Macroeconomics Group Exercise

ELEN3018 – Economics of Design
School of Electrical Information Engineering
University of the Witwatersrand, Private Bag 3, 2050, Johannesburg, South Africa)

Blake Denham - 1714988, Jonathan Taylor - 1665909, Victoria Bench - 1611349

***Abstract*—This report presents the research, analysis and forecast for a R100 000 investment on the JSE with the purpose of maximising capital growth over the forthcoming year. The banking sector was considered the most promising option given the present economic conditions in South Africa and holds suitable investor confidence and anticipated gains. The share portfolio is comprised of 50% Standard Bank Group Limited and 50% Firstrand Limited shares.**

***Index Terms*—P/E ratio, EPS, SARB**

I. Introduction

IT is required that any engineering venture is designed in such a way that it is viable within the current economic environment. An understanding of the behavior of the economics is essential in any engineering role. This project has been assigned to encourage thinking with the realities of producing an actual engineering product in the real world and how macroeconomic concepts covered in lectures affect these realities. These realities include owning a business, gaining capital from investors and understanding indicators of growth and confidence. The chosen sector of the JSE was banking. These students hope to learn how to apply macroeconomics principles to justify the decision to invest in companies in this sector. This will require an investigation and analysis of the South African bank performance to date in order to predict the future performance of the company.

II. Full Description

This project is a theorized motivation for a R100 000 investment in a single sector of the JSE in order to maximize dividend yield over the next 12 months.

A. Sector Selection

A lot of uncertainty in the market was caused by the COVID-19 outbreak and the announcement of a 21-day lockdown in April. This resulted in a massive drop in the ALSI, as seen in Figure 1. In order to take advantage of the drop, the strategy to maximize return on investment was to identify a sector that had taken a considerable hit due to COVID-19 and has a good chance of recovering.

The finance sector, banking in particular, proved to be a strong candidate. The financial 15 FINI price dropping by almost 50% after lockdown was announced (as seen in Figure 2). Additionally, we know that largest South African banks have been stress tested and found to be sufficiently capitalized to withstand the negative effects of COVID-19 [1].

Along with Fitch and Moody's degradation of South African banks to junk status, stock prices dropped by to a low of R8.23 at the end of March (Figure 2). Considering Moody's evaluation was made in the midst of a global health and financial crisis just as a nationwide lockdown was announced, however, leads us to believe that the drop is an investment opportunity as there is big potential for growth in the years to come as lockdown restrictions are reduced. Additionally Fitch ratings agency says that despite the sharp reduction in the banking sector's profitability over the first five months of the year, it does not expect to make further downgrades to the credit ratings of the country's five largest banks [2], which shows optimism for growth and recovery.

The evaluated potential for growth is also based on a possible over-reaction of the market to COVID-19. The COVID-19 projections published in May for this time of the year have not been met. The projections expected 40 000 COVID-19 deaths by November and anywhere from 1.2 to 1.6-million symptomatic cases during peaks in July or August [3], while in reality only 14000 deaths and 630000 cases have been recorded to date as seen in as seen in **??** and **??** provided by Worldometer [4]. This over estimation of the effects of COVID-19 so far may have caused not only a market over compensation, but also over compensation in bank provisions.

With reduced interest rates, stable inflation and increased risk aversion, negative effects of reduced disposable income could be mitigated [1]. Loan repayments should generally become more affordable [1] and the Reserve Bank expects real GDP to grow by 6% by next year [5] shown in Figure 5, leaving banks with a strong growth potential.

B. Share Selection

The biggest risk in investing in banking shares at the moment is the likely accumulation of too much bad debt by lending to parties that are not able to pay back loans due to loss of income under lockdown conditions [6].

As a reaction to the COVID crisis, bank provisions increased to 26% from the corresponding reporting period in 2019 [6]. It is a requirement of the IFRS-9 accounting standard that banks to set provisional funds aside to account for anticipated future bad debts [7]. This takes away from company profits and in turn investor dividends are reduced or possibly mitigated. Although, considering the over-estimated effects of COVID-19, it is does potentially look worse than it is [7] and it is possible that a large portion of these provisions can be redirected back to profits once by this quarter next year.

