Muhammed Seedat

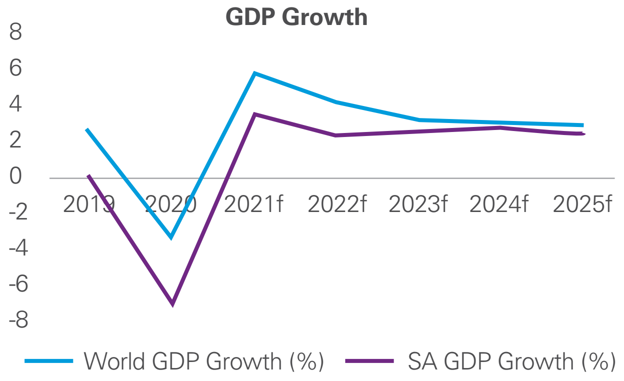
Senior Manager
Insurance
Tel: +27 82 576 3413
Email: muhammed.seedat@kpmg.co.za

Financial market update

The current market conditions are tricky to navigate and result from the economic and health crisis brought on by the COVID-19 pandemic. Asset prices, as a result of good news surrounding the vaccine rollouts, have reached new highs. The rise of retail traders (read "meme stocks"), non-fungible tokens and increased stock market buoyancy indicates a dislocation in financial markets.

This subsequent recovery leaves a threat for a possible market correction should investor confidence wane and favourable fiscal and monetary policies end.[1]

A sudden halt!



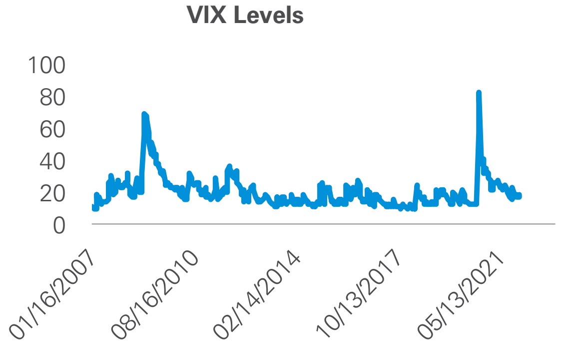
Source: Fitch Solutions

In March 2020, life as we knew it (before COVID-19) came to a sudden halt. In an attempt to stop the spread of the virus, lockdowns were introduced, which brought about an unprecedented drop in economic activity. This slump in economic activity resulting from the lockdowns is displayed by the significant contraction in the GDP figures for 2020, both locally and globally.

Over the following few graphs, we will go through the response to this sudden halt, the responsive measures put in place, and the trajectory of the above chart indicates the success of these measures.

The uptick was driven by a recovery in private consumption and external factors favourable to the South African economy, such as rising commodity prices.

Volatility follows panic!



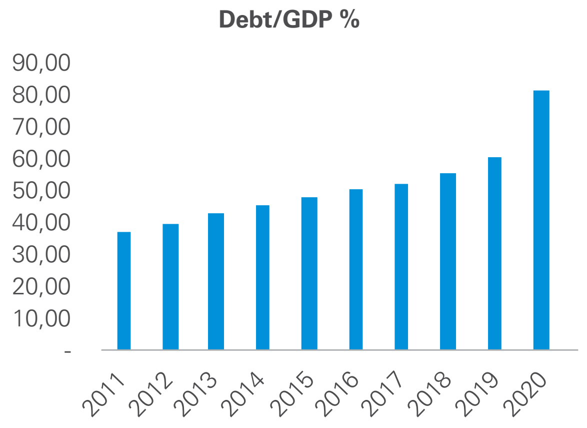
Source: Cboe

The sudden halt led to a drop in equity markets across the board, a surge in credit spreads, and an overall increase in volatility. The effect is depicted by the spikes in volatility as indicated by the Chicago Board Options Exchange's (CBOE) Volatility Index (VIX) above, which has reached levels not seen since the Global Financial Crisis of 2008. The VIX, which is constructed using price data from traded options on the S&P 500 Index and is commonly known as the "Fear Gauge," is used by investors to gauge overall systemic risk.[2]

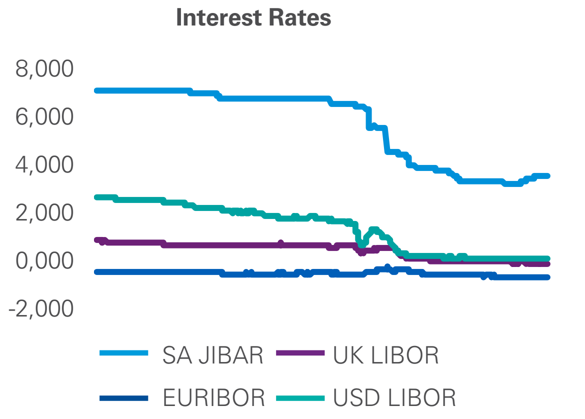
1 Financial Perils in Check for Now, Eyes Turn to Risk of Market Correction – IMF Blog

2 The South African Insurance Industry Survey 2020. https://assets.kpmg/content/dam/kpmg/za/pdf/pdf2020/financial-markets-update-and-considerations-for-insurers.pdf

Quell the fears!



