprint for this policy response comes largely out of the global financial crisis (GFC) from twelve years ago, but with two key differences. Firstly, the response was much quicker this time around. The government declared a national state of disaster a mere ten days after the first case was confirmed in SA. Four days after that, the SARB Monetary Policy Committee announced the first rate cute, and six days thereafter, the country was in hard lockdown. This promptness undoubtedly helped with arresting the economic deterioration and perhaps made it possible for a swift recovery to take place. However, the second distinction – and perhaps the more important – is that these actions come at a time where interest rates were already relatively low and government indebtedness was already relatively high. Going into the GFC, the repo rate was as high as 12% compared to 6.25% before this crisis; and the national debt to GDP was c.26% then, compared to c.62% now. The latter gives way to the argument that although these interventions were borne out of necessity from an economic standpoint, they can be seen as 'kicking the can down the road'. Market participants would be savvy to this – and it should incite a sense of caution when considering risky assets.

What then, if anything, can be made of these recent moves?

Well, the first point to acknowledge is probably the distinction between the market and economic performance. Notwithstanding their intricate ties, the two should be clearly delineated. The economy is considered strong when unemployment is low, production is high, and there is a healthy level of aggregate demand for goods and services. The market is considered strong based on the return of proxy market indices such as the Top 40 Index. Although the former should have a causal effect on the latter, the biased constitution of some market indices can blur this relationship. Approximately 56% of the companies that make up the Top 40 Index by weight derive their earnings outside South Africa. These earnings are therefore not driven by the same factors that drive the domestic economy. In fact, this can be taken a step further by highlighting that such earnings are relatively inflated in softer economic conditions due to the weaker domestic currency.

The second point to acknowledge is that in this crisis, as is the case in any crisis, there will be benefactors and beneficiaries. The proliferation of technology-based methods to get through everyday tasks without physical contact is irreversible, and counters that offer such services have essentially been catapulted forward several years. It's a benefit that has come at the expense of traditional brick-and-mortar sectors. If economic output is a function of capital, labour and technology – as is the case under the neoclassical economics framework, the advancement and adoption of new technology is the only way to achieve permanent growth, albeit at the expense of other sectors.

A third and final point to consider is the market expectation that central banks will be there to offer further relief to the markets, despite the consequences down the road. If the markets believe that central banks will continue to adopt the ‘in the long run we are all dead’ approach and step on the accelerator whenever markets turn bearish, the underlying economics will remain inconsequential and markets will continue on their bullish run until inflation overshoots and the monetary authorities eventually have no choice but to lift their foot off the loud pedal.

Ends.

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