ECONOMIC OVERVIEW

QUARTER 4 2020

MENTENOVA

Contents

EXECUTIVE SUMMARY

In the final quarter of 2020, the world faced another (more worrying) wave of COVID-19 infections, leadership contests and changes, and notable scientific feats. While the number of COVID-19 infections reached record highs, sending many countries back into hard lockdowns, positive progress on the vaccine front offered hope that some relief from the pandemic may be on the horizon. This served to bolster global markets in Q4 and underpinned risk sentiment into year-end, seeing most global equities and risk assets end the year firmly in the green.

Politics remained a major theme in the fourth quarter as the world observed the outcome of the highly anticipated US election. While Joe Biden was victorious, President Trump refused to concede, keeping political tensions elevated into year-end. Now, as we head into a new year, US politics are once again in sharp focus following protest action at the Capitol building in Washington DC, which led to the death of five individuals and a decision by the House of Representatives to impeach Trump for the second time during his presidency. Meanwhile, the outcome of the Georgia Senate run-off has bolstered expectations that another large US fiscal stimulus package is in store for the country this year, although the slim majority win by the Democrats means that Biden will still require the backing of the Republicans to move ahead with his policy plans.

Global monetary policy remained broadly accommodative in the final quarter of the year as major developed market central banks kept interest rates near zero and continued to expand their balance sheets, with the US Federal Reserve's assets valued at $7.4 trillion by the end of the year. This is a pattern that is expected to prevail in the early part of 2021 as monetary policymakers attempt to spur economic recovery and make way for ongoing fiscal support.

The improved outlook in the fourth quarter, as vaccination plans and programmes gained momentum, sparked a rotation into cyclical counters, with value stocks outperforming their momentum and growth counterparts over the quarter. With low exposure to the sectors that benefitted from the pandemic shifts, cyclical stocks were particularly hard hit in 2020. However, investors are now finding value in these sectors and this rotation is likely to continue in 2021 if the outlook continues to improve. Yet, having said that, the near-term outlook remains highly uncertain as countries across the globe continue to struggle with rising numbers of COVID-19 cases and harsher restrictions on activity. The race to secure and roll out vaccines will be a top priority for governments in the coming months. How successful countries are in taming the COVID-19 beast will be a major determinant of the pace of global economic recovery following a turbulent 2020 and, by extension, how financial markets perform.

On the domestic front, South Africa, too, carried the burden of soaring numbers of infections and new lockdown measures into year-end, placing further pressure on the domestic economy. Effectively managing the second wave of infections in the coming weeks and months will be crucial if further economic devastation is to be avoided after last year's near economic collapse. Beyond this, however, structural reforms are still desperately needed to set the domestic economy on a more sustainable path.

Downgrades by Moody's and Fitch in November last year served as a stark reminder of the fiscal challenges that South Africa faces. Investors will therefore be listening carefully to the annual budget in February for insights into how the government plans to address the ballooning budget deficit and soaring debt levels.

ECONOMIC OVERVIEW

COVID-19 SECOND WAVE PICKS UP PACE IN Q4

Despite showing signs of slowing in the third quarter, the COVID-19 pandemic took centre stage again in the final quarter of 2020 as the world grappled with a fresh wave of infections, while efforts to approve and start distributing COVID-19 vaccines were ramped up dramatically. By the end of December, the average daily number of new cases globally had soared to approximately 650,000 – in sharp contrast to a daily average of just over 280,000 in September.

Figure 1: Average daily new COVID-19 cases since June 2020: Global total

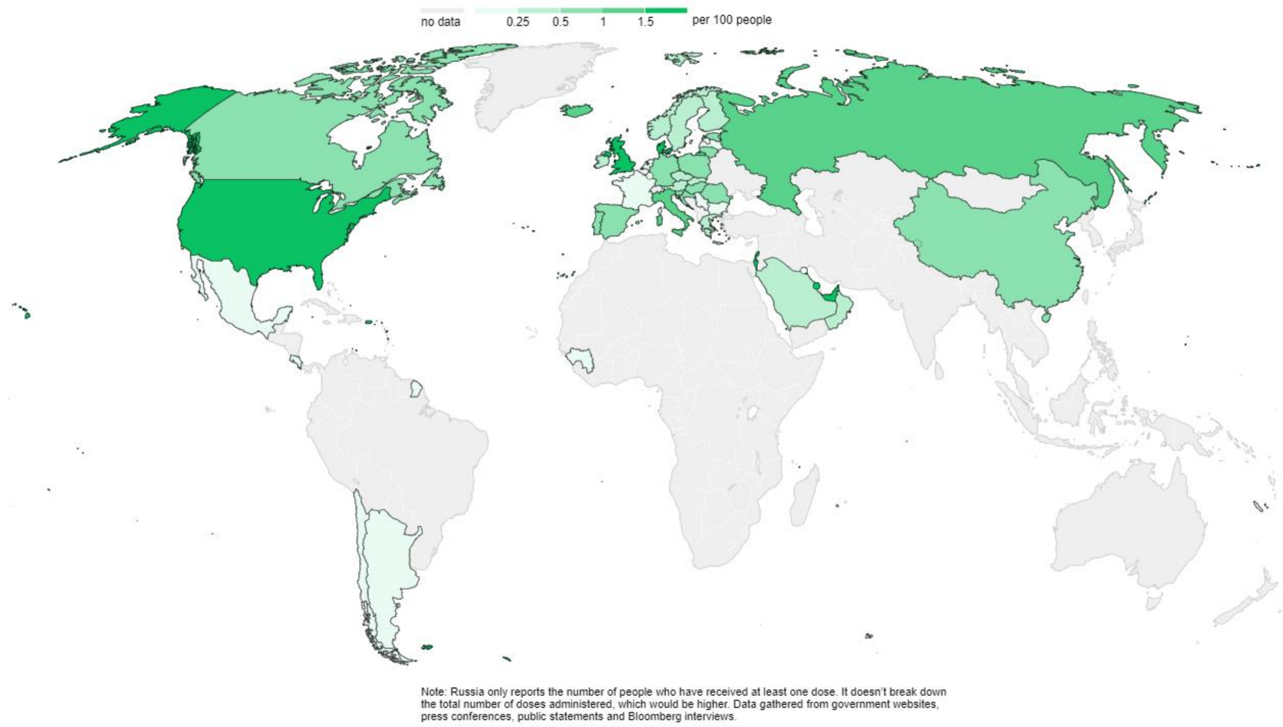
Average daily new cases	June	July	August	September	October	November	December
Global	**143 016**	**230 796**	**254 229**	**283 065**	**389 461**	**572 937**	**651 278**
Argentina	1 589	4 089	7 304	11 109	13 417	8 587	6 483
Australia	24	302	275	43	16	11	17
Brazil	29 573	40 659	40 187	30 089	23 376	26 676	43 229
China	21	93	73	21	26	51	99
Germany	400	483	1 110	1 604	7 706	17 937	22 278
India	13 162	35 823	64 361	87 381	60 371	42 624	25 931
Italy	253	224	699	1 522	11 760	30 737	16 310
Japan	62	568	1 037	507	572	1 587	2 802
Mexico	4 514	6 405	5 643	4 789	5 863	6 070	10 291
Russia	8 036	6 178	4 966	5 947	14 047	22 322	27 465
Saudi Arabia	3 519	2 745	1 286	628	409	336	174
South Africa	3 951	11 031	4 318	1 577	1 649	2 152	8 618
South Korea	45	48	189	124	89	267	875
U.K.	923	632	1 074	3 925	18 031	20 631	27 822
U.S.	28 141	62 164	47 361	40 104	60 945	147 286	207 336

With the benefit of hindsight, global authorities responded more cautiously to the new wave of infections, attempting, as far as possible, to avoid the level of economic destruction resulting from the initial round of lockdown restrictions. However, new variants of the virus and surging infection rates have forced many countries back into tight lockdowns, which inevitably continue to suppress economic growth.

