The CIO Memo

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After the crawl, What next?

IN BRIEF

- To date, this year has presented a mixed bag of investment prospects, challenges, and opportunities for Ghana, influenced largely by the global pandemic's impact on international markets
- The local macroeconomic landscape is improving from the scourge of the pandemic as the fiscal deficit declined from 11.7% at the close of 2020, to 5.1% by the end of the 1H2021
- However, the local market rally appears to be slowing to a stop as the liquidity tailwind that propelled it wanes
- We expect the return of market volatility in significant and often confusing spells as investors price rate hikes by major central banks.
- Increase in market volatility presents buying opportunities for investors who are willing to take risk

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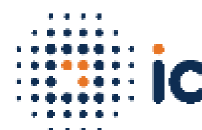
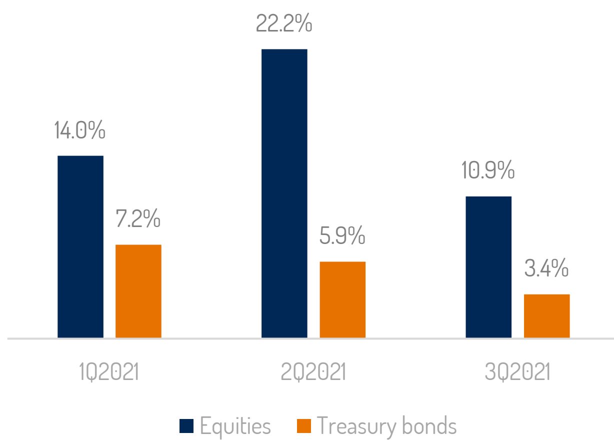


To date, this year has presented a mixed bag of investment prospects, challenges, and opportunities for Ghana, influenced largely by the global pandemic's impact on international markets. Nevertheless, it appears that despite the spread of the Delta variant of the COVID-19 virus, a global economic recovery is underway.

However, it is ironic that, after the sprint in 1H2021, followed by a market crawl in 3Q2021, now, as we move towards the relatively calmer phase of the pandemic, the local market rally appears to be slowing to a stop as the liquidity tailwind that propelled it wanes. The local market eked out its smallest advances for the quarter since the beginning of the year.

Quarterly performance of Ghanaian financial markets



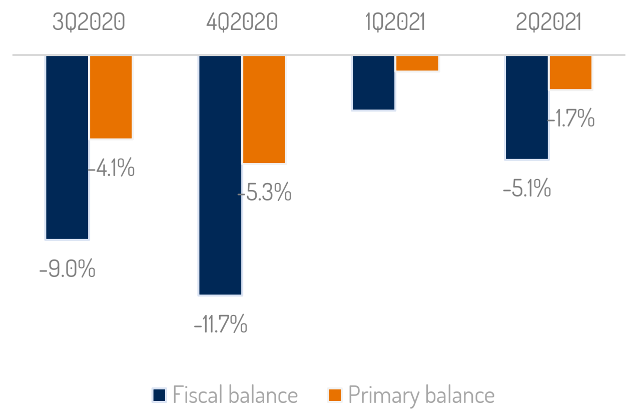
Source: Ghana Stock Exchange; Standard & Poor's

Nevertheless, both bulls and bears found evidence to further their arguments in the unusual 3Q2021 environment.

The bulls versus the bears

Locally, the economic picture for market bulls is improving steadily with Ghana on course to record a real GDP growth rate of 5.0% at the end of 2021, from 0.9% in 2020. In addition, the fiscal deficit narrowed from 11.7% in FY2020 to 5.1% as at 1H2021, supporting the bullish rhetoric.