It is therefor important to consider banks with less susceptible to bad debts. These are banks with less unsecured loans and a client base with higher income levels in addition to long histories of dividend payouts.

Of the top 5 banks in South Africa, FirstRand Bank and Standard Bank were selected. These are the top 2 banks trading at the moment in terms on earnings and market cap. These banks have less unsecured loans than their competitors and are know to be more prudent lenders. Additionally, with well establish reputations of dividend payout and sustained growth, these are Investment Grade banks trading at a highly discounted rates compared to historical valuations [8].

1. FirstRand Bank

FirstRand is a financial services group and one of the top South African retail, commercial and investment banks. First National Bank (FNB), Rand Merchant Bank (RMB), Ashburton Investments, and Wesbank are all prevalent brands that form part the FirstRand Group.

Established in 1998, FirstRand has a track record of consistent growth in high quality earnings, and superior and sustainable returns for shareholders, with a high yield and long and consistent history of paying dividends [9].

FirstRand is known as a highly prudent well-managed lender [6] and even though profits are expected to shrink in 2020, the bank stands sufficiently capitalized to withstand the bad debt pressures of COVID-19, seen in Figure 6.

Historically FirstRand bank has not been considered a good dividend stock option due to issuing a considerable number of new stocks in 2019 and paying out more than half of its profits [9]. According to simplywallst.com, companies that consistently issue new shares are often suboptimal from a dividend perspective. However, the price at which the stocks are trading at the moment and the probability of recovery lead us to believe that there is dividend yield growth potential worth investing in.

2. Standard Bank

Standard bank is a South African financial services provider and Africa's biggest asset-backed lender [10]. Out of the top 5 banks in South Africa, it has by far the largest exposure to other African countries whose economies were less affected by the Covid-19 lockdown than SA.

In a recent article, the bank was referred to by global bank equity specialist Paul Hollingworth as "innovative but circumspect" [6], which rings well in these unprecedented circumstances. This is corroborated by the fact that it is first African bank to shift its operations onto Amazon Web Services in 2019 as well as continues to invest heavily in IT, finding "new ways to enhance customer experiences, and power their entire enterprise operations more efficiently and effectively on the world's leading cloud" [11].

The historical dividend payout is considered slightly unstable, as they have been cut one or more times over the last decade, but is still within normal bounds [12]. However, the dividend growth potential is substantial with an expected growth in earnings per share in 2021 with even more promising forecasts for 2022 and beyond as shown in Figures 7 and 8.

III. Quarterly Description

Factors that can affect a bank's share price include general market sentiment, predictions about the future, and the demand for banking services [13]. Therefore we shall be looking mainly at the South African and world economy as a whole when analysing why our chosen stock has moved the way it has in the last 12 months.

A. Q3 2019 (Sept 2019 - Nov 2019)

In Q3 2019, SARB (South African Reserve Bank) cut its GDP growth forecasts for 2020 and 2021 to 1.5% (from 1.8%) and 1.8% (from 2.0%) respectively. Inflation remained stable, with CPI at 4.3% y/y in August, up from 4.0% in July [14]. In addition, potential further credit rating downgrades and the rising national budget deficit continued to decrease confidence in the local market. This is because of the financing requirements for Eskom and other State Owned Enterprises (SOEs) are increasing. Ratings agency Fitch downgraded its outlook for South Africa's sovereign rating from 'stable' to 'negative'.

SA equities were traded unevenly and traded lower during the quarter due to the concerns listed above. The FTSE/JSE ALSI returned -4.6% for the quarter. The financial sector delivered -6.8%. In addition, rand weakened 7.5% against the US Dollar, 4.0% against the Pound Sterling and 2.9% against the Euro.

In positive news, President Cyril Ramaphosa reappointed Lesetja Kganyago to a second five-year term as SARB governor, helping increase investor confidence in the central bank policy continuity and its expertise. The President also appointed an 18-member Economic Advisory Council (EAC) comprised of both local and international economic experts to help develop reform policies. The SARB's latest quarterly projection model pointed to no interest rate changes for banks through year-end.

This lead to the Fin 15's stock price increasing by 4.34, Standard Bank decreasing 12.54 [15] and Firstrand increasing 2.21 through Q3 [16]. (See Figure 9 and 10 in the Appendix).