VACCINE RACE TO DOMINATE IN 2021

Despite the year starting with new lockdown measures, global investors have been emboldened by the speedy development and distribution of COVID-19 vaccines by several global manufacturers, which offer the world hope that there will soon be some relief from the worst pandemic in a century. According to the latest data collected by Bloomberg, more than 29 million doses have already been administered in 43 countries.

Figure 2: World map of COVID-19 vaccinations



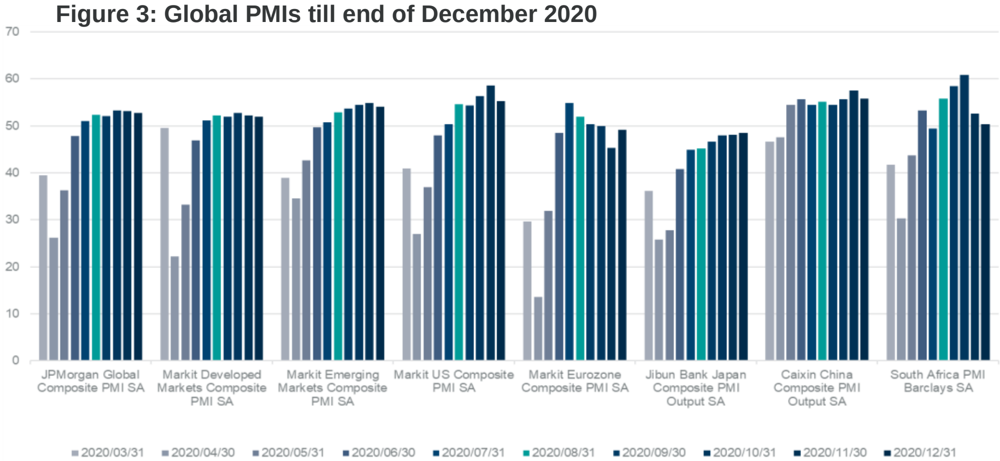
Source: Bloomberg

The extraordinarily quick pace at which vaccines have been developed is promising. However, factors such as cost and storage requirements are expected to be barriers for poorer countries and far-flung territories. Whereas a country like Canada has secured three times the doses it needs to vaccinate its population, many emerging markets, including South Africa, have only secured a small proportion of its total requirements. This heralds an uneven rollout of vaccines across the globe.

OPTIMISTIC OUTLOOK FOR 2021… BUT RISKS ABOUND

In its latest, semi-annual Global Economic Prospects report, The World Bank said that it expects global GDP to expand by 4% this year following an estimated 4.3% contraction in 2020 – the highest forecast for global growth in more than a decade, albeit from a low base. This more optimistic outlook is supported by high-frequency economic data out of the developed world, which continues to point to a recovery in sentiment and activity off 2020 lows.

Figure 3: Global PMIs till end of December 2020

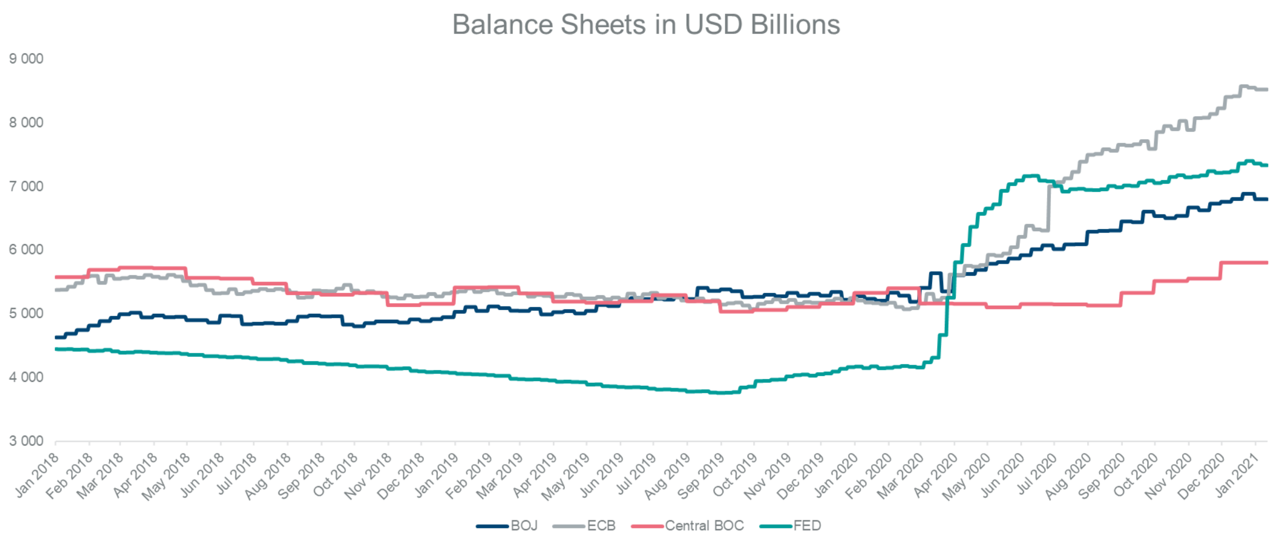


The World Bank did, however, cite an "exceptional level of uncertainty" surrounding the near-term outlook, with countries' ability to contain further virus surges and secure enough vaccines for their populations expected to have a significant impact on the pace of global economic recovery in the coming quarters.

MORE STIMULUS

Supporting the more optimistic macro outlook for 2021 are expectations that both monetary and fiscal policy will remain loose following last year's stimulus response to the pandemic, with the US Federal Reserve expected to keep rates near zero and continue its asset purchases. In 2020 alone, the US Fed almost doubled the size of its balance sheet, with the value of total assets rising from approximately $4 trillion to $7.4 trillion, reflecting the central bank's aggressive response to the pandemic. Other major central banks followed suit, with positive liquidity injections from the ECB, the Bank of Japan and the Central Bank of China recorded throughout the fourth quarter.

Figure 4: Size of central banks' balance sheets at beginning of January



While a strong economic rebound in the coming quarters could in time lead to policy normalisation, the fragile state of the global economy, soft inflation and the need to keep borrowing costs low to allow ongoing fiscal support all point to monetary policy remaining broadly accommodative for the foreseeable future. This view is supported by the US Federal Reserve's recent statement that it intends to continue with its accommodative policy until "substantial progress" is made towards achieving its employment and inflation goals.

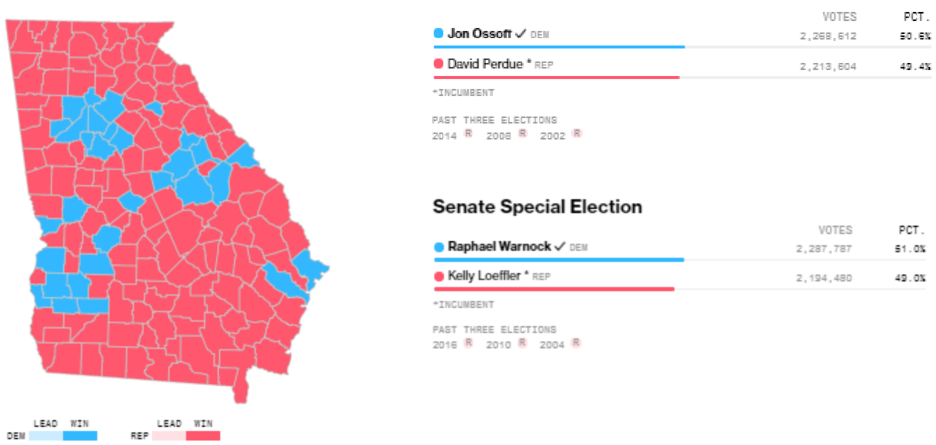
Aided by this loose monetary policy, fiscal authorities are also likely to continue offering fiscal support as pressure mounts for further support to stem the fallout from the recent resurgence in COVID-19 cases. In Europe, for instance, governments are under increasing pressure to support companies and workers with fiscal aid packages, while in the US, the government is planning further fiscal support in the coming months following the signing of a US$900 billion relief bill in December.