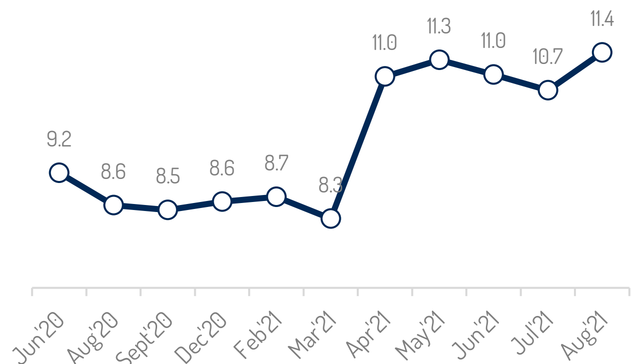
Evolution of fiscal and primary balance



Source: Bank of Ghana

Furthermore, with a healthy gross international reserve of USD 11.4bn, representing 5.2 months import cover at the end of August 2021, and a further USD 1.5bn expected from the annual cocoa syndicated loan, the fundamentals of the local currency remains positive. This lends additional support to the bullish narrative.

Evolution of Gross international reserves (USD bn)



Source: Bank of Ghana

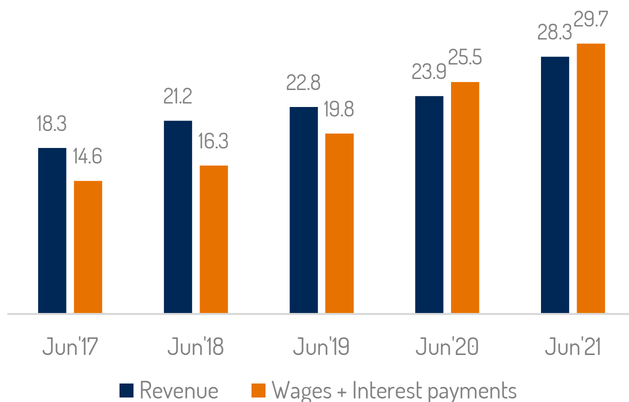
Though an economic recovery is underway, I must caution the bulls that, despite the improving fiscal landscape and a healthy reserve, the local currency has recently been under the cosh, depreciating by ~3.9% against the U.S. dollar in 3Q2021, highlighting the demand pressure on the central bank.

To frustrated bears, the local market rally since June 2020 had little to do with the local macroeconomic environment but was rather fuelled more by favourable external conditions. Thus, any improvement in the local environment will not have a strong bearing on a local market rally.

The bears would argue that major central banks' increasingly weak dovish stance portend tougher sledding for the local market in the next 12 months.

Ghana's non-existent fiscal room is at the heart of the bears' argument, as they view Ghana as more vulnerable to external shocks and the country continues to be classified as being at high risk of debt distress.

Ghana's fiscal landscape (GHS bn)



Source: Ministry of Finance

While I share the sentiments of optimists who point to the improving fiscal landscape and efforts to formalise the Ghanaian economy, recent history suggests that the external environment serves as a useful early indicator for the local markets. That said, my point of departure with the bears is that the external environment remains uncertain, as the doves and hawks continue to haggle over policy direction in the corridors of major central banks.

Currently, those same central banks are pivoting towards rate hikes, and the market is pricing in this possibility. However, no one knows enough about the evolution of the COVID-19 pandemic, and its overshadowing spectre; including the spread of emerging variants of the virus and the pace of vaccination campaigns around the world, to accurately predict the pace of rate hikes.

In this shifting environment, buying opportunities could emerge amid the uncertainty surrounding rate hikes and its pace. We are, therefore, constructive on risky assets, with technical and not fundamental reasons underpinning our stance.

As contrarian investors, we look forward to market turmoil to pick bargains otherwise unavailable during a calm and predictable market. While the onset of the pandemic created a market frenzy, we now anticipate that the reversal of policy response will similarly affect investor mood. This will afford us the opportunity to cherry-pick bargains as uncertainty breeds volatility – which leads to discounted asset prices.

Given the uncertainties surrounding the next phase of the pandemic and attendant policy response, I would like to paint three scenarios that could drive investor sentiments over the next twelve months. Feel free to choose the scenario that best supports your natural inclination:

Scenario 1: Early deceleration

This scenario assumes that global economic growth will remain strong and supportive of risky assets. While the strong recovery would lead to inflationary pressures, this would, however, prove transitory. Consequently, in a bid to avoid an economic crash, major central banks will slowly release the liquidity accelerator. This scenario also assumes that the first major rate hike will occur in 1Q2022.

