Cinnabar Monthly Insight: May 2020

A massive recovery in equity markets has occurred over the past couple of months. The dramatic sell-off to mid-March has all but been eradicated. The FTSE/JSE All Share Index (ALSI) fell 33% from the beginning of the year to its lowest point in March. Since then the market has rallied over 41%, resulting in it being only 4.5% down for the year. Similarly, the US S&P 500 has erased all losses for the year through a 39% rally after falling 31% to the 23rd of March.

These market recoveries have been rapid relative to past examples. It would appear that we have seen a V-shaped stock market recovery which was unexpected. Most commentators had bet on a U-shape recovery, implying an extended-term rally. One must, however, acknowledge that these recoveries are limited to equities and not to their respective economies. Economies worldwide are in a recession, and none are likely to recover this year.

The market correction earlier this year was fairly consistent across most companies on the JSE – there were not many places to hide. In contrast, the recovery has been dominated by far fewer number of businesses. Only ten companies of the 144 in the ALSI have contributed more than 0.1% return to the index year to date. Without the likes of Naspers (and Prosus) and the resource companies (BHP, Sibanye, Anglogold, Goldfields) the rally would not exist. Financials are down over 22% year to date, and they account for many of the blue-chip SA businesses.

In the US, the Information Technology (IT) sector has dominated the recovery. IT now accounts for 25% of the S&P 500 by market cap. The six largest companies, Microsoft, Apple, Amazon, Facebook and Alphabet (Google) account for 18.6% of the index of 500 companies. The IT sector returned 11.7% return year to date, far more than the second-largest industry, Health Care which only produced 2.6%. As in SA, the big losers this year have been Financials and Energy, down 12.4% and 21.1% respectively.

In recent days there have been some massive price recoveries in companies that were oversold. Hertz, the car rental company, is up 650%, after entering voluntary bankruptcy. There is a concern now that equity markets are currently trading purely on sentiment and not on valuation, as earnings have predictably been terrible for the 2nd quarter of 2020. Usually, fundamentals like this would cause prices to fall. However, the massive stimulation from the US government and the Federal Reserve has excited investors. The market appears to be looking well into the future, well after Covid-19 has been beaten.

One could argue that there are still legs to the recovery, particularly in the stocks that have been decimated but will recover when the economies of the world open up further. Oil companies, leisure and tourism companies and banks will still exist – at least the better quality ones – and these industries will rebound. At the same time, it is difficult to see the tech stocks falling; rather, their returns could be more muted given the surge they have already enjoyed. If the recovery of jobs continues to be positive, this could bode well for the US economy and market. Here in SA, we are less confident. We see more pain for SA Inc. companies and expect that the economy will not recover nearly as quickly. The ALSI may continue to go up, but we believe this will be driven by the dual-listed rand hedge stocks and perhaps the resource businesses. SA banks may be well-run blue-chip companies; however, the economy is not supportive enough to see a rebound. For that matter, we remain positioned towards rand hedges and offshore equity.

Market Update

United States of America

A second GDP estimate confirmed the US economy contracted in the first quarter at the sharpest rate since 2008, shrinking by an annualized 5%. In May, US Manufacturing PMI came in at 39.8, the second-steepest deterioration in manufacturing operating conditions since April of 2009, and above a record low of 36.1 in April. April saw the lowest level of inflation since October 2015 after a 32% drop in gasoline prices helped ease inflation to 0.3% from 1.5% in March. With Americans forced to stay home and businesses required to close, retail sales in the US sank 16.4% from April. Government social benefits paid to individuals as part of the federal economic recovery programs helped personal income in the US to jump 10.5% month-over-month in April. However, the lockdown has plunged US personal spending by 13.6% month-over-month in April. With the labour force participation rate in the United States increasing to 60.8% in May, the US economy ended the month creating 2.5 million jobs, raising hopes that the economic damage caused by the coronavirus pandemic may be less harmful than feared. The unemployment rate fell to 13.3% from 14.7% as firms in the food, construction and health care sectors took on staff.

UK

The UK economy shrank at the sharpest pace since the global financial crisis in the first quarter, decreasing by 1.6% year-on-year, a 5.7% drop from a year earlier in March. The decline is mainly due to lower consumption, investment, and exports amid social distancing restrictions. The downturn in the second quarter will be significantly steeper when the full impact of the national lockdown is felt. In April Britain’s retail sales decreased to 22.60%, its biggest slump in retail sales on record, while consumer price inflation slowed to 0.8% year-on-year from 1.5% in the previous month as energy price caps caused decreases in housing and utility prices. In the three months to March, UK unemployment improved to 3.9% from 4% in the previous period, however, April saw 2.097 million people claiming unemployment related benefits in the UK - an increase of 856,500 as the effects of the COVID-19 pandemic were felt. The economy now appears to have bottomed out; manufacturing PMI stood at 40.7 in May up from 32.6 in April. The gradual easing of lockdown measures should support a recovery in domestic economic activity.

