

COVID 19

Dear Pension Fund Members

The confluence of recent market events has triggered an extremely violent fall in global and local investment markets. The world has arguably not seen anything similar in the past 3 decades. This could not have come at a worst time – last year we saw global economic growth starting to stagnate while South Africa entered a recession with economic growth non-existent.

Despite this gloomy introduction, the ARC Pension Fund experienced very good returns during 2019 and has continued to do so until this most recent “Black Swan Event”. Relative to our peers, we continue to deliver returns that are above the average of the relevant ASISA* categories. This cannot be attributed to any kind of foresight, but rather the fact that we have gradually de-risked portfolios over time because of the slowing down in global growth and a stagnant South African economy. However, we are not escaping the current declines and the global contraction will continue to have a negative impact on all investment portfolios.

* ASISA – Association of Savings and Investments of South Africa.

In the economic and financial world, a “black swan” refers to an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity and their severe impact.

Most retirement fund portfolios typically have exposure to local and global equity markets and other so-called riskier asset classes. It is these asset classes (Equities, Listed Property and even Bonds to a lesser extent), which have dropped significantly because of the current events. It is also important to remember that retirement fund portfolios are not fully exposed to market volatility due to the diversification inherent in such portfolios by design and the limitations of Regulation 28. While retirement fund portfolios have a long-term orientation, it does however mean that significant negative returns can be experienced in most retirement fund portfolios over the short and medium terms.

What should I do as a retirement fund investor?

Firstly, the Corona Virus is a massive humanitarian crisis that require us to focus on factors that we can control – and not those that we can't. Behavioural changes – such as extreme personal hygiene and social and physical distancing - is the key lever in containing the spread of the disease, and much of the measures put in place rely on people consistently

doing the right thing. Please adhere to the measures implemented and advised by Government and closer to home, the ARC leadership.

Secondly, in managing retirement fund portfolios, we are also focused on those factors within our control, rather than those we have no control over. Our investment portfolios are constructed using sensible investment principles such as diversification, rebalancing, and the adoption of a long-term approach. These are factors within our control and have in the past proven to be the most effective approach to unpredictable financial markets and irrational human behaviour. The investment committee will remain disciplined and robust in our decision making. We are realistic around the challenging short-term prospects for local and global markets, but we also remain optimistic for the long-term and determined in delivering financial resilience to our members.

We urge members to also refrain from making emotional investment decisions based on fear, or from trying to predict what markets will do next. Such strategies have an extremely high probability to destroy long-term value!

The number of COVID 19 infections outside of mainland China continues to rise at an alarming pace and the only good news from the past two weeks is that most affected countries, including South Africa, have implemented strict measures, as opposed to a “wait and see” approach, in dealing with this very significant event. Most of the new infections reported daily are now outside of mainland China with 155 countries with reported infections thus far.

The consensus view, supported by preliminary economic data, is that China will incur a decline in GDP during Q1 2020. There are tentative indications that business activity in China is slowly improving as new infections subside. It is probably too early (and will be risky) to use these initial indications as predictive of what the future holds on the economic front. Further consensus is that Europe is very likely to go into a full-blown recession with negative GDP performance expected in all major European economies. With the virus now having a firm hold (and spreading) in the United States, there is little doubt that the US economy will experience a significant slowdown over the coming months. A recession in the United States would almost certainly signal a global recession.

The South African economy is already in a recession and, prior to the virus concerns, was expected to grow by approximately 0.5% during 2020. The lock-down measures already announced by world leaders will in likelihood become even more stringent over the next few weeks. South Africa will not escape this and will likely have the effect of extending South Africa's current economic recession well into 2020.

Having read widely over the past weeks on this “Black Swan Event”, I quote a recent summary by Stanlib's Kevin Lings (17 March 2020) for those who are interested in a more comprehensive economic view.

Global economic impact of COVID-19

The economic impact of the virus has intensified substantially in the past few days and now represents a set of circumstances the world has never experienced before. Essentially, the economic impact of the virus can be broken down into three areas of concern:

A global supply-side shock. This is most evident in China, with the closing of many factories and distribution hubs as workers were told to stay at home in order to reduce the risk of further infections. The fall-off in manufacturing activity within China severely disturbed global supply chains leading to a shortage of many goods around the world. The situation has been aggravated by the international spread of the virus as well as the 'just-in-time' inventory system many companies operate.

A demand-side shock. This is now evident in many countries, especially Europe, as tourism plummets and people avoid large gatherings. The result is far less retail activity, empty hotels, vacant tourist attractions as well as the cancelling of sporting events. While the spread of the virus has increased on-line demand for goods and services, this has not been nearly enough to compensate for the decline in in-store activity.