Source: Fitch Solutions

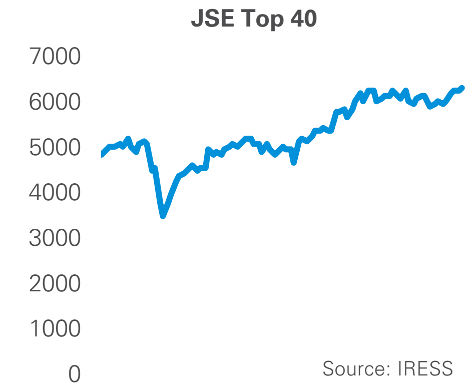


Source: Refinitiv Eikon

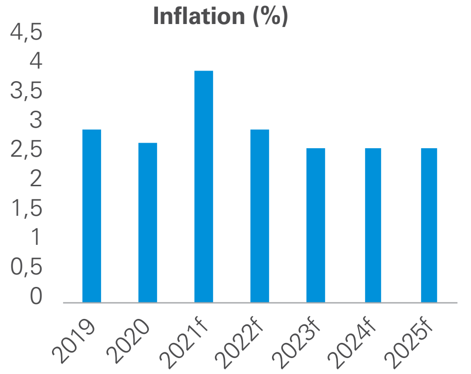
In response to this 1-in-200 year event, central banks and governments have provided unprecedented monetary and fiscal stimulus to the economy. Central banks have lowered interest rates across the board and embarked on asset-buying schemes, and governments have implemented stimulus programmes. For example, in South Africa, our response included tax measures to alleviate cash flow burdens on tax compliant small to medium-sized businesses arising from the COVID-19 pandemic and lockdown and debt-relief schemes.

The various stimuli provided led to an expansion in sovereign debt and an expansion in central bank's balance sheets. In the current low-interest-rate environment, the servicing costs of this debt are relatively low. However, there will be a concern when rates start to rise, increasing the servicing cost of this debt on the national budget. Most of South Africa's debt is denominated in ZAR with a maturity of over ten years, which mitigates the increased debt levels. However, the continued indebtedness of our state-owned enterprises, whose debt is guaranteed by the South African government, will weigh heavily on investor confidence for foreign direct investment.

The recovery!



Source: IRESS



Source: Fitch Solutions

We have seen a recovery in equity markets buoyed by the fiscal and monetary stimulus, combined with the gradual reopening of the economy post lockdown. However, uncertainty around new variants of the virus and subsequent lockdowns have left volatility in financial markets at an elevated level.

There has been a spike in inflation figures, which is currently believed to be transitionary due to the unusual dynamics brought about by the pandemic. As a result, central banks will need to balance the relevant transitionary inflation pressures and their outlook on rates.[3]

The impact on insurers

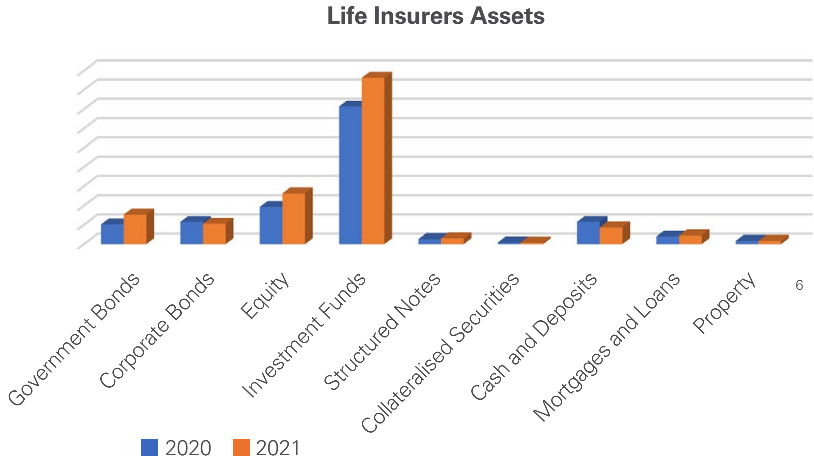
The volatility displayed across all asset classes, combined with increased morbidity and mortality rates and business interruption claims, low-interest rates and a liquidity crunch due to the pandemic, pose and continue to pose risks for insurers.[4]

Industry results have shown that insurers' asset portfolios demonstrated resilience, could withstand peak COVID-19 market stresses and did not significantly impact capital and solvency requirements. The split in insurers asset portfolios has also remained relatively consistent year-on-year, with the uptick in equity markets showing the real difference.