Europe

The Gross Domestic Product (GDP) in the Euro Area contracted 3.10% in the first quarter of 2020 over the same quarter of the previous year, as lockdown measures adopted in March froze business and household activity. With the prolonged containment measures, which are now gradually being lifted, the second quarter is set to deal an even harder blow. Euro zone’s unemployment rate rose slightly in April to 7.3% with 12 million people out of work. May’s business confidence indicator decreased from -1.99 to -2.43; however, consumers were somewhat more optimistic, with consumer confidence in the Euro Area confirmed at -18.8 in May 2020, up from -22. Moreover, overall economic sentiment also improved with the economic sentiment indicator increasing to

67.5 in May from its record low of 64.9 in the previous month. Eurozone Manufacturing PMI came in at 39.4 in May above April's all-time low of 33.4. With a long way to go in recovery, the European Central Bank said it would increase the size of its bond-buying programme by €600 billion to €1.35 trillion and extend the programme until June 2021. The move will keep borrowing costs low for countries and firms as they face budget deficits and the onset of a recession.

Japan

The Japanese economy shrank 0.6% in the first quarter, compared with a market consensus of a 0.5% decline. This was the first recession since 2015, as the COVID-19 crisis took a massive toll on activity and demand. In April, Japan's consumer price inflation sank to 0.1% YoY, its lowest level since November 2016, while the unemployment rate edged up to 2.6% from 2.5%. In May, manufacturing PMI came in at 38.4, pointing to the steepest contraction in the sector since March 2009; however, consumer confidence increased to 24 from 21.6. The Bank of Japan left its short-term interest rate unchanged at -0.1% during an emergency meeting on the 22nd of May but launched a new lending program worth JPY 30 trillion to support the economy. To help businesses and consumers cope, the government rolled out stimulus worth roughly 20% of GDP in April, and in May the cabinet approved additional stimulus which doubled the amount previously provided, bringing the total to 40% of GDP.

China

During April, China's annual inflation rate fell to 3.3% from 4.3% in the previous month, and unemployment increased to 6% from 5.90%. Numbers for May showed China's trade surplus widened sharply to USD 62.93 billion, up from USD 41.20 billion in the same month the previous year, as the drop in imports exceeded the fall in exports amid growing tensions with the US. Meanwhile, the economy is slowly recovering from the coronavirus-induced economic shock in the first quarter, when GDP shrunk for the first time in decades. China's General Manufacturing PMI came in at its highest reading since January, increasing to 50.7 in May from 49.4 and beating market consensus of 49.6. On the political front, Premier Li Keqiang stressed the importance of stabilizing jobs and alleviating poverty. The government unveiled a larger fiscal deficit target for this year to stimulate economic growth and support employment. According to analysts, the size of the total fiscal stimulus will amount to around 7% of GDP. That said, M2 money supply, which is a broad measure of money supply that covers cash in circulation and all deposits, increased by 11.1% from a year earlier in April. However, retail sales remained weak in April, suggesting that private consumption is faltering.

South Africa

Troubles at the state-owned utility provider Eskom; a contraction in manufacturing output for January and February, and the Covid-19 related lockdown measures in March are some of the forces which will contribute to a likely economic recession for the South African economy in the first quarter. For the second quarter, the economy is expected to deteriorate even further. Strict containment measures have hammered investment activity and private spending, with business confidence at record lows in April. With the economy gradually shifting to alert level 4, partially reopening the economy, South Africa's Absa Manufacturing PMI increased to 50.2 in May from 46.1 in the previous month. The reading pointed to the first expansion in the country's manufacturing sector since last July. However, policymakers expect a 7% GDP contraction in 2020, even if lockdown restrictions ease in the next months. The South Africa Reserve Bank slashed its key repo rate by 50bps to 3.75% during its May meeting. On the political front, concerns over debt sustainability due to a ballooning fiscal deficit may prompt the country to seek additional IMF support to prevent a liquidity crisis.