US POLITICS IN FOCUS

Following a hotly contested election in November, US politics have dominated the news in recent months as the transition to a new administration began to get under way. The transition, though, has been anything but smooth as Trump and his supporters have not been willing to accept defeat, often using dangerous rhetoric to dispute the outcome and effectively keep the country divided. The cauldron of discontent eventually boiled over on the 6th of January when Trump supporters stormed the Capitol building to protest, and interfere with the formal ratification of, the election results. This event, together with Trump's second impeachment by the House of Representatives, has again heightened political tensions and uncertainty in the US.

Notwithstanding the political turmoil in the US, President-elect Joe Biden is expected to begin his presidency in the third week of January and finalise his choices for key Cabinet posts. From a fiscal standpoint, Biden has called for "trillions of dollars" in additional fiscal stimulus, although the slim majority secured by the Democrats in the Georgia Senate run-off earlier in this month means that Biden will need the support of the Republicans in the Senate to implement his policy plans.

Figure 5: Georgia Senate run-off results



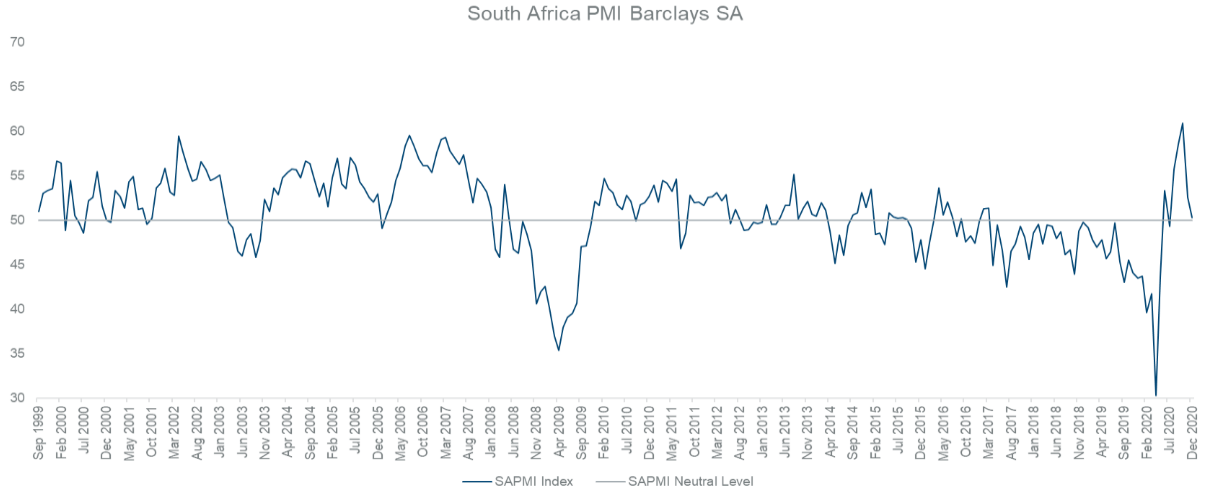
Source: Bloomberg

DOMESTIC CHALLENGES LOOM LARGE

Finally, turning to the domestic environment, South Africa faces a myriad of challenges as we head into 2021. While dealing decisively with the second wave of infections in the country is a priority at present, addressing structural issues in the economy and the ballooning fiscal deficit, curtailing corruption and securing enough vaccines to inoculate the entire population are some of the major challenges that lie ahead.

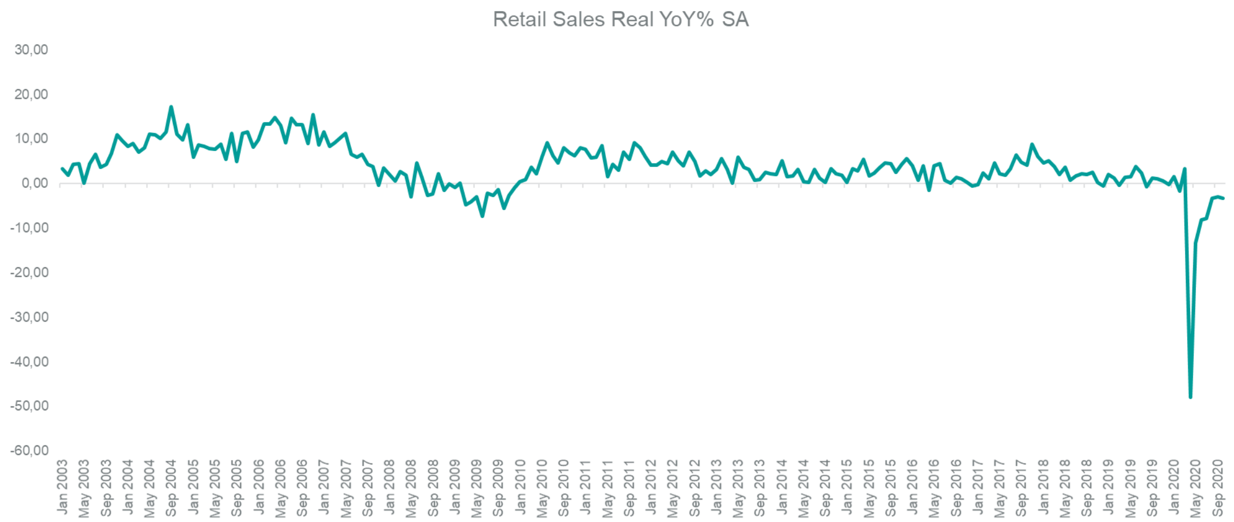
The South African economy was one of the hardest hit in 2020, and ramped-up lockdown restrictions over the festive season are expected to have dealt the economy yet another severe blow. This is reflected in the latest PMI data, which shows that manufacturing conditions in December dropped to the lowest level in five months, returning to neutral levels from the expansionary territory in the months prior to that.

Figure 6: SA Barclays PMI to end of December 2020



While consumption has gradually improved off 2020 lows, the fallout from the pandemic-induced lockdowns is likely to keep local consumers and households under pressure as 2021 unfolds. A recovery to pre-COVID levels appears some way off still, with a tightening of lockdown arrangements over the festive season pointing to a weak start to the year for the local economy.