B. Q4 2019 (Dec 2019 - Feb 2020)

At the start of Q4 2019, the IMF's Medium-Term Budget Policy Statement (MTBPS) lowered South Africa's growth projections and raised government's debt burden predictions from around 60% to 71% of GDP in 2022/23 – a very high level. This lead, in part, to both S&P and Moody's lowering their credit outlook on SA sovereign debt to 'negative' status. SARB lowered its growth predictions to 0.5% for 2019, 1.4% for 2020 and 1.7% for 2021. This reduction made sense as Q3 GDP growth was announced at -0.6% y/y, a lower than expected rate. This lead South Africa close to a technical recession in this quarter.

In positive news, The FTSE/JSE ALSI returned 4.6% for the quarter, the financial sector delivered 2.8%. Finally, the rand strengthened against all three major currencies in Q4. It increased 7.6% against the US dollar, 0.9% against the pound sterling and 4.9% against the euro [17].

However, as news about the Covid-19 outbreak started to spread, general fear in the markets lead to the Fin 15's stock price decreasing by 18.11, Standard Bank decreasing 14.11 [15] and Firstrand having no change through Q4 [16].

C. Q1 2020 (Mar 2020 - May 2020)

This quarter was one of the worst for South Africa since Q3 1998 as of the rapid spread of the Covid-19 virus around the globe. All categories of assets, even ”safe” government bonds, were affected by wholesale selling. South Africa performed even worse than most countries due to its already declining government finances and recessionary economic environment discussed in Q3 and Q4 2019. This was even worse by the Moody’s downgrade of South Africa’s sovereign credit rating to ”below investment-grade” status in late March.

The SA government’s announcement of some fiscal tax and spending measures to help individuals and small businesses keep going under the local shutdown is expected to vastly increase the government budget deficit. SARB revised its GDP growth forecast for SA to -0.2% in 2020 from 1.4%. The FTSE/JSE All Share Index returned -21.4% for Q1 2020. The financial sector returned -39.5%. The rand heavily decreased against all three major currencies amid the Covid-19 wholesale, decreasing 27.4% versus the US Dollar, 19.5% versus the Pound Sterling and 24.7% versus the Euro [18].

Finally, Fin 15’s stock price decreasing by 34.21, Standard Bank decreasing 48.61 [15] and Firstrand decreasing 20.67 through Q1 [15].

D. Q2 2020 (Jun 2020 - Aug 2020)

For Q2 2020, the South African economy worsened even though there has been a gradual re-opening of the economy since June. However, local equities improved more than those in many other countries. The South African GDP decreased by 2.0% q/q in Q1 2020 (better than the -3.8% q/q expected). The already bad recession-like conditions discussed pre-Covid-19, combined with the lockdown, led to a drastic decrease in investment, industrial production and consumer and business spending.

The SARB lowered its GDP growth prediction to -7.0% for the year, versus -6.1% in April, while predicting 3.8% growth in 2021 and 2.9% growth in 2022. Additionally, The April CPI came in at 3.0% y/y, its lowest level since 2005.

Furthermore, the government budget deficit is now expected at 15.7% of GDP in the current 2020-21 financial year, more than twice the previous estimate of 6.8%. The South African equity market experienced a much better quarter than Q1 2020, with the ALSI delivered a 23.2% return and the financial sector returned 12.9%. The rand increased moderately against all three major currencies , increasing 2.7% versus the US dollar, 3.0% versus the pound sterling and 0.4% versus the euro [19].

This lead to the Fin 15’s stock price decreasing by 1.66 [15], Standard Bank increasing by 6.24 and FirstRand decreasing by 4.83 in Q2 [16].

IV. Forecast

A. GDP forecast

According to Standard Bank’s Corona update of March 2020[20]. The GDP from 2019 to 2020 had dropped by 5%, This was the worst contraction on record and would frame a deeper recession than during the global financial crisis of 2008, however from 2020 to 2021, Standard Bank forecasts the GDP to increase by 4.6%. A more recent and revised forecast from Fitch expects the GDP to decline 6.7% in 2020, followed by a rebound of 3.9% in 2021[3]. Figure (11) from Statista[3], shows a contraction of 5.8% in 2020 followed by a 4% increase to the GDP in 2021.