With an early easing of the liquidity accelerator, markets will gradually adapt to rate hikes, in a relatively less frenzied manner, which could create a favourable environment for the local market, as assets in Ghana are either selling at a fair or full price. While the gradual adjustment in major central bank positioning would support local assets, one should however not, discount the market volatilities usually associated with monetary tightening.

Scenario 2: Late braking

An alternative future scenario is the late slamming of the brakes, taking policymakers by surprise at global economic growth and, in turn, resulting in inflation that endures beyond expectation – or conception. This scenario would force major central banks to raise interest rates to prematurely rein in inflation.

The sudden shock to markets resulting from the unexpected rate hikes would send investors into a frenzy leading to bearish sentiments that might not bode well for frontier and smaller markets like Ghana.

Scenario 3: Idling engine

The third alternative future paints a picture where the pandemic continues to cast a long shadow, and global economic growth disappoints amid partial lockdowns in response to the continuous mutation of the virus. This would end all deliberations around rate hikes in any shape or form, as the road to economic recovery hits one pothole after another. The risk of this scenario becoming a reality is dependent on the number of Covid-19 cases recorded during and after the Christmas season.

An idling engine scenario would perpetuate the current landscape where liquidity drives asset performance and not the fundamental value. The liquidity music will not stop, and the profit party will continue under this scenario.

While all three scenarios assume that the worst of the pandemic is behind us amid vaccine rollouts and the reopening of economies, we think the market will price in scenario two, even though we expect scenario one to play out as central banks will not want to roll back the gains made from their policy response to the pandemic. Being contrarian and an opportunist, we see an opportunity emerging as the gulf between market expectations and major central bank actions widens and fear grips the market.

However, the pandemic underpins a selective approach in picking risky assets, buying on weakness

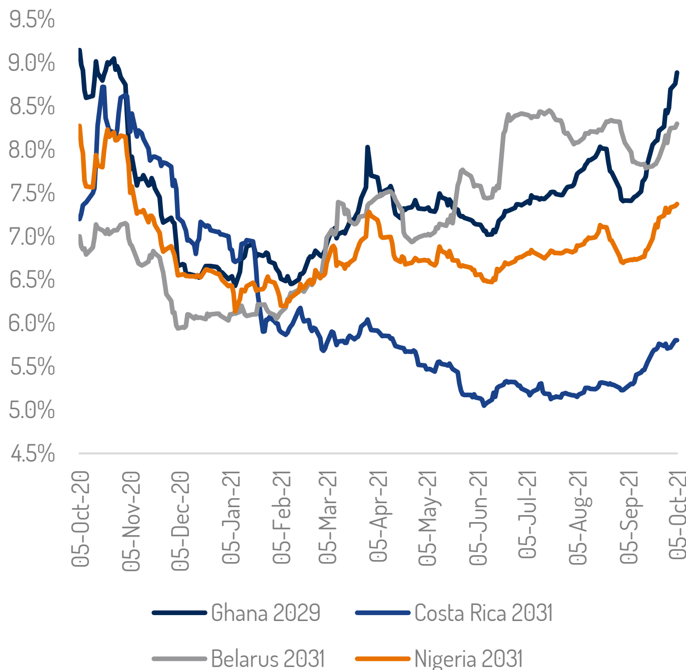
Rates

Attractive entry price amid policy uncertainty warrants broad diversification

Even though we hold the view that rate hikes by major central banks will be gradual and not erratic, we anticipate bouts of volatility along the way as investors are likely to overreact to a switch in tack from monetary policy. We therefore expect the market to offer an attractive entry point for investors who are less risk averse.

The Ghana Eurobond space has already evidenced this scenario, with yields closing at nearly 10% in dollar terms, despite an improving external account balance. In a world starved of yield (21% of the global debt market is trading at negative real yields), the Ghana Eurobonds offer attractive valuation and coupon income, highlighting a higher return-risk ratio for investors to consider.