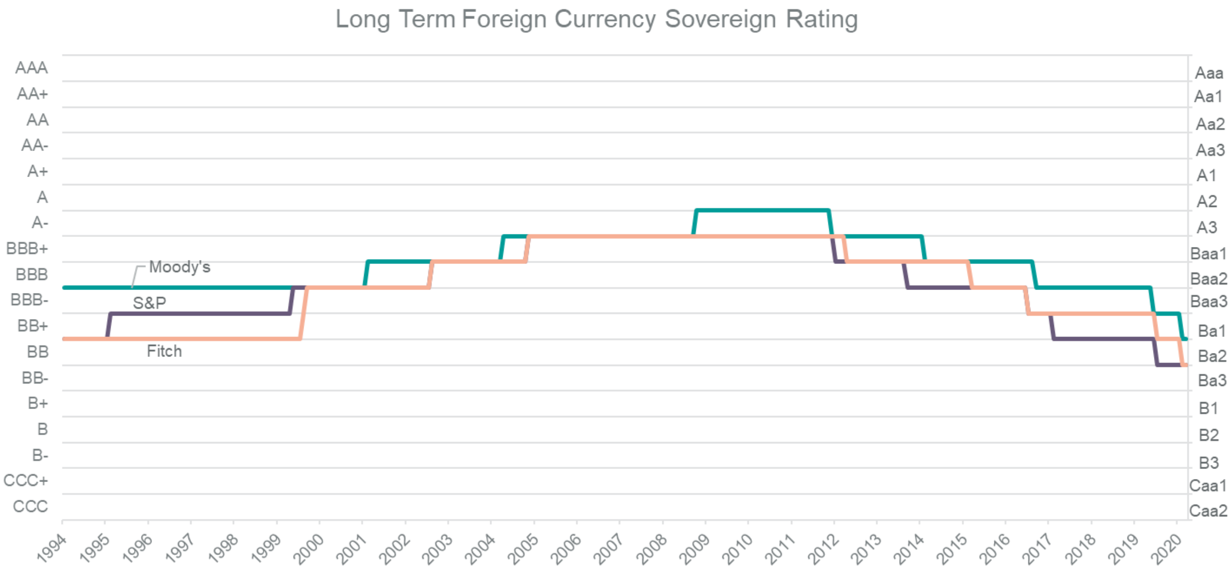
Figure 7: SA retail sales to end of October 2020



In line with the rest of the world, South Africa must act swiftly to secure enough vaccines to offer the country some relief from the pandemic. President Ramaphosa's recent announcement that the country has secured 20 million doses of the vaccine is encouraging. Yet the country's reported vaccination strategy has attracted both scrutiny and criticism in recent weeks, with details of the vaccine procurement plan, in particular, being scant at this stage.

Tackling the impact of COVID-19 is of course a priority for the government this year. However, implementing long-overdue structural economic reforms and reining in the budget deficit are likely to remain top of mind for investors and credit rating agencies alike. Government needs to address these if the country is to avoid further credit rating downgrades. Moody's cut South Africa's credit rating to Ba2 (two notches below investment grade) with a negative outlook, while Fitch lowered the country's rating to BB- (three notches below investment grade) with a negative outlook. This suggests that the country's credit rating score risks remaining skewed downwards.

Figure 8: SA long-term foreign currency ratings by Fitch, Moody's and S&P



MARKET OVERVIEW

Global equities made solid gains in Q4, driven by the news of effective vaccines, which lifted hopes of a global recovery in 2021, and the US presidential election results. Emerging markets generated the strongest returns, supported by the rally in commodity prices and US dollar weakness.

Figure 9: Performance of major indices and asset classes

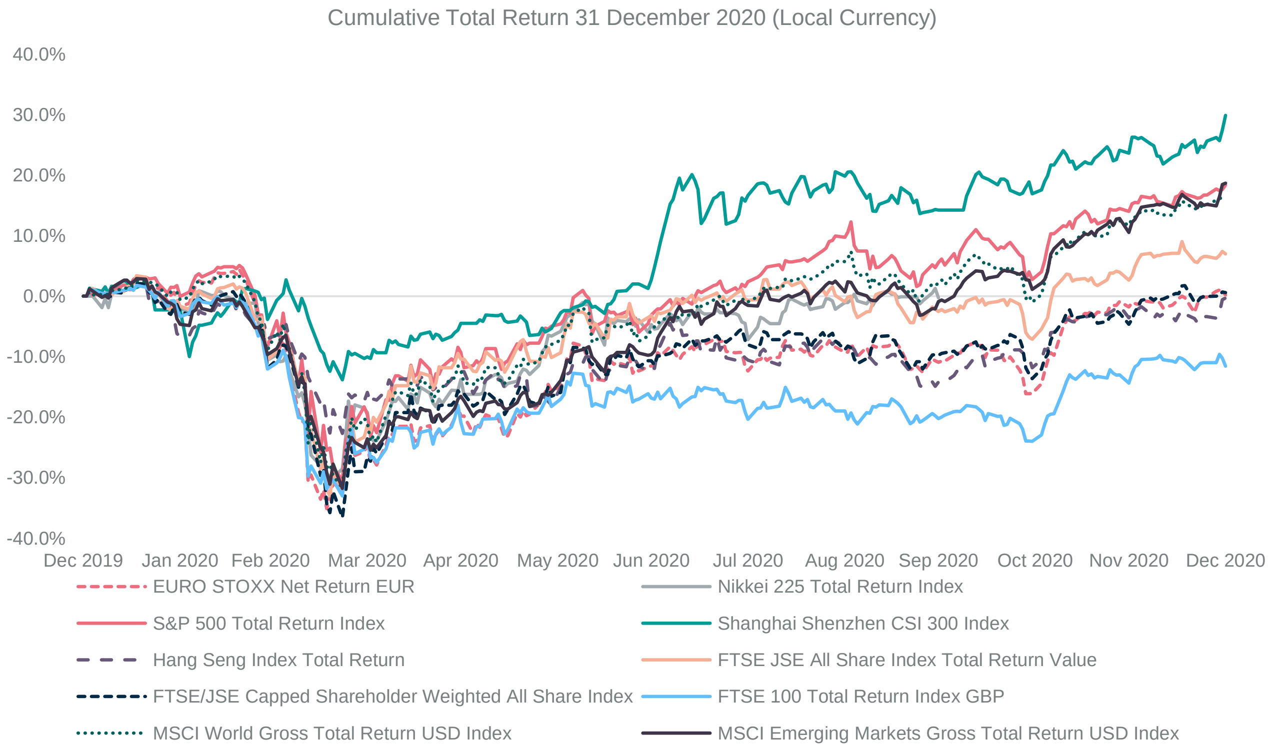
31 December 2020 (Local Currency)	1M	3M	YTD	1 Year	3 Year (annualised)	5 Year (annualised)	10 Year (annualised)
FTSE/JSE ALSI Total Return	4.2%	9.8%	7.0%	7.0%	3.1%	6.4%	9.6%
FTSE/JSE Capped SWIX Total Return	5.5%	11.5%	0.6%	0.6%	-1.5%	3.2%	
S&P 500 Total Return	3.8%	12.1%	18.4%	18.4%	14.2%	15.2%	13.9%
STOXX 600 Total Return	2.6%	10.8%	-2.0%	-2.0%	3.5%	4.5%	6.7%
Nikkei 225 Total Return	4.0%	18.5%	18.3%	18.3%	8.6%	9.7%	12.5%
MSCI World Total Return	4.3%	14.1%	16.5%	16.5%	11.1%	12.8%	10.5%
MSCI ACWI Total Return	4.7%	14.8%	16.8%	16.8%	10.6%	12.9%	9.7%
MSCI EM Total Return	7.4%	19.8%	18.7%	18.7%	6.6%	13.2%	4.0%