From these three sources the average consensus is that the GDP will recover suitably in 2021, and ultimately increase the stock prices of Standard Bank and First Rand, because of the close relationship between GDP and banks profitability.

If the recovery does not happen as predicted. There will be a loss of profits amongst banks due to failure of debt repayment due to loss of income. However if the rebound does occur left over money from provisioning will likely be put back towards dividends.

B. Covid-19

Unfortunately, it is difficult to forecast how the pandemic will pan out over the next year, however by looking at the initial forecast for the pandemic we can get a rough sense of where it is heading.

It was initially forecast that by August 2020, there would be a peak of between 1.2 - 1.6 million symptomatic infections, with approximately 40,000 deaths, but the actual statistics now show approximately 600,000 infections with just over 15,000 deaths, What this shows was a massive over estimation on the severity of the pandemic, and suggests that the government will ease restrictions, especially for economic circumstances, in the near future.[22]

As restrictions are lifted and the economy becomes more stimulated. The growth of the GDP will be supported, as well as growing the stock prices.

C. Stock prices

By looking at the lowest prices of the stock market at the start of the economic lockdown, we can set the minimum price of the stock for a worst case scenario. Otherwise, it is reasonable to assume that the stock price will grow, ideally back to where it was before the drop caused by Covid-19, that is a full recovery. This would be one of the best case scenarios.

The stock prices for Standard Bank has gone down by 49% from 2019’s prices due to the pandemic. From the quarterly analysis we can see that the stocks have started growing again in the last 5 months, but they have not recovered completely to pre-lockdown conditions.[23]

The stock prices for First Rand have followed an almost identical trend to Standard Bank, as the stock prices decreased by 41%.

The projection for the stock price of Standard Bank shares shown in figure (14), are positive, with a maximum gain of 43% ranging to a maximum loss of 5%, on average the general consensus is for the price to increase 26%, which is a substantial gain[26]. This assumes an optimistic view of the future regarding the pandemic.[24]

Similarly, First Rand share prices are also expected to grow a substantial amount in the next year. Figure (13) shows a best case of 57.8% and average case of 30.7% and worst case of remaining the same price.

The P/E ratios of the Standard Bank and First Rand stocks are lower than average, at around 7.1, indicating under value as mentioned earlier. This means that the value of our stocks are likely to grow and consequently produce a greater return on investment.

D. Dividends

Historically, banks try to keep a stable dividend yield, as it is a good way to show investors that they are reliable. This means that as stock prices rise or drop, the dividend amount follow accordingly.

South African Banks in general are very conservative and reserve capital to pay out dividends, even when profits are low.

Standard bank claims that they will pay a full year dividends this year at a price of 418.7-586.2 cents.[26] What this can tell us is that as stock prices increase now, the dividends value for next year will likely increase, especially since it is probable that Standard Bank over provisioned in preparation for Covid-19.[28]

First Rand has paid dividends for August already, similarly to Standard bank they will also pay out dividends and as the stock price increases the dividend yield would decrease motivating the increase in dividends.[29]

E. Inflation

Inflation is currently at an all time low, subsequently interest rates are also at an all time low, causing lower profits from banks as profitability is directly linked to interest rates.[30]

Standard bank predicts that the CPI will be 4.5 in 2021, which compared to this year which was 3.7 indicates a lot more inflation[20]. Which as mentioned earlier will directly increase profits of the bank and subsequently the value of our investment.

F. The Global Financial Crisis of 2008

We can look into one of histories worst financial crisis to see how our selected stocks will fair within a year.

On the 2009Q1 Standard Bank's stock price reached the minimum value throughout the recession at a value of R62.50, which was 35.6% decline from the value 12 months prior to that (2008Q1). The next year Standard Banks price increased by 65.4% the following year.

Similarly, First Rand dropped by 36% and within a year almost recovered, as the stock price increased by 33%.

