MEMO FROM THE CIO

Looking to the future

Isaac Adomako Boamah

Today's challenge facing long-term investors is constructing portfolios in an environment where asset prices appear detached from economic reality amid an unpredictable recovery path. So far, policy measures have cushioned both markets and, to a lesser extent, the local economy from the pandemic's immediate impact. Nonetheless, the distribution of potential economic scenarios over the next 12 months is unusually broad. Therefore, investors should consider building portfolios that can withstand a range of future paths.

At the peak of the crisis in March, concerns about market liquidity overrode the future economic path as panic took hold of investors leading to rampant sales. Consequently, both governments and central banks supplied liquidity to calm the nerves of investors. Looking ahead, we expect more intervention as investors remain skeptical about the global outlook. However, this crisis is rooted in public health, and thus markets will continuously be driven by the virus.

Virus musings

The shock and disbelief that arrived with the pandemic have receded. However, progress in testing and vaccines is the only route to having our lives and livelihoods back. While we do not underestimate the loss of lives and livelihoods due to the virus, we believe that the global progress on testing and vaccines is moving in the right direction.

Our silver lining in Ghana is that the number of recorded COVID-19 cases is not as high as we envisaged. Consequently, the fear of a full-blown public health crisis remains an imagination, for now. The number of active cases and total deaths currently stands at 657, and 310 respectively. Although this is bad in absolute terms, the country's experience with the virus is better than developed countries with superior health infrastructure. As we all know, markets trade more on expectations than the reality, so to some extent, our lower than expected number of active cases helps.

In addition to our relatively low number of active cases, the US Fed’s attempt to put a lid on the dollar and a further dovish stance from major central banks will continue to drive investors into frontier markets like Ghana. A low global interest rate regime will likely soften pressure on the local currency as portfolio outflow slows down. At the peak of the crisis in March, the net portfolio outflow from the domestic bond market stood at GHS 1.3bn compared to a net inflow of GHS 23.0m at the end of August, reflecting the change in

investor sentiment. Change in market sentiments and a reported 4.0 months import cover should cushion the local currency as economic activities rebound.

Economic activities rebound but the sprint is turning into a slog.

The world is in a better place than three months ago as economic activities have picked up. The initial fear of COVID-19 has reduced amid continuous progress towards finding a vaccine. Global growth since the bottom in April has surprised many of us who feared the worst at the beginning of the pandemic. However, recent data from both the UK and the US (Jobs created: 4.8m in June vs. 1.8m in August) suggests that the pace of recovery has slowed down on account of the expiration of stimulus benefits. Consequently, we have seen a dip in investor sentiments towards frontier markets as prices of Ghana Eurobonds declined from 95 to 85, at the end of the third quarter. Zambia's recent request to delay payment of coupons on their Eurobonds has added fuel to investor concerns about the creditworthiness of some export-dependent economies in Africa. However, we expect investors' stance to soften on account of a renewed round of fiscal and monetary stimulus amid the concerns that the pace of economic recovery that started at a sprint is turning into a slog. While we expect the next round of fiscal and monetary stimulus to lift investors' mood, we believe the impact on asset prices will be less compared to the initial reaction of the market in April.

Despite the loose monetary stance from major central banks, the Bank of Ghana maintained its policy rate at an eight-year low for a third consecutive meeting on account of the pickup in economic activities. The central bank’s composite index of economic activity (CIEA) increased by 3.6% in July 2020 (compared to a contraction of 10.6% in May 2020), on account of consumer spending, industrial consumption of electricity and construction activities. However, the employment rate is yet to reflect a pick-up in economic activities as the number of private-sector contributors to SSNIT has dipped from 800k in January to 650k in July 2020. We expect employment to pick up if schools reopen in January 2021.

Even though the initial signs of economic recovery are encouraging, the country's resource envelope has shrunk, adding to the evidence that the local economy could take many months, if not years, to recover fully. Public sector wages and interest payments for the first half-year of 2020 outstrips the country’s total revenue by GHS 3 billion. The reduced fiscal envelope, and mounting debt levels, highlights Ghana's fragile economic environment. Given the country’s fiscal limitations, the tendency for the market to pick cues from the monetary desk has increased.

How are we positioned today?

Financial markets face two opposing forces. On the one hand, the data shows positive surprises since June, indicating a swift recovery in economic activity. On the other, the spread of the virus is still far from being contained globally. The threat of the virus developing uncontrollably in some countries or fears of a second wave could weigh on the economic recovery, despite support from governments and central banks. Consequently, we increased our exposure to Treasury securities displaying attractive valuations while also

reducing our risky assets positions. From now on, we can generate alpha from treasury securities, and thus the need for risk exposure has diminished.

How should we position for the new future?

The process of investing involves making a prediction of the future and translating it into prices you are willing to pay today. We do this by assuming that the things that worked in the past will work in the future while bearing in mind that our assumptions might be flawed. However, is it prudent today in making decisions regarding the future to assume a return to the status quo? For instance, we may think conventionally that a higher fiscal deficit will result in a higher interest rate; however, this might not be the case where central banks and governments have built a liquidity wall to support the financial market. We believe that the coordinated central bank action during the pandemic has put a floor under risk-free assets.

At the beginning of the crisis, we parked our cash in short-dated Treasury securities while seeking further understanding of the pandemic and its effect on both the global and the local economy. Maintaining our exposure at the front end of the yield curve means that we expect further weakening of the already-fragile local economy and a possible second wave of the virus will make a challenging macroeconomic environment. The difficulty with this thinking is that arranging our portfolio to succeed under a pessimistic outcome put us in a tight spot if the worst does not happen. Consequently, we intend to reconstruct the portfolio to withstand a range of future paths.

Part of the portfolio reconstruction process involves a rethink of the purpose of a bond portfolio. Instead of focusing on yield curve positioning, we think a bond portfolio should have four main sub-portfolios, each constructed differently to achieve specific objectives.

DRIL – **D**iversification, **R**eturn, **I**ncome and **L**iquidity.

Given our expectation that greater-than-normal uncertainty will likely be the norm for the foreseeable future, we believe that an "all-purpose" bond portfolio has outlived its sell date. The time has come for us to construct bond portfolios to achieve specific goals such as diversification, return, income, and liquidity. If constructed well, each sub-portfolio will contribute to making the whole more significant than the sum of its parts.

Our equities stance: Best of breed

In perilous times, sticking with quality always trumps speculation in the long run and that has been our posture for Ghanaian equities since the market turned bearish in 2019. We have focused on best of breed stocks that trade at significant discounts to their fair value while maintaining a stop-loss trading strategy to hedge our downside. While we are guided by the fact that markets can remain irrational longer than our equity portfolio can stay above water, we draw confidence from our neighbours in Nigeria and Kenya where stocks have recovered sharply since the pandemic and we are reminded of how quickly sentiments can turn from negative to positive.

Conclusion

The world is in a better place now than six months ago as our knowledge of the virus and response to the economic havoc it wreaked has resulted in a rebound in economic activities. However, central banks' policy response has created a wedge between financial markets and the real economy. We believe the decoupling between markets and the real economy will persist for the foreseeable future. Consequently, investors need to shift from building "all-purpose" to "single-purpose" portfolios while bearing in mind that the virus is not over with us.