STEFI	0.3%	1.0%	5.4%	5.4%	6.7%	7.0%	6.4%
ALBI	2.4%	6.7%	8.7%	8.7%	8.9%	10.4%	8.2%
IGOV	2.3%	5.5%	3.9%	3.9%	2.1%	3.0%	6.1%
WGBI	1.4%	2.8%	10.1%	10.1%	5.0%	4.8%	2.3%
SAPY Total Return	13.7%	22.2%	-34.5%	-34.5%	-20.7%	-8.4%	3.5%
MSCI US REIT Total Return	3.3%	11.5%	-7.6%	-7.6%	3.5%	4.8%	8.3%
STOXX 600 Real Estate Total Return	3.9%	11.4%	-8.9%	-8.9%	1.2%	1.6%	7.2%
Crude Oil	8.8%	26.5%	-21.5%	-21.5%	-8.2%	6.8%	-5.9%
Aluminium	-3.2%	12.2%	9.4%	9.4%	-4.4%	5.6%	-2.2%
Copper	2.5%	16.4%	25.8%	25.8%	2.3%	10.5%	-2.1%
Gold	6.8%	0.7%	25.1%	25.1%	13.4%	12.3%	2.9%
Platinum	10.8%	20.0%	10.9%	10.9%	4.9%	3.8%	-4.9%
Nickel	0.0%	0.0%	0.0%	0.0%	1.8%	7.5%	-3.0%
Palladium	2.8%	6.0%	25.9%	25.9%	32.0%	34.2%	11.8%
Iron Ore	23.7%	27.2%	77.9%	77.9%	29.3%	28.6%	
USDZAR	-5.0%	-12.3%	5.0%	5.0%	5.9%	-1.0%	8.3%
GBPZAR	-2.5%	-7.2%	8.2%	8.2%	6.3%	-2.5%	6.9%
EURZAR	-2.7%	-8.5%	14.4%	14.4%	6.5%	1.3%	7.3%
JPYZAR	-4.1%	-10.5%	10.2%	10.2%	9.0%	2.0%	5.7%

Source: Bloomberg

The Chinese stock market posted its best performance in the third quarter (up by 11.2%), largely reflective of the success of President Xi's government's outbreak-containment measures, together with steady, ongoing, industrial-led economic recovery. Foreign direct investment into China, which had been up since April, rebounded by 18.7% in August year on year.

Figure 10: Performance of major equity indices YTD 2020 as at 31 December 2020 (local currencies)

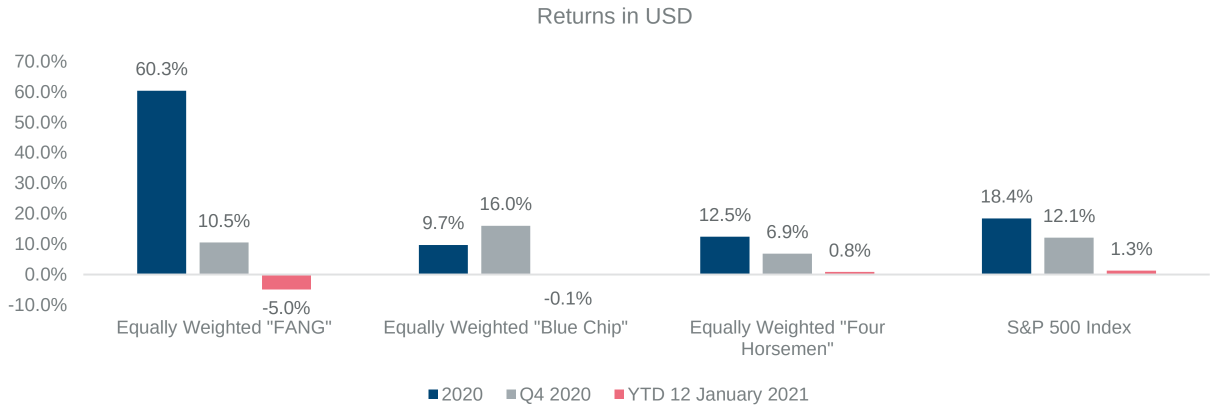


Source: Bloomberg

Equity markets in most regions ended the year in positive territory, except for the FTSE 100 (at -11.5% for the year), despite vaccine news in Q4 reversing some of the losses suffered.

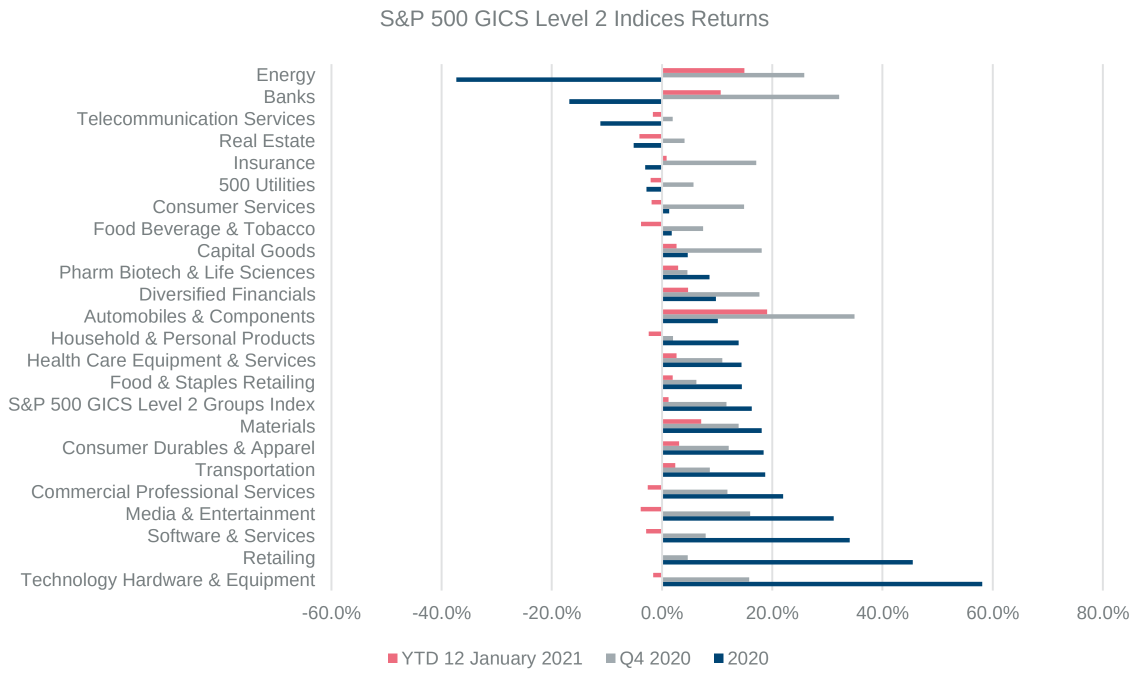
In the US, the big techs – which have benefitted from the pandemic due to a growing, work-from-home trend and accelerated digitalisation – were the winners in 2020. The Federal Reserve stated that it would continue to support the country's economic recovery with current levels of quantitative easing. The US Congress also approved a US$900 billion stimulus package in late December. Together with vaccine-related news, some cyclical sectors made strong gains in Q4.