What this shows is that banks, as long as they do not go bankrupt or default debts, it is likely for them to recover and provide a huge return on investment

V. Summary

- The financial sector took a hard hit following the global outbreak of Covid-19 due to the high probability of bad debt accumulation as a result of income losses.
- Even before the pandemic hit, banks were found to be a little unstable, but showed sustained growth over the past decade, and proved to be sufficiently capitalised under stress tests.
- An over compensation to Covid-19 by the market and the recommended provision regulations is possible, leaving the top banks potentially undervalued in the midst of lockdown.
- FirstRand Bank and Standard Bank are safe investment options with good dividend growth and payout history, as well as sufficient capital and less unsecured loans than competitors.
- The quaterly analysis shows the hard hit the economy took due to covid-19, as well as the beginning of the recovery for stock prices.
- Expected GDP expansion due to increased consumer spending coming out of an economic shutdown is correlated with an increase in bank earnings.
- An optimistic approach yields high predicted return on investment, from both stock prices and dividends from the two shares.

VI. Conclusion

In conclusion, the effects of Covid-19 on the economy complicate the analysis on the historical trends of JSE stocks in order to predict future return.

Investment in the banking sector can be considered wise, as discounted stock prices can be taken advantage of with an almost certain growth from a historically low point.

There is a strong possibility that Q4 dividends will not be payed out for this financial year, however a strong recovery is expected.

In retrospect, with shares in FirstRand Bank and Standard Bank entering the beginning of recovery, it would perhaps have been wise to invest earlier (closer to April) when the stock prices were at an all time low with the strong probability of recovery to maximise dividend yield. Similarly, substantial growth is likely to happen over more than 12 months and this could require more patience as a long term investment.

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APPENDIX

Fig. 1. JSE All Share Index over the last year

Fig. 2. JSE Financial 15 (Fini 15) over the last year

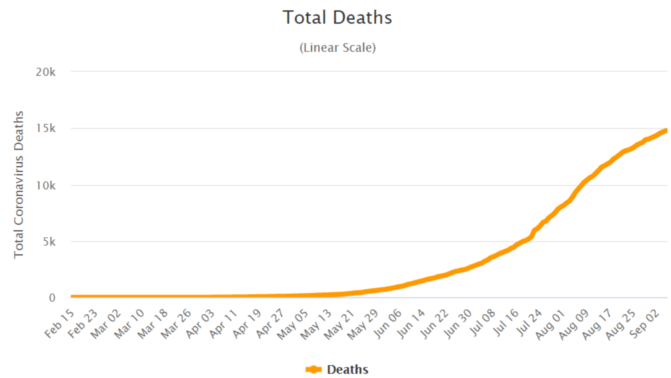

Fig. 3. Total Deaths Due To COVID-19 in South Africa. Source: Worldometer (accessed from: https://www.worldometers.info/coronavirus/country/south-africa/)

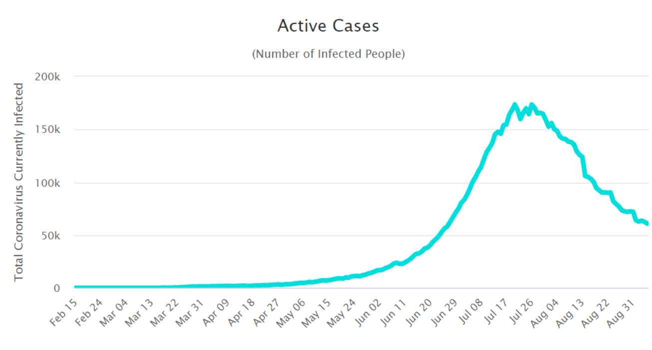

Fig. 4. Total Active COVID-19 Cases in South Africa. Source: Worldometer (accessed from: https://www.worldometers.info/coronavirus/country/south-africa/)

