MARKET INSIGHTS AND INVESTMENT PERSPECTIVES

Our perspectives on key themes driving global asset prices over the next few months as we head to the end of a unforeseen year

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US ELECTION

US split congress reduces radical policy risks, but Jan 5th Georgia run-offs could change everything

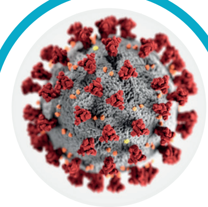
The next key outcome for markets is who controls the US Senate?
If the two outstanding seats in Georgia go to the Democrats, the Senate will be split 50/50 Republican and Democrats, with the casting vote going to the new Vice President. This creates an easier path for Democrats to pass new legislation, such as:

- Higher corporate and personal taxation
- Raised minimum wages
- Improved healthcare
- Climate change
- Potentially re-joining Iran nuclear deal, WHO and Paris Climate Agreement

The market is in favour of Democrats controlling both the Senate and the House of Representatives as this would provide more control and enable passing fiscal stimulus measures that will benefit the lowest earners, who were hardest hit by Covid-19 lockdowns. Provided there is no recession next year this should benefit US economy and equity markets.

A US$ weakening cycle is also more likely if the Democrats gain control given stimulatory spending means Rest of World equities, as well as commodities and emerging markets outperform US equity in this scenario.

COVID-19 VACCINE



Vaccine developments – reduces downside risks to corporate earnings

Pfizer and its partner and Moderna recently announced Covid-19 vaccines under development show greater than 90% and 94.5% effectiveness respectively.

"Sample sizes are small, but results are highly encouraging and statistically significant."

Further positive vaccine developments are also expected from the AstraZeneca/Oxford and we watch closely developments in the Johnson & Johnson vaccines due to manufacturing agreements in SA.

But the world may not be back to normality too fast. A number of hurdles include:

1. cold chain logistics for transporting these vaccines,
2. producing sufficient volume for global needs,
3. the likelihood that wealthy nations will receive the vaccines first, and
4. uncertainties over peoples' willingness to take a vaccine.

What does this mean for markets?
Markets were already pricing in some positive news. Importantly though – the vaccine hope reduces tail risk for corporate earnings providing a light at the end of the tunnel. From an equity investor perspective, the vaccine may help market rotation from growth stocks into value and more cyclical stocks.

BREXIT

Brexit – deal likely soon, potential upside for underperforming, cheap UK assets

Deadlines continue to shift and if no deal agreed the UK will leave Europe on 1 January 2021.
Three main issues are preventing a Brexit deal between Britain and the European Union:

1. **Level playing field:** Europe's insistence on legal commitment that European companies will not face unfair competition in Britain, while the UK considers it should have the right to channel funding to particular sectors.
2. **Governance:** Europe's demand for specific rules written into a trade agreement in the event that one side breaches the agreement.
3. **Fishing rights:** a major and emotive sticking point for the UK despite the sector's insignificant contribution to the country's GDP.

"A deal is likely to be concluded shortly and the reality is that the terms would not be as favourable to the UK as they currently receive."

Markets may react positively to the fact there will be no "hard" Brexit but longer-term prospects for the UK economy look uncertain, especially after Covid-19.

The FTSE 100 index has materially underperformed the rest of the world year to date. The UK equity market is now the cheapest developed market, based on a normalised price to book ratio.

GLOBAL LIQUIDITY

Global liquidity here to stay until growth and inflation normalize

Central banks reacted with monetary stimulus far faster in this financial crisis than they did during the Global Financial Crisis of 2008. About $8 trillion was injected into global markets within a matter of months, much of which flowed to asset prices. This explains the biggest equity correction and recovery in history.

But there are risks:

1. Asset price bubbles are created. For example Apple. Apple's earnings have been almost flat for the past 18 months, but the share price has risen exponentially. These companies may continue to have good growth rates for the longer term but current valuations are high due to low discount rates. Valuations could correct rapidly if government indebtedness causes a spike in bond yields.
2. Money will be trapped in the banking system if banks maintain tight lending standards in the face of uncertainty. May be eased with:
   - the roll-out of vaccines.
   - sufficient demand for credit.
3. Excess money supply could lead to higher inflation. This is always the risk when printing money. The Democratic Party in the US is likely to make more substantial social grants, which would encourage inflation.

The low interest rate cycle created by quantitative easing means bonds will not give investors the protection one would have received in previous bear equity cycles.

SA'S FISCAL CHALLENGES

SA in a tough place, we need to structurally change growth trajectory

"SA is facing a substantial fiscal deficit, as expenditure has risen faster than revenue in the past 10 years, a trend exacerbated by the Covid-19 pandemic and lockdown."

Given the challenges of already relatively high personal and corporate tax rates and eroded tax morality National Treasury's forecast that future tax revenue will grow faster than expenditure appears overoptimistic. Even if government can stimulate revenue with growth policies, expenditure remains a challenge as the cost of government debt servicing is expected to be 6% of GDP by 2024, compared with less than 2% before 2010.

On a positive side, SA currently offers very attractive real bond yields relative to negative real yields in developed markets and to other emerging markets. **If SA cannot get expenditure under control and grow its revenue, foreign investorsalready holding a smaller proportion of SA government debt than in the past, could sell their holdings, causing bond yields to rise significantly.**

"Foreign investors will continue to eye SA as long as if they can see signs in the background that internal issues are being resolved. Charging of senior ANC leaders for corruption was viewed as a positive step."

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