Figure 11: US equity performance in US$



Sources: Bloomberg, AlpineMacro, FANG stocks (Facebook, Apple, Amazon, Netflix, Alphabet/Google), four horsemen stocks (Microsoft, Cisco, Intel and Oracle), blue-chip stocks (Coca-Cola, Walt Disney, General Electric, IBM, Johnson & Johnson, McDonald's, Merck and Procter & Gamble)

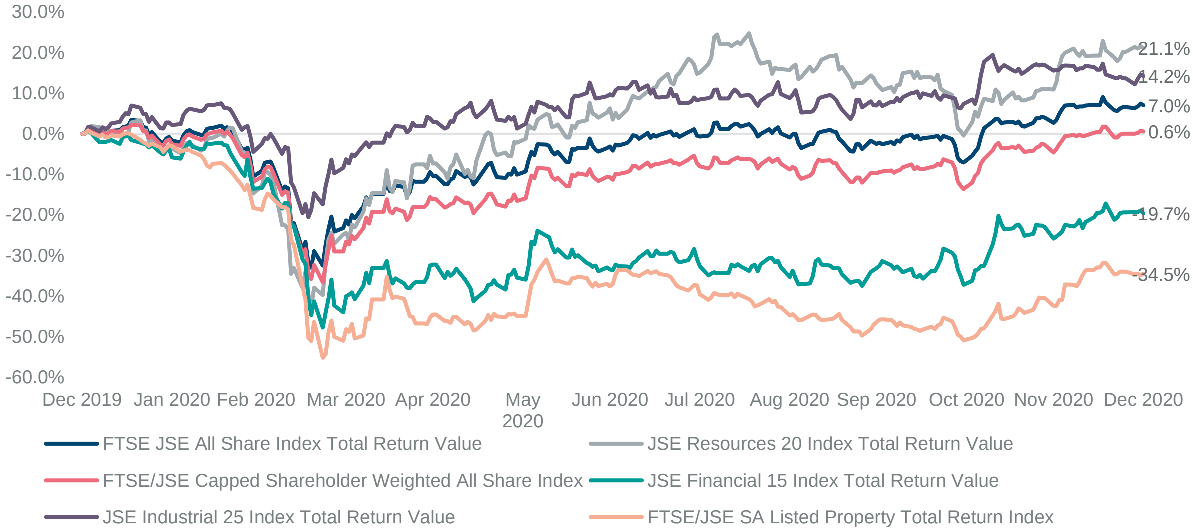
Figure 12: S&P 500 GICS Level 2 sub-indices



Sources: Bloomberg

The SA equity market displayed similar trends to those of the laggards earlier in the year (such as financials and listed property), returning over 20% in Q4, although this did not come close to recouping all the pandemic-related losses.

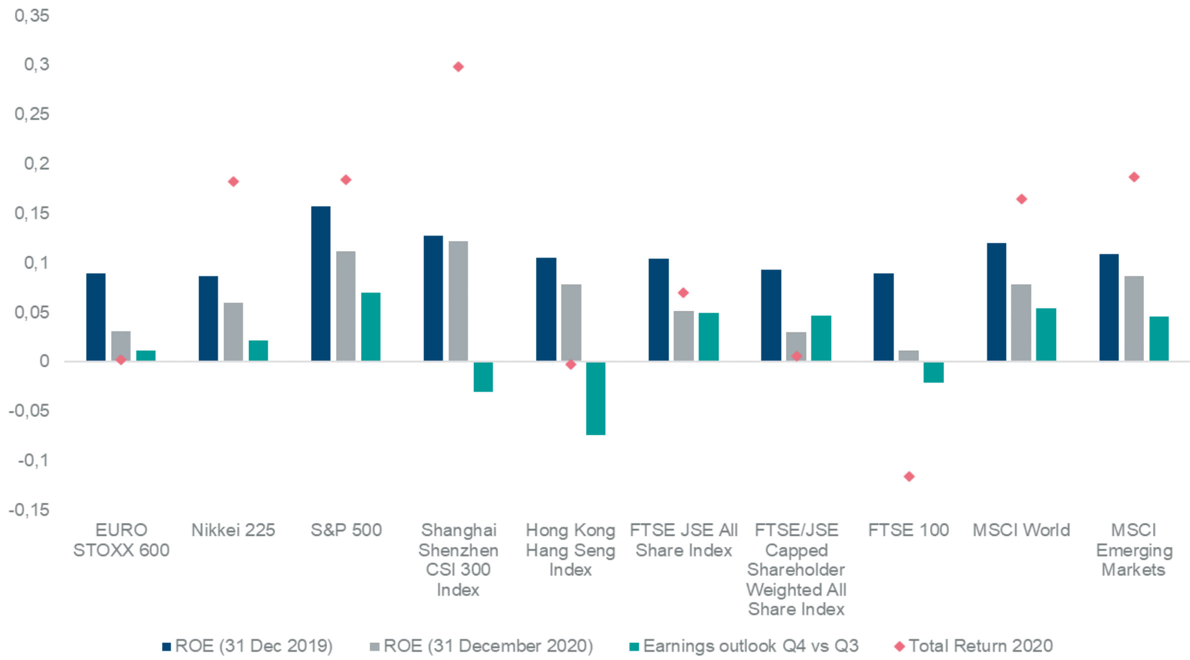
Figure 13: SA equity index performance YTD as at 31 December 2020



Source: Bloomberg

The earnings outlook improved for most regions (based on earnings estimates) over the previous quarter. The severity of the fundamental deterioration (i.e. impact on ROE) and the sentiment on forward earnings seemed to be correlated with the performance of most equity markets over the period.

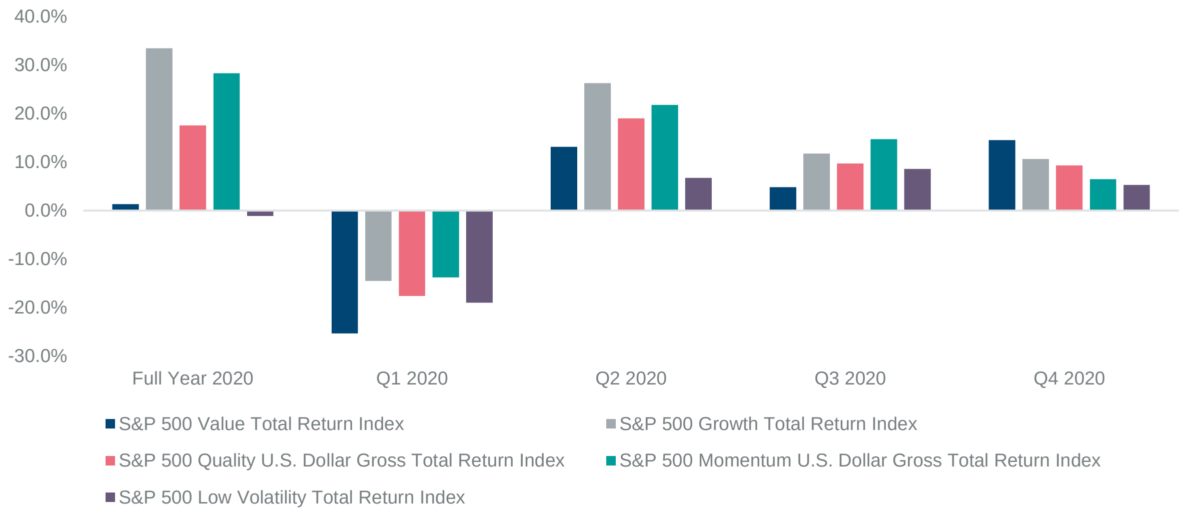
Figure 14: Major equity index performance vs return on equity and earnings outlook as at 31 December 2020



Source: Bloomberg

We saw, from a style perspective, that the S&P 500 Value Index and the S&P 500 Low Volatility Index underperformed against other style factors for the year. The S&P 500 Growth and Momentum indices showed the strongest rebound in Q2 after the COVID-19-related crash in Q1. Momentum was the best performer in Q3 and the Value Index outperformed the rest, with sector rotation taking place in Q4.

