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THE CORONAVIRUS: ARE WE HEADING TO A GLOBAL RECESSION?

Global equity markets and commodity prices are experiencing one of their worst drawdowns in the past 20 years. The recent 15% drop in global equities from their peak has resulted in about $6 trillion being wiped off the market capitalization of global equities, with the MSCI All World Index down 11% year to date. Slow output normalization in China with a broadening outbreak globally of the Coronavirus with 58 countries now reporting infections have motivated large cuts to first quarter GDP growth projections. This has also lead to large cuts in second quarter GDP growth projections as the epicentre of the epidemic has spread from China to Europe and other parts of SE Asia with the USA becoming the newest focus of the COVID 19 crisis, despite a very low number of actual cases (60). Markets are now meaningfully starting to discount a global recession as the very weak data out of China points to a meaningful contraction in the Chinese economy in the first quarter of 2020. Already the consensus 2020 S&P EPS has been cut from $180 to $174.

Markets hate uncertainty and some stability in risk assets is only likely to emerge once there is a definite peak in US/European infection rates and a slow decline to a single digit pace. In the meantime, several governments are stepping up their easing efforts both monetary and fiscal, particularly in SE Asia. Fed Fund futures rates are pricing in more than 60 basis points in Fed rate cuts by mid-year 2020. US long bonds have hit new all-time lows surpassing the lows in 2016 with the US 10 year at 1.25%. It is of course possible that the Coronavirus delivers the world's first pandemic induced recession, but history and containment measures together with several stimulatory measures suggest that the economic impact should be limited to the first half of 2020 with a rebound in the second half of 2020 a likely scenario. For the bears, it is worth mentioning that a full-blown recession normally results in a drawdown in the S&P of 30% which would imply still big equity downside from here.

For our readers interested in the recent budget speech delivered by SA Minister of Finance, Tito Mboweni:

The South African budget speech delivered on the 26th February 2020 revealed some real surprises with the National Treasury effectively calling it quits (for the time being) on trying to reduce the ever growing massive fiscal deficits by increasing a wide range of taxes such as personal income taxes, VAT, transfer duties, wealth taxes, dividend taxes and corporate taxes. Instead, the focus has shifted for the first time in 5 years to reducing government expenditure and specifically government employee compensation. We would argue that this is the first hint of a break in the conciliatory style/manner of the Ramaphosa administration as they are effectively tackling Cosatu (SA Trade Union Federation) head on over the last remaining year of a three year existing wage package which is only due to end in 2021 but National Treasury has pencilled in some R32bn of savings in 2020/2021 fiscal year.

This position together with some of the moves afoot at Eskom and the beginning/opening of increased competition to Eskom's power generation monopoly and a more aggressive move away from coal has put it on a collision course with its biggest backer - organised Labour. Should no savings come from a reduction in state employee wages, the budget deficit is likely to be close to 8% of GDP in 2020/2021. We believe that Moody's will keep SA on credit watch in March 2020 and wait to see if wage negotiations bear any fruit (they have waited so long and this is to definitively give the Ramaphosa administration time to deliver reforms). Should there be no reductions in the wage bill in the current year, the junk status downgrade will materialize quickly. We also believe this temporary reprieve from Moody's will open the way for the SARB to cut rates by another 25 basis points in March 2020 as many other emerging market Central Banks loosen policy on the back of the slowdown in growth due to the Coronavirus outbreak. SA Incorporated domestically focused listed equities are at multi–year lows using valuations and prices as yardsticks and investor positioning both locally and internationally is hardly bullish. Should there be no signs of an improvement in the macro-economic environment in SA in 2020 due to a pick up in the reform pace/agenda affecting issues such as the reliability of electricity and reigning in the fiscal deficit, it is hard to see investors positioning themselves more positively in SA Incorporated stocks for an eventual turnaround in domestic earning prospects.

A host of recent results from blue chip JSE domestically focused businesses including the likes of Bidvest, AVI, KAP, Curro, Woolworths, Tigers and Redefine Properties have revealed an evolving earnings recession in SA. It is worth remembering that it was the hint of spending and tax reforms in Brazil in 2018 that caused a major turnaround in the fortunes of the Brazilian Bovespa and made it one of the best performing emerging stock markets in 2018/2019.

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