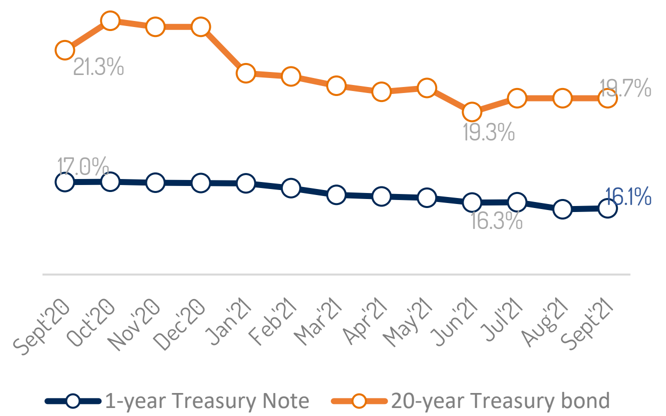
Yield evolution of selected Single B rated Eurobonds



Source: Bloomberg

The recent pullback in local yields suggests the window is closing for this year's rally as some of the liquidity momentum slows. As part of the pandemic's policy response, the central bank reduced banks' cash reserve requirement from 10% to 8%, releasing cash to the local economy, some of which found its way into the bond market. However, in 2H2021, the policy was reversed for all banks that opted to pay dividends, resulting in less cash sloshing around the local bond market. This has led to a steeper yield curve as the term spread between the 20-year and 1-year Treasury security widens from 3.0% in 2Q2021 to 3.6% in 3Q2021.

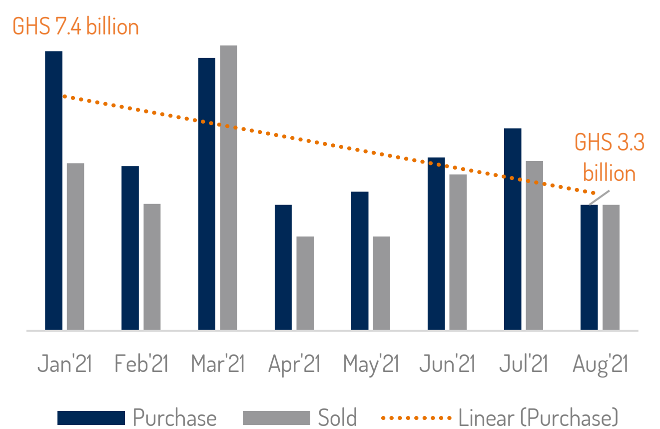
Term spread between the 20-year and 1-year LCY Treasury security



Source: IC Insights

While only inflows from offshore investors can stem the tide of a liquidity crunch in the local market, the prospect of an increase in portfolio inflows remains slim in an economic environment on the brink of tightening across the globe.

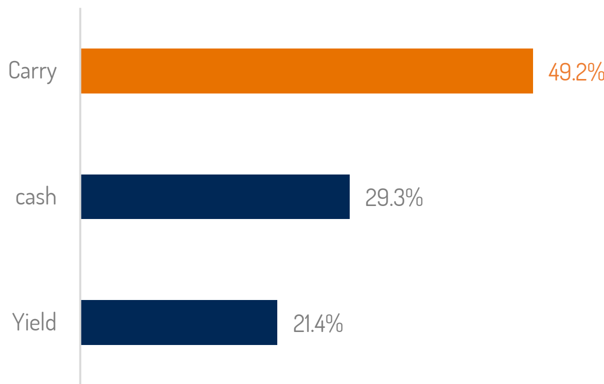
Sale vs purchases of LCY bonds by foreign investors



Source: IC Insights

Since the beginning of 2H2021 we have positioned our portfolio for a cash and carry play, highlighting our ability to supply liquidity at a premium to the market. Hence, we are primed to pick bargains across the local yield curve when fear grips the market and bouts of volatility drive investors to a panicked frenzy.