The shock to global financial markets, including credit markets. As COVID-19 spreads to countries outside of mainland China, many investors switched from holding risky assets (equities) into perceived safe-haven assets, for example US government bonds. This switch has resulted in the US equity market losing almost 30% of its value since 19 February - and remains under enormous pressure despite extensive monetary stimulus from the US Federal Reserve. During the same period the South African equity market also declined by a shocking 30%.

In contrast, the US 10-year bond yield fell from 1.56% on 19 February to 0.54% on 9 March, its lowest yield ever recorded. Since then the yield has risen somewhat to 0.73%, although this appears to relate to liquidity issues, which the Federal Reserve has subsequently tried to mitigate.

Unfortunately, the South African 10-year bond market has weakened noticeably in the past few days, with the 10-year bond yield rising by around 100bps. This largely reflects foreign investor concerns about the economic impact of COVID-19 on most emerging economies, and is not specific to South Africa, although the deterioration in South Africa's fiscal position and weak economic environment is clearly unhelpful. At the same time the Rand exchange rate has weakened substantially, depreciating by almost 16% since the beginning of 2020 and by around 9% since 19 February. This decline in the value of the Rand is also not specific to South Africa. Since the beginning of the year the Colombian Peso, Russian Rouble, Chilean Peso, Brazilian Real, and Mexican Peso have all lost well over 10% of their value against the US Dollar.

There is also a significant concern about the lack of liquidity in international credit markets. This is reflected in a sharp widening of credit spreads as banks and investors adjust their risk assessment to take account of the deteriorating economic environment. A lack of access to affordable credit could severely damage key parts of the world economy as business conditions are heavily impacted by COVID-19. This was a key factor in the US Federal Reserve cutting interest rates by 50bps at an unscheduled FOMC meeting on 3 March and then by a further 100bps at an unscheduled meeting on 15 March. The Federal Reserve also announced that they are re-initiating conventional QE and will look to purchase a further \$500 billion government bonds and \$200 billion mortgages backed securities. [Last night (South African time), the US announced further substantial measures to support businesses and consumers alike]. While these are bold measures from the Federal Reserve, they are likely to have only a limited impact on the world economy since the damaging economic effect of the virus is primarily caused by the isolation measures needed to contain the spread of the virus.

The international oil price (Brent crude) plunged from around \$53/bl at the start of March to \$36/bl on 9 March and \$29/bl on 16 March, a drop of 45%. The sharp decline in the oil price can be ascribed to the breakdown of talks between OPEC and Russia regarding the need to cut oil production in order to support the oil prices, as well as Saudi Arabia's response to this breakdown in discussions by indicating that they would increase output. However, the economic disruptions caused by COVID-19 has also led to a sharp fall-off in oil demand, further undermining the oil price in recent days.

It is worth highlighting that the sharp fall-off in the oil price, combined with the continued spread of the virus internationally and the systematic downward revisions to global growth estimates, has started to more significantly undermine emerging markets, including foreign investor appetite for emerging market assets.

The combination of a supply-side, demand-side and financial shock is rapidly undermining business, household and investor confidence around the world. Unsurprisingly, most economists, including ourselves, are in the process of revising their GDP growth estimates lower, while at the same time trying to gauge the spread of the virus. It is not the virus itself that is undermining the world economy, but rather the measures that are needed to contain and control the spread of the virus.

At this stage we are expecting that China's GDP will have declined quarter-on-quarter in Q1 2020, but that there should be some pick-up in activity in Q2 2020 as more businesses resume production and travel restrictions within the country start to be slowly lifted. In contrast, there is now extreme concern about how rapidly the virus continues to spread within Europe. Given that the economy of Europe is similar in GDP size to China and is also very open to international trade, the impact on the world economy of a recession in Europe, which is now our base case expectation, is likely to be very meaningful over the coming weeks and months.

The United States, which remains the world's largest economy, has seen their number of infections rise from 66 at the end of February to 554 on 9 March to 4 661 on 16 March. A sharp and uncontrolled increase in the number of COVID-19 cases in the United States that leads to widespread travel restrictions and the closure of many businesses would clearly push the world economy in recession. Consequently, the spread of the virus in Europe and the United States is being watched very carefully, but we need to warn that a global recession is fast becoming our base case assumption.

Lastly, data on the spread of the virus, the assessment of its economic impact and its effect on global financial markets is evolving daily. The measures introduced by the major central banks have, so far, had only a very limited effect on stabilising the financial markets. We have revised our global growth estimates meaningfully lower, including a revision of South Africa's GDP growth for 2020 to reflect an extension of the recession that started in H2 2019. Hopefully, the fiscal and monetary authorities in South Africa are soon able to announce a range of support measures to assist the economy over the coming weeks.

All the best and remain safe!!

FC Greeff
Principal Officer