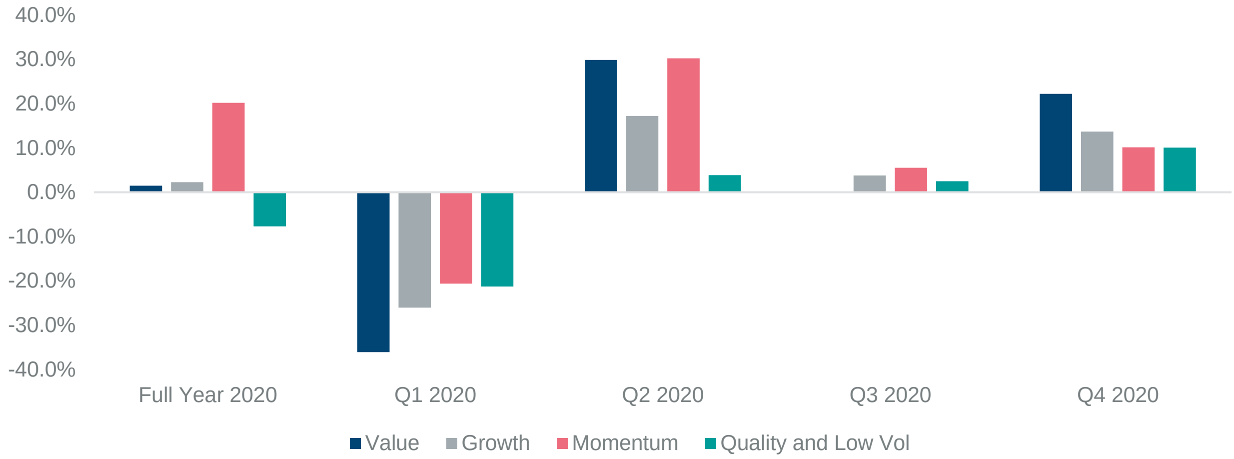
Figure 15: S&P 500 style indices performance as at 31 December 2020



Source: Bloomberg

We saw that Momentum did well for the year relative to other style indices in South Africa, based on our proprietary-style factor indices. The Value Index, similar to the US indices, suffered the strongest blow in Q1, but delivered strong returns in Q2 and Q4 last year.

Figure 16: SA style indices performance as at 31 December 2020



Source: Bloomberg

Global bond yields diverged as the US 10-year Treasury yields were 21bps higher over the quarter, but the German 10-year yield fell by 5bps. Spanish and Italian 10-year yields also declined by 20bps and 35bps, respectively, as the ECB increased its quantitative easing efforts. The SA 10-year yield dropped by 68bps, benefitting from the improving risk appetite of investors.

Figure 17: 10-year government bond yield as at 31 December 2020

Source: Bloomberg

The US 10-year vs 2-year and 10-year vs 3-month Treasury spread increased markedly, from 56bps and 59bps to 79bps and 85bps over the quarter.

Figure 18: 10-year vs 2-year US Treasury yield spread vs US recession

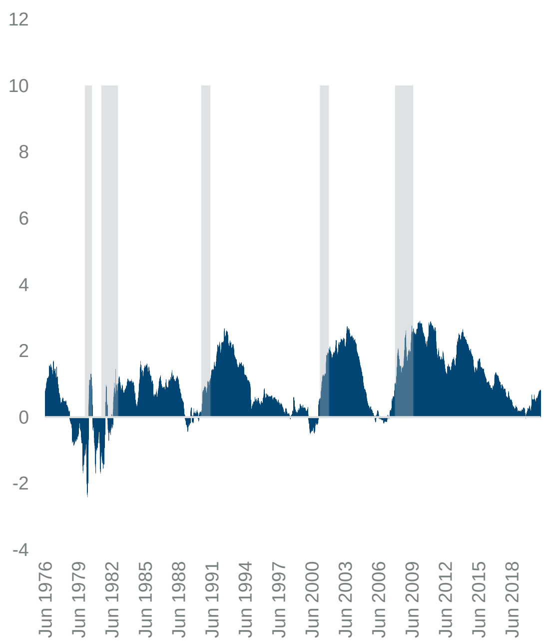
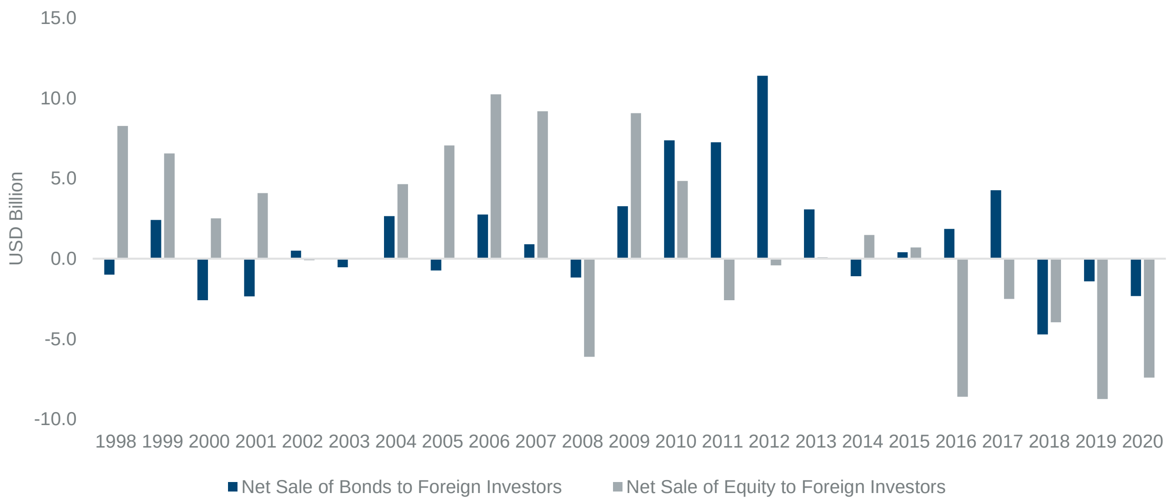


Figure 19: 10-year vs 3-month US Treasury yield spread

Source: Bloomberg

Foreign investors net sold US$2.3 billion and US$7.4 billion worth of local bonds and equities, respectively, in 2020. There was, however, a significant improvement in the last two months of 2020 as foreign investors purchased approximately US$2.1 billion worth of local bonds. This saw non-resident holdings of SA government bonds increase slightly from 28.96% to 29.70% from October to November 2020.

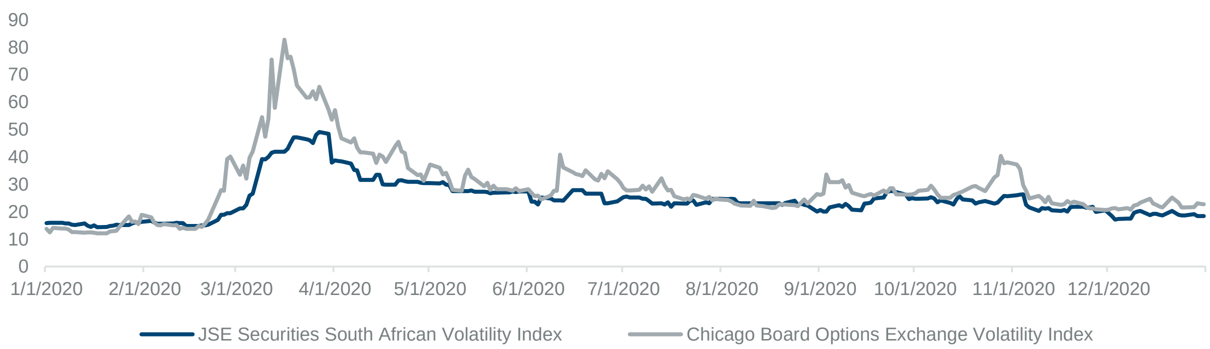
Figure 20: Net sale of local bonds and equities by foreign investors



Source: Bloomberg

Both the VIX and SAVI indices dropped from 25 and 26, respectively, in September to 18 and 23, respectively, in December when the dust settled after the US presidential election. The Brent crude oil price also recovered from US$40.94 per barrel in September to US$51.72 in December as OPEC's extension of production cuts and the start of the vaccine rollout programme boosted optimism about a quicker-than-expected return to normalcy in 2021.