Sources: New York Times, Trading Economics, Bloomberg, IMF, Cinnabar Investment Management, The Economist

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As At 31 May 2020	YTD	Last Month	Last Quarter	1 Year	2 Years	3 Years	5 Years	10 Years
South African Asset Classes								
STeFI Call Deposit ZAR	2.4	0.4	1.3	6.3	6.4	6.5	6.6	5.9
Beassa ALBI TR ZAR	1.6	7.1	0.4	6.4	7.1	8.2	7.7	8.5
FTSE/JSE SA Listed Property TR ZAR	-44.9	-0.8	-32.6	-45.9	-28.2	-21.6	-11.4	3.5
FTSE/JSE All Share TR ZAR	-10.1	0.3	0.5	-6.0	-1.9	1.3	2.5	9.7
FTSE/JSE Market Capitalisations								
FTSE/JSE Small Cap TR ZAR	-29.0	-3.2	-17.5	-30.9	-22.8	-15.5	-8.2	5.2
FTSE/JSE Mid Cap TR ZAR	-29.9	0.2	-17.0	-20.4	-10.6	-6.5	-2.5	7.3
FTSE/JSE Top 40 TR ZAR	-6.9	0.4	3.1	-2.8	0.0	2.8	3.2	10.0
FTSE/JSE Sectors								
FTSE/JSE Ind/Financials TR ZAR	-34.4	-3.2	-23.5	-36.3	-19.7	-10.4	-6.1	7.1
FTSE/JSE SA Industrials TR ZAR	-1.4	-1.8	4.3	-0.3	-1.8	-1.6	1.8	13.5
FTSE/JSE SA Resources TR ZAR	-3.0	5.6	13.7	13.8	15.2	19.9	7.0	3.6
Global Equities in ZAR								
FTSE/JSE All Share TR ZAR	-10.1	0.3	-21.4	-6.0	-1.9	1.3	2.5	9.7
MSCI World Free GR USD	16.0	0.7	1.0	30.0	22.4	17.3	14.6	19.4
MSCI EM GR USD	6.0	-3.2	-2.4	16.2	10.7	10.4	9.0	11.7
S&P 500 TR USD	19.8	0.6	2.7	36.6	27.7	21.4	18.3	22.9
FTSE 100 TR GBP	-3.8	-2.8	-9.0	4.7	5.4	5.4	4.5	12.8
Nikkei 225 Average TR JPY	18.8	3.2	3.9	32.5	20.2	17.6	14.4	18.1
SSE Composite PR CNY	14.9	-5.5	13.1	15.1	7.2	5.3	-4.9	9.2
Global Equities in USD								
FTSE/JSE All Share TR ZAR	-28.7	4.5	-38.4	-22.3	-16.8	-8.0	-4.9	1.0
MSCI World Free GR USD	-8.0	4.9	-20.9	7.4	3.8	6.5	6.4	9.9
MSCI EM GR USD	-15.9	0.8	-23.6	-4.0	-6.2	0.2	1.3	2.8
S&P 500 TR USD	-5.0	4.8	-19.6	12.8	8.2	10.2	9.9	13.2
FTSE 100 TR GBP	-23.7	1.3	-28.7	-13.5	-10.7	-4.4	-2.9	3.8
Nikkei 225 Average TR JPY	-5.8	7.5	-18.7	9.4	1.9	6.7	6.3	8.7
SSE Composite PR CNY	-8.8	-1.6	-11.4	-4.9	-9.1	-4.4	-11.7	0.5
Commodities in USD								
S&P GSCI Copper Spot	-13.0	3.6	-4.7	-7.9	-11.5	-1.8	-2.2	-2.5
LBMA Gold Price PM USD	14.1	1.5	7.4	33.4	15.1	10.9	7.7	3.7
Oil Price Brent Crude PR	-46.5	39.8	-30.1	-45.2	-32.5	-11.1	-11.6	-7.2
LBMA Platinum PM PR USD	-13.3	7.6	-5.3	4.3	-4.6	-4.5	-5.8	-6.1

Source: Morningstar Direct, annualised returns are presented for periods longer than 1 year.

	2020/05/31	YTD	Last Month	Last Quarter	1 Year	2 Years	3 Years	5 Years	10 Years
Currencies									
US Dollar	R 17.62	-20.3%	4.3%	-10.8%	-17.4%	-15.2%	-9.2%	-7.1%	-8.1%
Euro	R 19.42	-18.8%	1.2%	-12.0%	-15.7%	-13.0%	-8.8%	-7.2%	-6.9%
Pound Sterling	R 21.79	-14.9%	6.4%	-7.8%	-15.8%	-12.0%	-7.9%	-3.2%	-6.6%

Source: Quandl as at 31 May 2020.

Sources: New York Times, Trading Economics, Bloomberg, IMF, Cinnabar Investment Management, The Economist