IC Asset Managers Treasury portfolio allocation



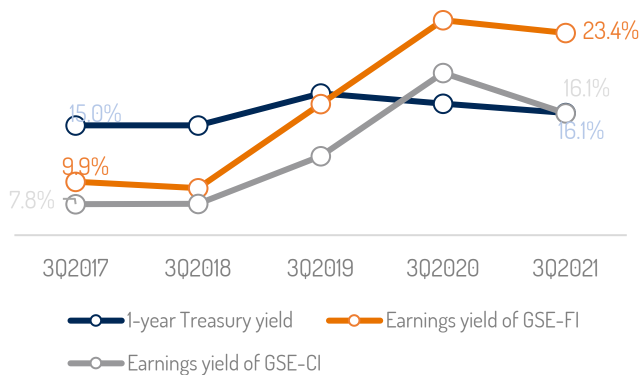
Source: IC Insights

Equities

Except financial stocks, the Ghana equities market is expensive relative to the risk-free rate

The price of the local asset markets has declined (yield rises when asset prices fall) in the past five years because of fiscal weakness resulting from the financial sector crisis followed by the pandemic. However, this year's rally of 41.7% (3Q2021) means that the local bourse, except for financial stocks, is selling at par with the one-year risk-free rate, making equities expensive because of their high-risk profile.

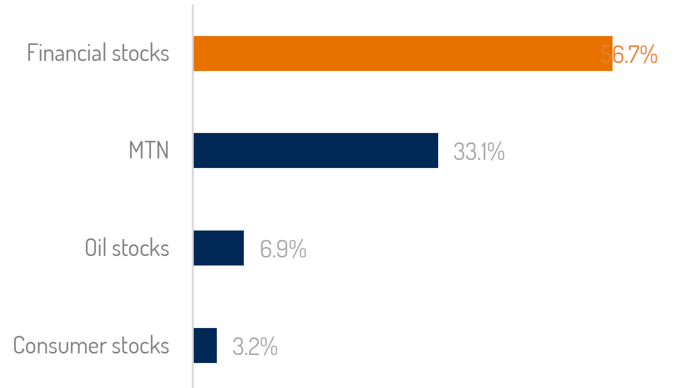
Bond yield Vs. equity earnings yield



Source: IC Insights

Given the relatively attractive price entry point for financial stocks, our portfolio is tilted towards tomorrow's flowers.

Equities portfolio allocation



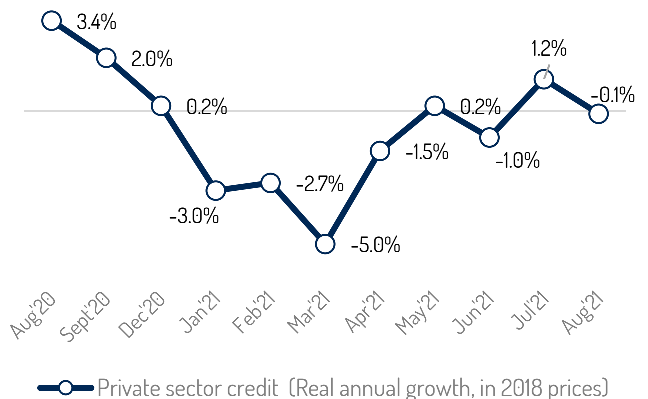
Source: IC Insights

We believe the Ghanaian equities market sells between a fair price and full price outside of financial stocks. However, we will not be surprised if the local bourse rally persists, as impending changes in the pension investment guideline that requires a minimum allocation of 2.5% to variable income securities, could unleash liquidity to the market. Unlike the rates market, equities are likely to benefit from regulatory intervention.

Credit: Bank liquidity declines amid pick up in lending activities

Since the beginning of the pandemic, banks have been slow to increase lending activities as they sought cover in treasury securities. However, the story is changing as economies reopen and trading activities pick up.

Private sector credit



Source: IC Insights

Given the banking sector's liquidity issues and the apprehension of the local pension industry towards bank deposits, it is not

implausible to imagine the emergence of new products that bridge the gap between savers and users of funds.

As a contrarian investor, we look forward to the next phase of the pandemic

There is a lot to be optimistic about relating to the current pandemic-centric environment, including increased knowledge about the virus, the steady improvement of the fiscal landscape, and increased vaccine rollout.

However, uncertainty surrounding the policy response towards the improving global environment has led to the return of market volatility in significant and often confusing spells. Our theory is that the market will overprice the policy response towards the next phase of the pandemic, opening buying opportunities for the daring — and we will be there.

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