Figure 21: VIX and SAVI indices for the year to date as at 31 December 2020

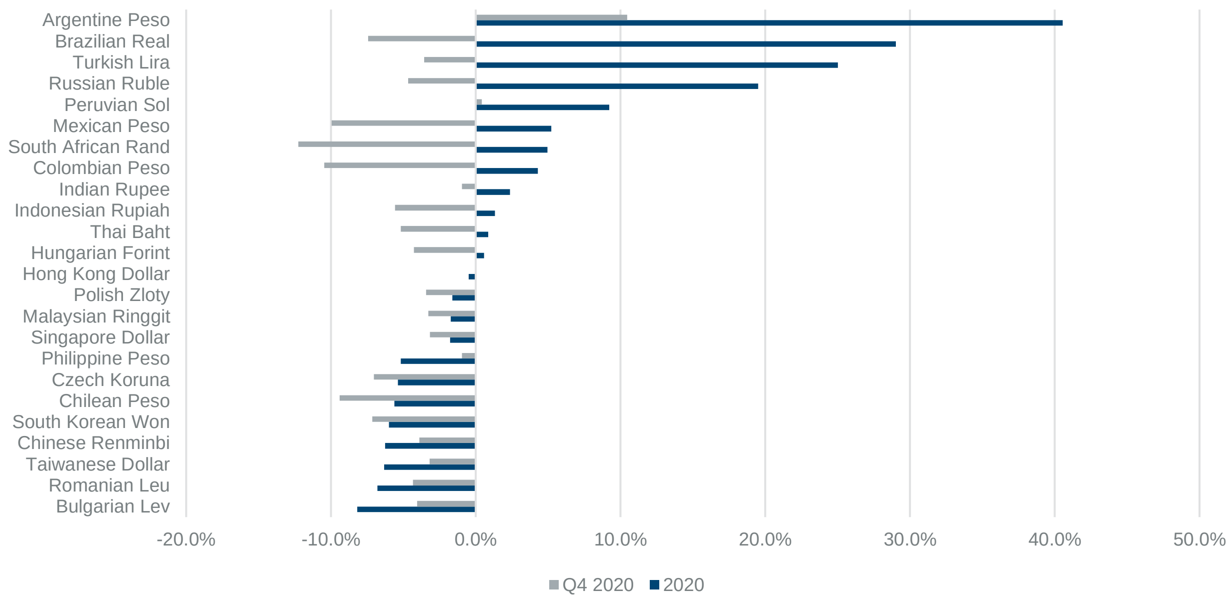


Source: Bloomberg

We saw the rand strengthen from R16.75/$ to R14.69/$ from 30 September to 31 December, as risk-on sentiment continued to dominate the market for much of the last quarter. In fact, it was the best-performing emerging market currency against the US dollar in Q4.

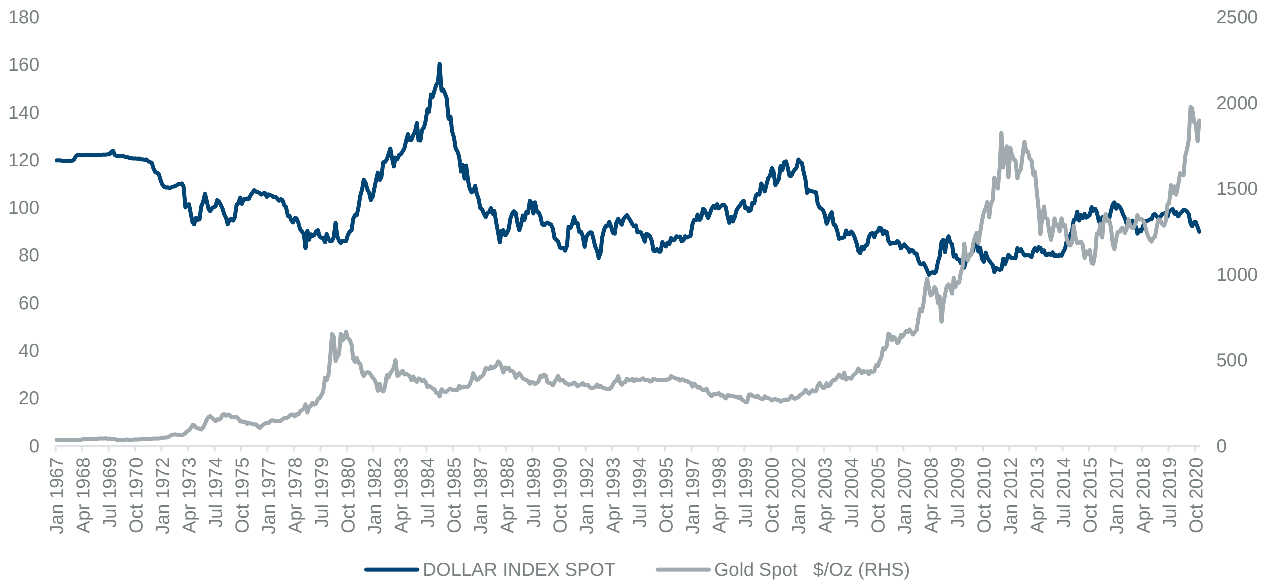
The US Dollar Index showed that the US dollar weakened by 4.2% against major currencies in the fourth quarter. This was because investors expected the pandemic to recede in the wake of countries' vaccine rollout programmes, driving demand away from the safety of US assets in search of higher yield. The gold price managed to gain 0.7% over the same period as inflation fears set in over the unprecedented levels of central bank stimulus.

Figure 22: Emerging market currency spot return as at 31 December 2020



Source: Bloomberg

Figure 23: Gold spot price in US$ vs the US Dollar Index as at 31 December 2020



Source: Bloomberg

FINAL WORDS

Heading into 2021, we still face a great deal of uncertainty stemming from the COVID-19 pandemic, with many countries struggling to contain another, evidently more powerful wave of infections. Meanwhile, political risks remain elevated as the US faces the threat of more violence in response to Joe Biden's inauguration and the impeachment of Donald Trump for the second time – this time in his last few days in office.

In this sombre atmosphere, some more short-term volatility is likely to be in store for us as we contemplate the new year, with the market likely to remain highly sensitive to what happens on the COVID-19 and geopolitical fronts. However, robust policy support and the gradual rollout of vaccines offer hope that an economic restart is on the horizon and will continue to underpin risk assets. The ongoing search for yield in a low interest-rate environment and an improved global economic outlook should ultimately prove beneficial for emerging markets like South Africa. Nevertheless, several idiosyncratic risks at the domestic level could keep investors feeling cautious about South Africa, with fiscal risks, in particular, likely to remain high on investors' radars. This is why the annual budget in February is such a pivotal event for South Africa and the market will be looking for signs that fiscal reform is seriously on the agenda.

MENTENOVA

CONTACT

CAROLYN WEIL, CFA®
c +27 83 325 8981 T +27 11 447 7716
F 086 272 1177 E cweil@mentenova.co.za

YANNI YANG, CFA®, FRM, CAIA
C +27 84 802 3784 **T** +27 11 447 7716
F 086 272 1177 **E** yyang@mentenova.co.za

Edited by: Ali Parry

3rd Floor, Oxford & Glenhove Building 2,
114 Oxford Road, Rosebank. www.mentenova.co.za