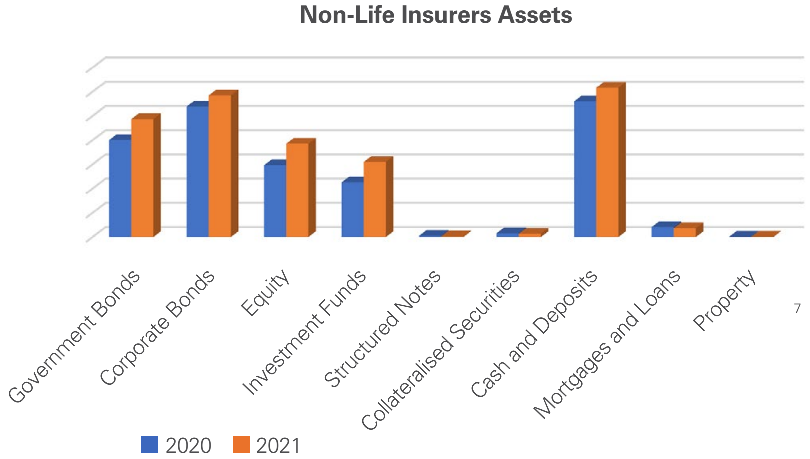
[3] https://www.imf.org/en/Publications/WEO/Issues/2021/07/27/world-economic-outlook-update-july-2021

[4] Impact of COVID-19 on Insurers (imf.org)

In general, we have seen that insurers have avoided knee-jerk reactions to market movements.[5]



[6]



[7]

[5] https://home.kpmg/xx/en/home/insights/2020/04/covid-19-solvency-capital-and-the-insurance-sector.html

[6] Selected South African insurance sector March 2021.pdf (resbank.co.za)

[7] Selected South African insurance sector March 2021.pdf (resbank.co.za)

[8] https://home.kpmg/xx/en/home/insights/2021/07/a-tale-of-two-recoveries.html

[9] https://home.kpmg/xx/en/home/insights/2020/04/covid-19-insights-emerging-risks.html

Outlook

There is still uncertainty, and while most insurers are well capitalised and have shown resilience in their balance sheets, closer monitoring of low-interest rates, equity markets, and credit are required.

The extraordinary measures put in place by central banks constrain future policy space to manoeuvre future crises.

Rising geopolitical tensions and stressed US-Sino diplomatic relations would also weigh heavily on the economic recovery and add to elevated market volatility.

Slow vaccine rollouts and the threat of new variants will continue to play a role in the economic trajectory over the coming years. In South Africa, rising unemployment and inequality has been exacerbated by the pandemic, and the threat of further social unrest remains.

It's clear that not all recoveries are created equal. KPMG in the US believes a K-shaped economic recovery is forming. Different parts of the economy are recovering from the pandemic at different rates and magnitudes. There are signs of this across many economies — with a dislocation between various industries, geographies and households.[8]

Factors that will continue to weigh heavy on the South African economic recovery include:

- Power supply - the continued impact of load-shedding and the generation capacity of Eskom, the increased pressure globally to move to clean energy, and the significant debt carried by Eskom are cause for concern.
- Economic reforms - over the past few months, we have seen a wide range of economic reforms tabled. The ability to execute these reforms will play a significant role in the economic recovery of South Africa.
- Monetary policy and the volatile Rand - with current inflationary pressures, any tightening in monetary policy to respond to these pressures may hinder economic recovery. Adding to that, the Rand continues to be a volatile emerging market currency.
- Climate change - we have seen increased indicators of this in South Africa indicated by the water crises (think "Day Zero") in the Western Cape, droughts in the Northern Cape and increased climate variability.
- Cyberattacks - the recent cyberattack against Transnet, which has led to a force-majeure event, indicates our national infrastructure's vulnerability.

The COVID-19 pandemic is a global stress event testing all businesses' financial, operational and commercial resilience. Against this backdrop, the financial services sector has to adapt rapidly to current constraints and market conditions.[9]

Due to the fluidity of financial markets, the information used in the above article was accurate at writing. Therefore, movements between the date of the report and the date of publishing are expected.