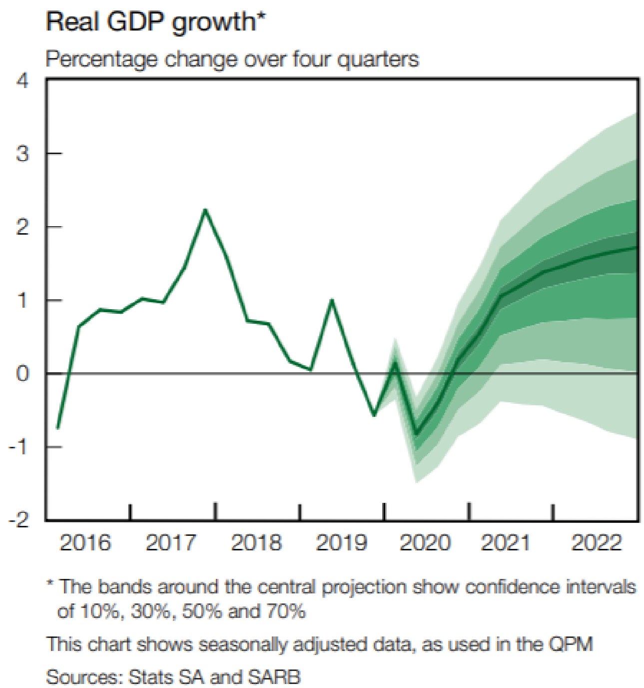

Fig. 5. South African Reserve Bank Real GDP forecast.

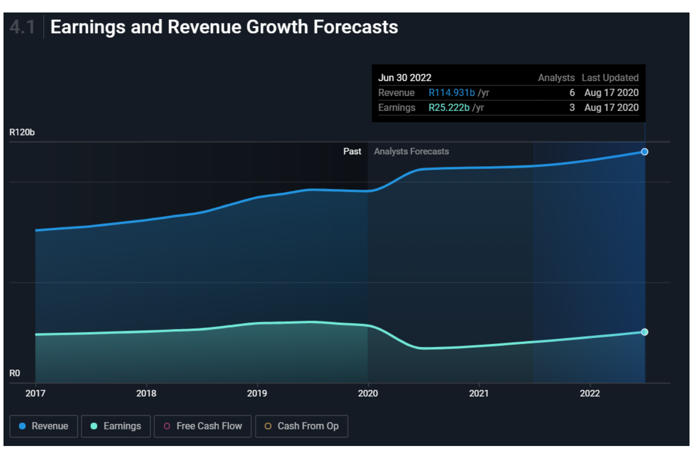

Fig. 6. FirstRand Revenue and Earnings Forecast. Source: Simply Wall St

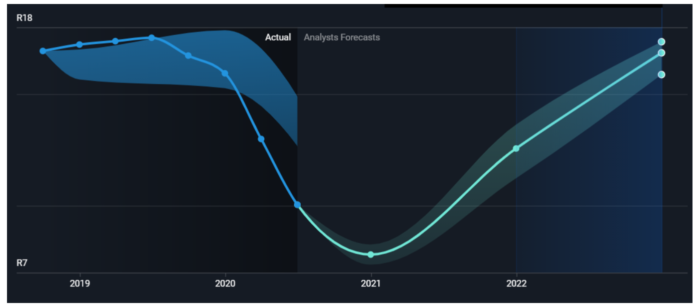

Fig. 7. Forecasted Earnings Per Share for Standard Bank. Source: Simplywallst.com

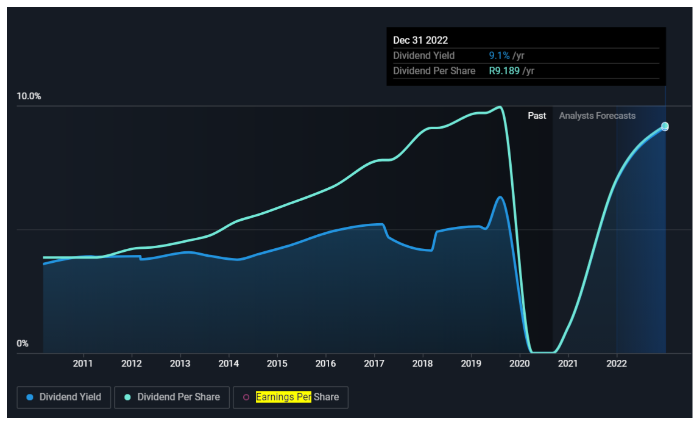

Fig. 8. Forecast Dividend Yield for Standard Bank. Source: Simplywallst.com

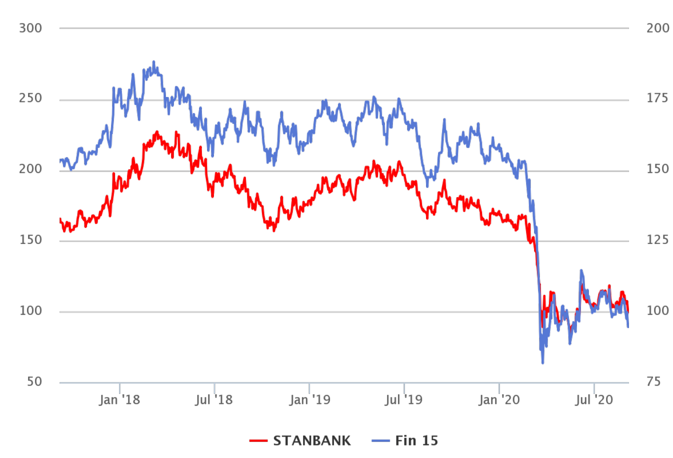

Fig. 9. 3 year graph of the Standard Bank Group Ltd. and Fin 15. Note their different y-axes on the left and right [3]

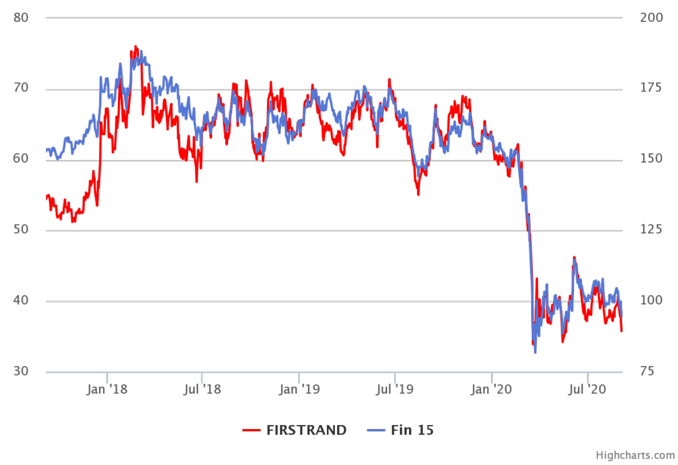

Fig. 10. 3 year graph of the FirstRand Ltd. and Fin 15. Note their different y-axes on the left and right [22]

Fig. 13. Predicted Stock price of First Rand Bank for the next 12 months [26]

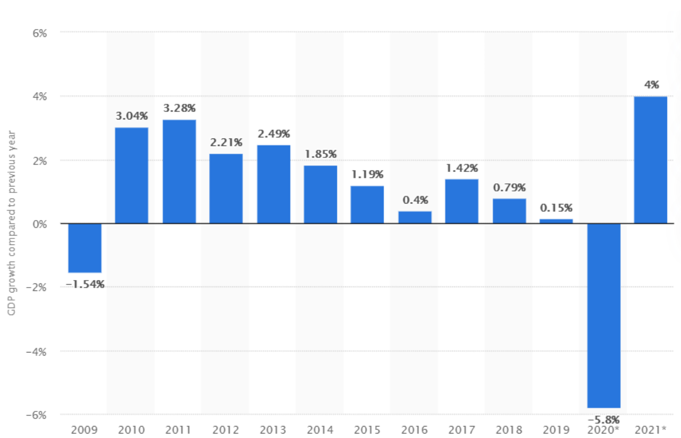

Fig. 11. Predicted GDP for 2020 and 2021 [3]

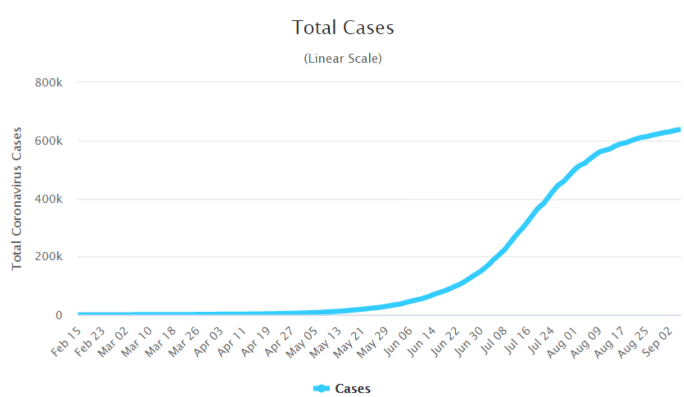

Fig. 14. Recorded infections of corona virus [27]

Fig. 12. Predicted Stock price of Standard Bank for the next 12 months [25]